



NFTs AS A FINANCIAL ASSET

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Abstract:

In this project we will focus on finding out what NFTs are and how they originated. We will look at the types that exist, the market evolution in recent years, the investment possibilities they offer and the characteristics that make them valuable to know which NFTs will be most in demand. Finally, we will describe how these assets should be accounted for and their tax implications.

Keywords:

NFT, Blockchain, value

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1. INTRODUCTION

The project will focus on analysing the market of NFTs, which have become one of the most popular assets for new investors and new generations in 2021. This has also been motivated by the evolution of the world of cryptocurrencies and the new opportunities offered by the continuous technological evolutions in the digital world.

We will start with a contextualization of what it is a non-fungible token (NFT henceforth), how it emerged, what it is used for, in which markets it operates and how it differs from cryptocurrencies. In addition, we will study its evolution over the last two and a half years, with an emphasis on which types of NFTs have been most popular these years.

One of the most important points of the project will be to know which NFTs have a real value for the investor and why this is the case in order to know what an investor must look for when investing in this type of digital asset. To be able to analyse this point in a greater detail, we will analyse 3 of the most popular NFT collections to find out what characteristics make these assets special.

In addition, it should be noted that being such a new market (asset) will raise questions as to how it should be accounted for and taxed, so we will analyse how this should be done.

Finally, before drawing conclusions about NFTs, we will look at new applications of NFTs in markets with high potential such as the rental of NFTs that will play an important role in the gaming world and in the metaverse.

The objective of the work will be to understand the NFT market and to be able to identify those aspects that an investor must consider when investing in NFTs, both in the own characteristics of NFTs as in the threats and issues that may occur when investing in NFTs.

Having analysed all the points explained above, as a conclusion we will give an opinion on whether it is potentially a good asset to invest in, and what characteristics are important to determinate the value of an NFT. Or if it is a dead-end market that has grown because of the fad of digital assets and cryptocurrencies.

2. NON-FUNGIBLE TOKENS (NFTs)

2.1. Origin of NFTs

The idea of NFT was born from the so-called "colored coins", which were tokens that were issued on the Bitcoin Blockchain in 2012-2013. (*B. Wong, 2021*). These tokens functioned in such a way that they represented real-world assets within the Blockchain and one of their most basic functions is that with them you could demonstrate ownership of a given asset. In those years, the technology was not sufficiently developed, but it served to create the necessary foundations for future applications and uses.

Although some successful NFTs had previously emerged, the first major NFT project was launched in June 2017 on the Ethereum network developed by Canadians John Watkinson and Matt Hall, from a studio called Larva Labs called CryptoPunks; (*B. Wong, 2021*). At the time of their launch, CryptoPunks costed between \$1 and \$34 per unit. However, today they can fetch millions of dollars. Initially, 10,000 unique avatar units were created, 9,000 of them were offered for sale and the other 1,000 units remained with their owners. Their appearance is inspired by the cypherpunk movement, and basically, they are unique 24x24 pixel, 8-bit avatars in NFT form (*K. Rees, 2017*). At their initial time, they could be claimed by anyone with an Ethereum wallet. For example, CryptoPunk #5822 was sold in 2022 for 8,000 ETH (\$23.7 million, at its time of valuation), revaluing by 1,410,000% in these last 5 years. Looking into the past, this same NFT, in June 2017 was sold for only 8 ETH (\$1,600, at its time of valuation) (*Villullas, 2022*).

Another important moment for the NFT industry was the sale in 2021 for \$69 million of a PDF artwork called "The first 5000 days" by the American digital artist Mike Winkelmann (*Litvinoff, 2021*). This work was a collage of 5,000 images that was created by the artist since 2007, and it took him 13 and a half years to finish his work. Mike Winkelmann himself placed great value on recent technological advances in the NFT world because, although the technology to collect and own digital works as they are understood today did not exist, there were already artists creating digital works for years (*Quiz, 2021*). As quoted by Mike Winkelmann: "*Artists have been using hardware and software to create artwork and distribute it on the internet for the past 20 years, but there was never a real way to own and collect it. With NFTs that's changed*" (*Litvinoff, 2021*).

2.2. What is an NFT?

To know exactly what an NFT is, it is first necessary to know the meaning of the word "fungibility". This word refers to units that can be replaced by identical elements. In other words, these assets would be interchangeable and indistinguishable from one another. For example, a ten-euro bill can be exchanged for a different ten-euro bill, so that bill is not unique, while an NFT is not equivalent to another in the same way.

A non-fungible token (NFT) is a type of cryptographic token that represents a unique, unrepeatably, and limited quantity asset (*Leal, 2022*), for which its exclusivity is tracked and ensured through the Blockchain network.

In short, the Blockchain is like a large database where its records are decentralized so that the network is not controlled or monitored by an authority. Therefore, these networks cannot be manipulated since the information passes through different nodes (or computers) distributed around the world. The Blockchain allows to transfer or share information securely through a blockchain where all activity is intertwined and recorded (*Sáez Hurtado, 2022*).

An NFT can represent various uses such as:

- **Digital Art:** This is the most common form and where we find collectibles, music, GIFs, videos....
- **Video games:** Many NFTs that are marketed are designs of appearances of certain video games, called "skins". This arises because many players like their characters to look exclusive.
- **Investments:** They can also be used as investments if the investor believes that an asset can be revalued over time.
- **Real estate sector:** The NFT allows to know the history of a property, to know who its owner is, the price at which it was sold in the past, debts, seizure orders...

2.3. Difference between cryptocurrencies and NFT

Cryptocurrencies and NFTs are the digital assets per excellence, and we usually tend to believe that they are the same thing, but, although they share certain similarities, their main characteristic is completely opposite. (*Analytics insight, 2022*)

First, we define cryptocurrency as a digital currency that uses cryptography to provide a secure payment system. These encryption techniques serve to regulate the generation

of monetary units and to verify the transfer of funds. They do not require a central bank or other type of institution to control them (*Barceló Ferre, 2017*).

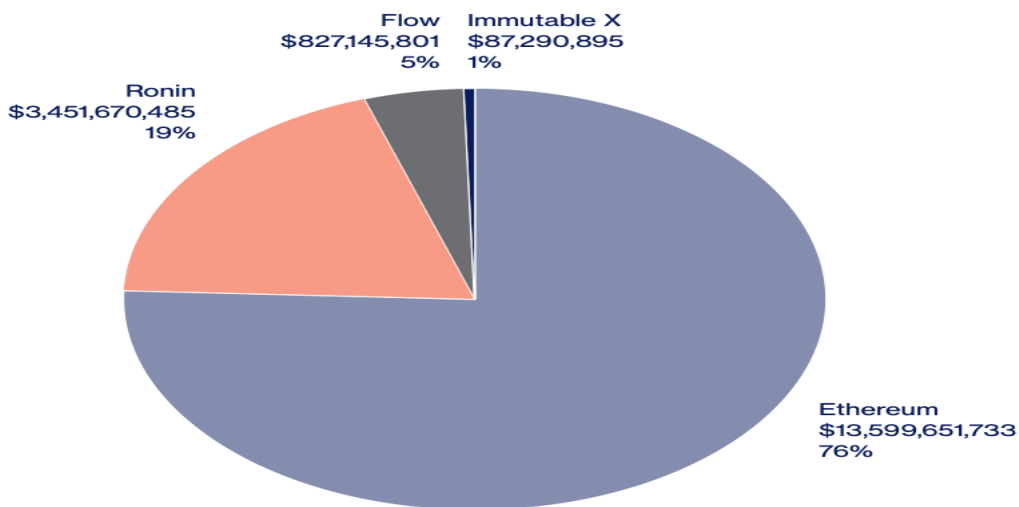
Most cryptocurrencies are decentralized networks based on the Blockchain network just like NFTs. A main characteristic of cryptocurrencies is that they are generally not issued by any central authority, which makes them immune to interference or manipulation by a government, which, it might happen with currencies like the dollar, euro, etc. Some examples of cryptocurrencies are Bitcoin, Cardano, Dogecoin, etc.

As we have said before, both cryptocurrencies and NFTs are based on the Blockchain, using similar innovation and standards, so they tend to bring similar investors. But their main difference is that a cryptocurrency is a currency that like any other has an economic value and is fungible, which means that within a given cryptocurrency it does not matter what currency you have because if you have a Bitcoin, it will have the same value as someone else's Bitcoin, while NFTs are not fungible and have a value that goes far beyond the economy. (*Analytics insight, 2022*)

2.4. Main NFT Blockchains

We find a variety of possible Blockchain NFTs which allow us to trade with NFTs. In the year 2021, we highlight Ethereum, Ronin, Flow Y and Immutable X over others.

Graphic 1: Breakdown of the volume of dollars traded between 4 of the main NFT blockchains (2021)



Source: nonfungible.com

In graphic 1 we can see a representation of the volume in dollars that has been traded in each market in 2021. Ethereum is significantly the market with the highest volume of transactions with 76% of the market. The NFT markets that stand out within this Blockchain are Opensea, which is the largest and most used of all, and sells NFTs worth approximately \$2.6 billion per month. To a lesser extent we find Superare with a monthly sales volume of approximately \$19.1 million and Rarible with a monthly sales volume of \$15 million. (Maldonado, 2021).

As we can see in the graph, Ethereum is followed to a lesser extent by Ronin with 19%, which stands out for being the blockchain of Axie Infinity, which is currently the most popular NFT game (Jansana, 2022).

Far from these last two follows Flow with 5%, where NBA Top Shot stands out, which is an NBA video cryptocurrency platform or Viv3, which is the first general NFT marketplace built on Flow, which serves as a platform to create, trade and own NFTs (Maldonado, 2021). Finally, we find Immutable X with 1%, far away from the rest. Immutable X could be defined as an open-source protocol that allows anyone to develop their own decentralized marketplace, which leverages the security of the Ethereum Blockchain, rather than competing with it, also aiming to address the growing problem of energy cost and carbon footprint that creates the production of NFTs on the Ethereum network. (Lista Mateos, 2022).

These data make us understand that Ethereum absorbs almost the entire NFT market and only Ronin, thanks to some of the successful collections that we can find in it, can currently make some competition. Also, smaller marketplaces can specialize in certain types of NFT or in a particular service as for example Immutable X to differentiate themselves from the rest and to bring something different compared to the other Blockchain.

2.5. NFT market evolution 2019-2022 (Q1)

2.5.1. 2019-2021

We will now analyse the evolution of the NFT market in recent years according to data from the nonfungible.com website:

Table 1: Evolution of the NFT market 2019 - 2021

2019	2020	2021
------	------	------

Volume of dollars traded	\$24,532,783	\$82,492,916 +236%	\$17,694,851,721 +21.350%
Volume of sales	1,619,516	1,415,638 -13%	27,414,477 +1.836%
Buyers	44,324	75,144 +70%	2,301,544 +2.962%
Sellers	25,036	31,774 +27%	1,197,796 +3,669%
Total active wallets	55,330	89,061 +61%	2,574,302 +1.822%
Total profit (when reselling)	\$2,890,230	\$12,074,654 +317.77%	\$5,407,158,315 +44.681%
Total loses (when reselling)	\$1,372,663	\$1,990,198 +44.99%	\$667,191,955 +33.423%
Average number of transactions	2.0	1.9 -5%	1.8 -5.26%
Average length of ownership	84	156 +85.71%	48 -69.23%
Market capitalisation	\$123,999,573	\$372,203,300 +200%	\$16,898,362,987 +4.440%
Number of active Smart Contracts	988	2,001 +103%	10,017 +401%
Average price	\$15.17	\$49.18 +224%	\$807.52 +1.542%

Source: nonfungible.com

The NFT market has grown greatly in recent years, but it is mainly in the year 2021 that it has seen its greatest peak and has become very popular as a potential investment asset.

In the table we can see incredible increases year after year until 2021 both in volume of dollars exchanged (increasing by 21,350% over the previous year) and in all the other variables displayed in the table. However, it would be a mistake to take these data for certain as a forecast on how this market will evolve in the future, as the NFT market is practically new, and it is in 2021 where the greatest boom took place. This raises several

questions for investors, who are wondering whether this market will really continue to grow in the future or whether a bubble could be developing.

The strong growth of the market in 2021 has produced a large increase in the price of most of the NFTs, which raises many doubts on the part of investors when it comes to trusting this market. In addition, due to this disproportionate growth, many new collections of low quality NFTs have appeared on the market due to the intention of many NFT artists to take advantage of the current situation, which may also raise doubts for investors (*Non-fungible, 2022*).

One of the data that can help us understand the growth of this market is the increase in both buyers and sellers. This data shows the strong interest in this new asset on the part of investors.

2.5.2. 2021(Q4) – 2022 (Q1)

For a better understanding of how the NFT market will evolve in the coming years, it is best to make a comparison between the last months of 2021 and the first months of 2022.

Table 2: Evolution of the NFT market 2021 (Q4) – 2022 (Q1)

	Q4 2021	Q1 2022
Volume of USD traded (Total)	\$14,531,875,047	\$16,456,945,150 +13.25%
Volume of USD traded	\$8,251,323,929	\$7,872,024,436 -4.60%
Number of sales	14,040,708	7,447,473 -46.96%
Buyers	1,696,613	1,172,235 -30.91%
Sellers	967,027	816,027 -15.61%
Active Wallets	1,948,934	1,455,107 -25.34%
Total profit (during resell)	\$3,443,080,881	\$3,326,763,612 -3.38%
Total loss (during resell)	\$826,914,555	1,235,723,313

		+49.44%
Average ownership duration (days)	25.6	39.6 +54.69%
Active Smart Contracts	1,271	1,404 +10.46%
Average price	\$587	1,057 +80.07%

Source: nonfungible.com

The first months of 2022 reflect a certain decline in the NFT market compared to the end of 2021, mainly in the number of sales, which fell by 46.96%, and in the number of buyers, which decreased by 30.91%. These variables mainly show that interest in NFTs has decreased to a certain extent, although it should be noted that after the disproportionate growth in 2021, it is normal that the numbers will decrease, and the market will tend to stabilise in the coming years. Another issue worth noting in the table is the decrease in total (qualified) volume by 4.60% while total (unqualified) volume has increased by 13.25%. This may be due to "wash trading", which is basically understood as the simultaneous buying and selling of an asset by an investor. Another cause has to do with the fact that other cases involve NFTs such as DeFi (Decentralized Finance) and represent large volumes that are not being considered as NFT exchange strictly speaking. Another issue to highlight is that the average price of NFTs is still increasing to a large extent (+80.07%). This fact has a clearer explanation and it is because in 2021 the video game NFT assets were more popular and had a lower value. Another explanation is the high speculation that the market has due to its high growth (*non-fungible, 2022*).

3. TYPES OF NFT:

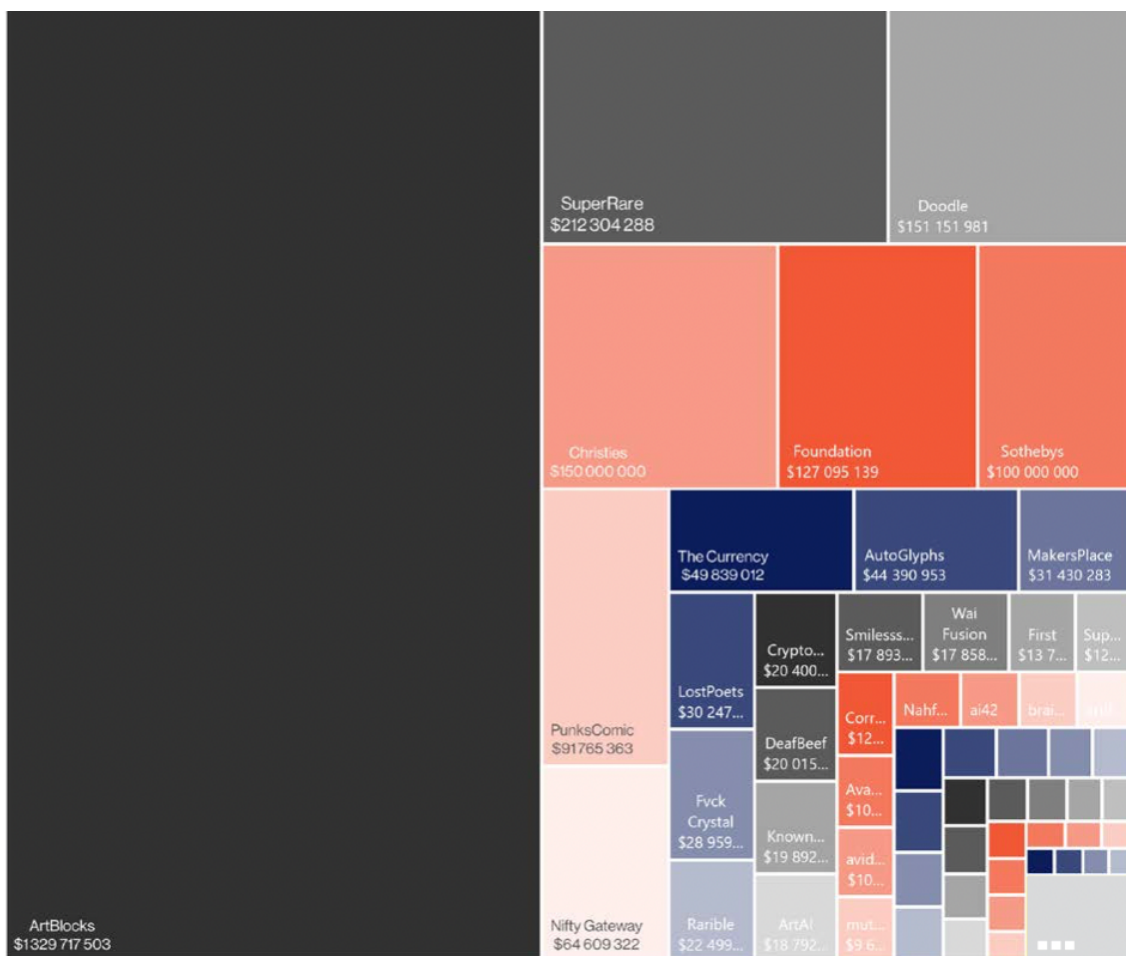
To understand which NFTs are most popular and which ones investors will need to focus on, it will be necessary to conduct an analysis of the most popular types of NFTs in 2021.

3.1. Crypto Art Market

We consider as crypto art any NFT asset and collection with an artistic function or that is recorded on the Blockchain as crypto art. Some collections such as CryptoPunks will be considered collectible and not art as such.

In 2021, according to an analysis by the website non-fungible, the cryptocurrency market had a total volume (USD) of \$2,798,220,643 and a number of sales of 774,307 units according to data from Ethereum, Christies, Sotheband Phillips. Among the three types of NFT distinctions we are going to make, it is the one with the worst data in terms of total volume and number of sales, representing around 16% of the NFT market. It is worth noting that 78.76% of crypto art NFT sales are profitable.

Graphic 2: Weekly evolution of the volume of profit and losses when buying/reselling NFTs



Source: nonfungible.com

As this graph indicates, within crypto-art, ArtBlocks dominate the market with more than a trillion dollars exchanged. ArtBlocks is a platform for the creation of NFTs in which collectors actively participate in the realisation of an artist's vision through the generation of unique algorithmic artworks (*ArtBlocks, 2021*). Far away from ArtBlocks we could highlight SuperRare, which is a platform or social network for creators and collectors of art where creators can create digital artworks and tokenise them (*Chong Tran, 2020*).

To put the crypto art market in perspective, the traditional art market in 2021 represented a total exchanged volume of \$14.6 billion compared to \$2.8 billion for crypto art (*Non-fungible, 2021*). It is worth noting that the technology that has enabled the emergence of crypto-art only emerged 5 years ago while the traditional art market has been around for many years in society and many investors and art enthusiasts have recently been motivated to explore the crypto-art market.

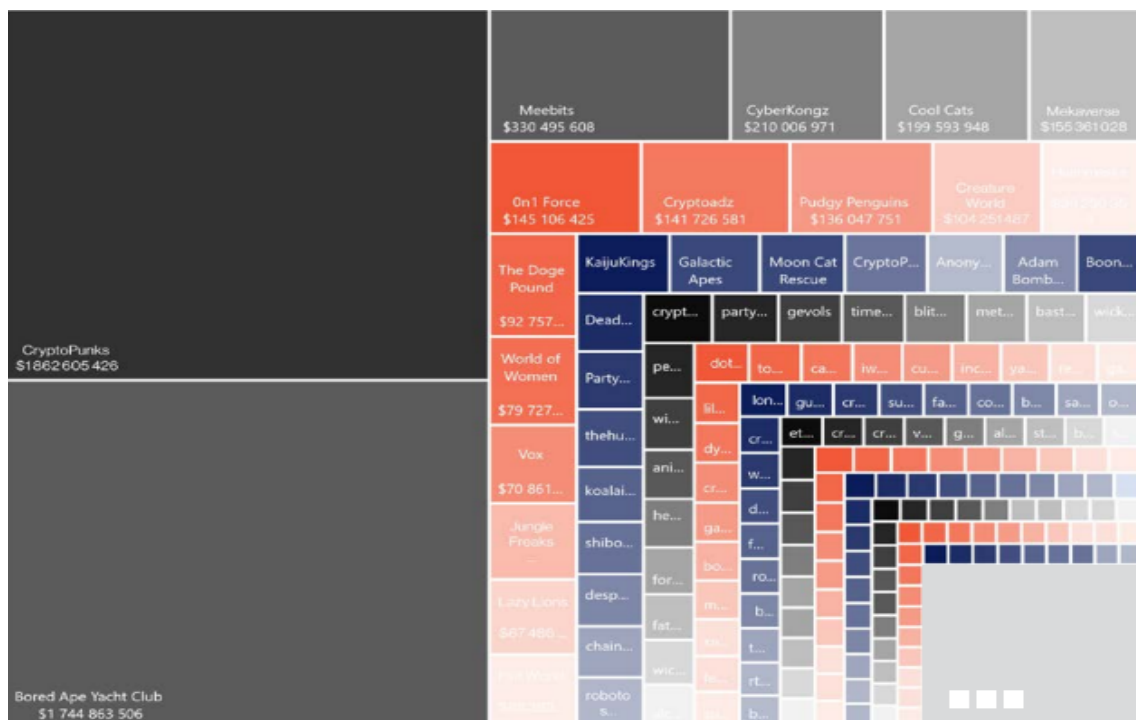
3.2. Collectibles

We consider a collectible to be an NFT asset whose primary function is to be purchased and displayed as part of a collection. CryptoPunks are a clear example of a collectible.

According to data from the website non-fungible, the market for NFT collectibles in 2021 has a total volume in USD of \$8,471,807,117 and a number of sales of 4,500,827 units according to data from Ethereum, Christie's, Sotheby's and Phillips. Compared to the crypto art market we can observe a considerably higher total volume, as well as a much higher number of sales, so we can conclude that the collectibles market is of great interest among investors and could be the most profitable at present.

In the following graph we can see which collections have had the highest sales volume in 2021.

Graphic 3: Weekly evolution of the volume of profit and losses when buying/reselling NFTs



Source: nonfungible.com

As can be seen in the graph, "Cryptopunks" and "Bored Ape Yacht Club" are the most popular collections in 2021 with a similar total volume, forming a total volume of approximately \$3.5 billion which would represent approximately 40% of the total volume of NFT collectibles in 2021. This reinforces the idea that in the NFT world, the key is to spot which collections are going to be the most successful, as a few collections are getting almost all the attention of buyers and many collections are barely worth anything.

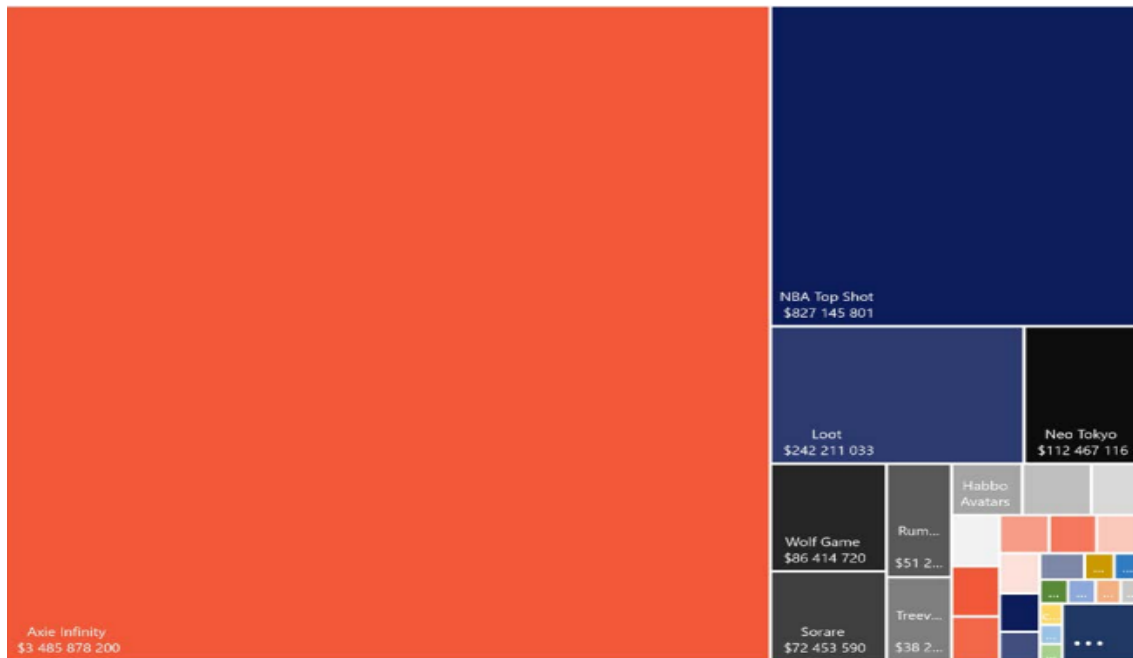
3.3. Gaming

Within "gaming" we can find a wide variety of types of games such as strategy games, card games, etc. We will define "Blockchain game" as any video game where its main assets are stored in the Blockchain or a network dependent on the Blockchain. This type of NFT market is one of the markets with the greatest potential to be discovered in the future and is the most intriguing for investors due to the infinite possibilities it can develop with technological advances (*Non-fungible, 2021*).

According to data from the website nonfungible.com, in 2021 the NFT gaming market had a total volume of \$5,177,192,804 billion and a number of sales of 20,986,532 units. Compared to the previous markets it is in total market volume between the art market and the collectibles market, but in the number of sales it exceeds both by a large extent. This indicates that, by having many more transactions, but less total volume, the assets are less valuable than, for example, collectibles or crypto-art assets. So, their market is not as similar to that of crypto art and collectibles as they are to each other.

In the following graph we can see which projects have had a higher volume in 2021.

Graphic 4: Breakdown of segment volume by project (USD)



Source: nongungible.com

Axie Infinity is the most popular project in 2021 approaching two-thirds of the total market.

Axie Infinity is an online gaming universe revolving around Pokemon-like creatures called Axie, which are represented by NFTs (Murphy, 2022). These creatures can be obtained to perform various functions within the game such as fighting, breeding, etc. One of the key reasons why the game has been so popular is that it rewards players for reaching certain levels. This is something very new nowadays thanks to the Blockchain because in the traditional gaming world you cannot get rewards that can be of monetary interest to their players and there were only in-game rewards. It is worth noting that Axies can be sold as NFTs in a real money market. For the size of this market in the NFT arena, Axie Infinity as of March 2022 generated \$4.17 billion in sales of NFTs.

3.4. Metaverse

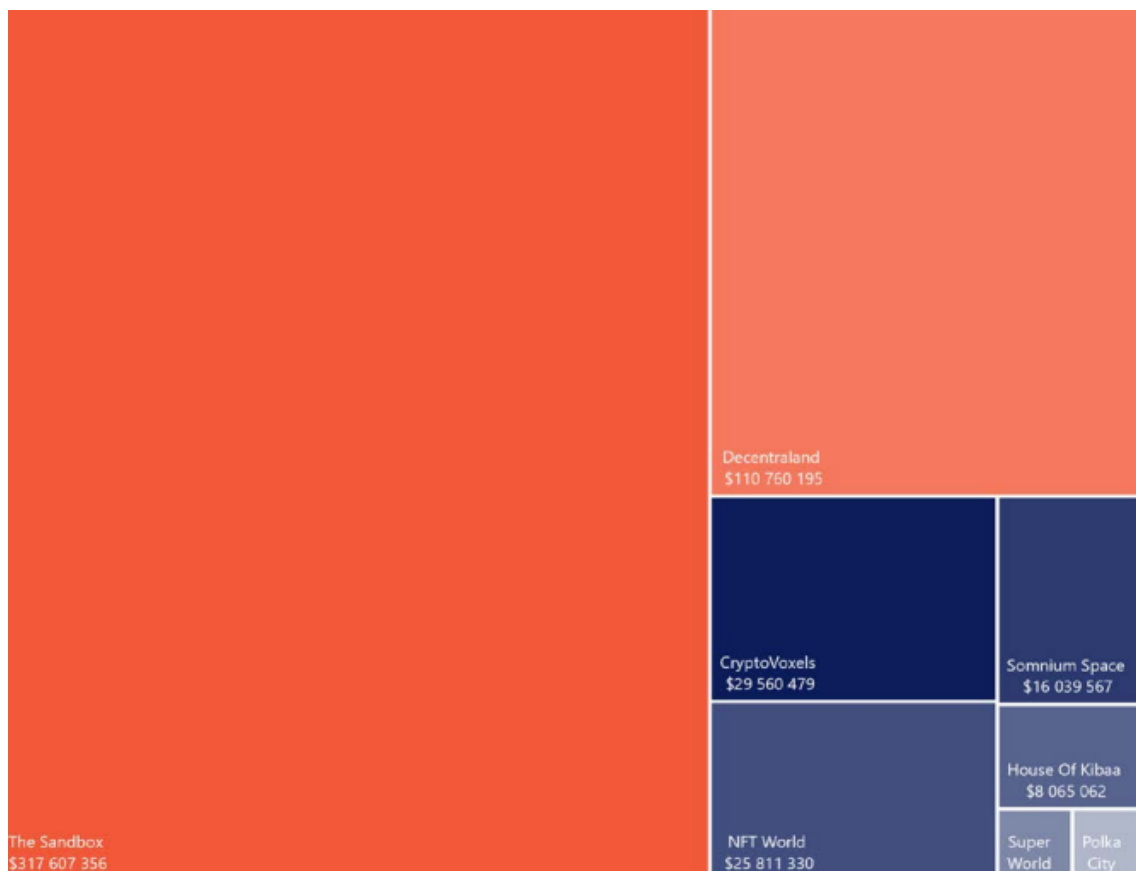
The metaverse is the market with the most technological scope for the future and the most intrigue for potential investors, due to Mark Zuckerberg's announcement that Facebook was going to start working on it.

To understand what the metaverse is, it could be defined as a network of interconnected virtual worlds that focuses on real-time interaction where people can work, interact with each other, carry out transactions or play games, among other functions (Talin, 2022). Within this we could foresee the emergence of a new economy where goods can be bought or sold and where NFTs and cryptocurrencies could be the currencies in this economy. (Maldonado, 2021).

According to data from the website nonfungible.com, the Metaverse market has had a total volume in USD of \$513,868,780 with a number of sales of 133,452 units. Compared to the previous markets, its numbers are much lower, but it is worth noting that it is a market whose value currently lies in its future potential together with the technological progress it will bring.

The following graph shows the most popular projects in 2021.

Graphic 5: Breakdown of segment volume by project (USD)



Source: nonfungible.com

SandBox is clearly the most popular project, which benefited greatly from Facebook's announcement of its goal to invest in the metaverse. Also noteworthy is Decentraland which, although it is somewhat distant from SandBOx, has a good share of the total market.

The SandBox can be defined as a metaverse or as a virtual open-world game. Its original intention was to take advantage of the rise of blockchain play-to-earn games and serve as a platform for their development. But noting that the metaverse has much more potential than that, there are also museums, buildings, parties... as is the case in Decentraland. The main reason why The SandBox is more popular than Decentraland is because of some of its software tools which give SandBox a competitive advantage (*non-Fungible, 2021*).

4. VALUATION OF NFT

The valuation of NFTs is a problematic issue for companies due to various reasons such as how much is the value of an NFT when it is on a company's balance sheet (or when an individual holds an NFT in his collection) or when an artist has created it and it is ready to be offered for sale. Currently, all these questions are difficult to answer.

This is because, as in the traditional art market, the value of NFTs is based on the perceptions of owners and buyers. None of the metrics that could be used to value private companies or traditional investment assets (such as equities) are available for NFTs. Furthermore, for an NFT, the amount the last buyer paid for the NFT gives you a rough indication of how much is worth, but the next buyer might pay a very different figure and it is the amount the next buyer will pay that will determine the value. (*Murphy, 2021*).

A key factor in initial valuation is the recognition that a more famous NFT artist may have over an unknown one. A collection by a more famous NFT artist might initially have a higher expected price than an unknown artist, but until it goes on sale you cannot tell.

Another factor affecting the price of NFTs that may go unnoticed is the value of cryptocurrencies, because cryptocurrencies can be used to buy NFTs. So, it is likely that the value of the asset may also be determined by the value of the cryptocurrency used at the time of the transaction, (*Massey, 2021*). Also, the cryptocurrency and the NFT market are volatile and legal frameworks are not fully established. Therefore, market fluctuations can affect the demand for NFTs, negatively affecting their value.

It is currently very difficult to know the value of an NFT. For a creator it could be based on the value he or she places on it or the cost of creating it but valuing an. The variety of uses that NFTs can have is also an aspect to consider as some allow their owners to do things, both in digital spaces and in the physical world. For example, they can function as membership cards or tickets, providing access to events, special discounts, even digital keys to online spaces where holders can interact with each other. This offers NFT holders value over and above simple ownership and provides their creators with a vector for building a community that is engaged around their brands (*Kaczynski and Duke Kominers, 2021*).

In addition, in many of these communities the property also transmits a series of partial or complete commercial rights, including a certain degree of governance in the way the community is managed. This allows the members of these communities to increase the value of the brand and therefore make the value of these NFTs higher. Without a strong community of users, NFT projects may quickly collapse because of a loss of interest, so it will be necessary to determine that the value proposition offered by the NFT project generates trust among its community. (*Kaczynski and Duke Kominers, 2021*)

A key aspect to consider when investing in NFTs is the cost involved in validating and processing transactions on the Blockchain. This is because users are responsible for paying for the computing power needed to carry out the transactions (*Kay, 2021*). This fee changes depending on the time of day and many users who invest in NFTs, even if they make a profit on the sale of an NFT, can make a loss due to the fees they have to pay for the power used to validate the transaction. One user, Martin, recounts his personal experience where he bought an NFT for \$30 on the Rarible NFT market and ended up losing over \$200, even though he sold the NFT for more than it cost him (*Kay, 2021*).

Another aspect to consider will be hacks, as digital assets are susceptible to being hacked. According to VICE, scams and thefts have reached up to \$14,000 in 2021 (*Kay, 2021*). These aspects will be taken into consideration when investing, although it is unlikely that an NFT will be stolen through hacking.

To invest in NFTs, we need to know what characteristics give value to a collection of NFTs and why some are more valuable than others. To do so, we will analyse three of the collections that have reached the highest volume in Ethereum historically, according to the NFTs website Drappapar.

These three collections are Meebits, Cryptopunks, and Bored Ape Yacht Club.

4.1. Meebits

This collection of NFTs was created by Larva Labs, the same company that launched cryptopunks, and in the first few hours 9,000 Meebits sold out for more than 22,500 ETH (approximately \$75 million at the time).

Meebits are 3D voxel characters that are produced by a bespoke algorithm. Their ownership is governed by the ERC-721 smart contract and they are interoperable with all Ethereum-based marketplaces (*Kaur, 2021*).

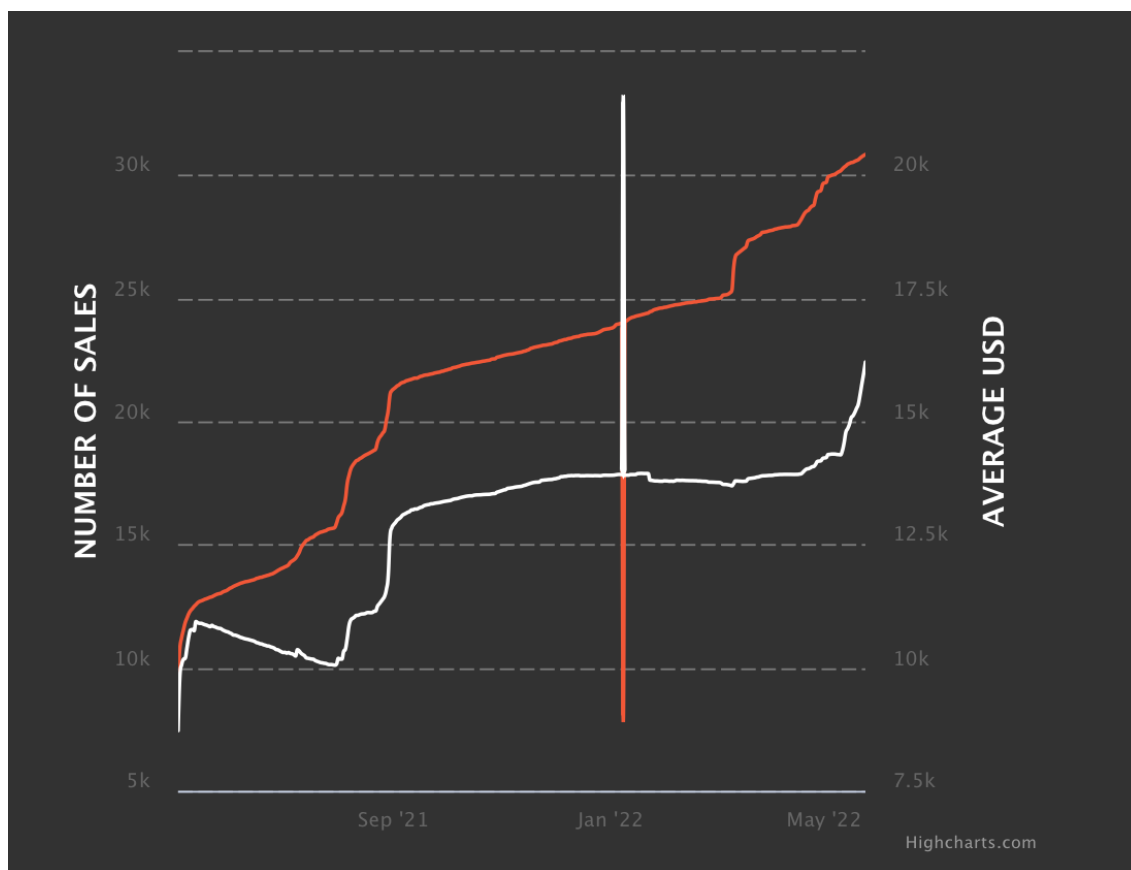
There are 20,000 3D Meebits and they are designed to appear as characters in popular games, including Minecraft and Roblox. They can be used in a wide variety of games and virtual worlds and they are ideal 3D avatars for the Metaverse. It is also worth noting that one of the reasons they have been popular is because they have been created by the same team that created CryptoPunks (*Kaur, 2021*).

Meebits have different uses than other collectible-type NFTs that are mainly used as collectibles. Some of their functions are as avatars for social networks or for the metaverse in the form of skins, they can be animated and 2D art can be made from a 3D Meebit.

For example, Meebit #17522 was sold in 2021 for 1,000 ETH (2.1 million dollars) (*James, 2021*). What makes this Meebit more attractive than the others is mainly its appearance, which is the quality that is most sought after in this type of NFTs. Since its main use is as an Avatar form, its appearance is different from the rest and in this case having a double pig face makes it stand out from the others that generally have a human form. Generally, Meebits with animal shapes have a higher price than those with human shapes and if you also include a certain rarity in these Meebits with animal shapes, which also makes them stand out from the other Meebits, we can argue that the Meebit has a higher value.

In the graph below we can see the sales growth of Meebits and the average price growth in dollars since its launch.

Graphic 5: Meebits number of sales and average price (USD)



Source: nonfungible.com

We can see that the number of sales has grown greatly since the start of the collection, followed by a growth in the sales price. At its launch, it had a strong peak of growth in price which was followed by a small relapse and it ended with a strong increase around the month of September in 2021 that exceeded the average price in dollars of 12.5k. Later, it came a period of stabilisation where the price fluctuated between 12.5k-15k, reaching the month of May 2022 an upward trend again.

Based on this analysis of Meebits, in future new collections of NFTs that have as functionality its use for avatars in virtual worlds of the Metaverse, we will have to pay attention to those that have characteristics that differentiate them from the rest. Also, greater value will be placed on NFTs that differentiate themselves and look for characteristics that provide greater rarity. In the Meebits we observed that those that have the shape of animals generally have a higher price than those that have human form. In addition, having some detail that brings more rarity as the Meebit #17522 that has two faces in one, we can argue that it provides higher value. Investing in NFT units with these characteristics can be profitable.

4.2. CryptoPunks

A CryptoPunk is a unique 24x24 pixel, 8-bit avatar that comes in the form of an NFT. Its creation originated as an experiment, conducted by Matt Hall and John Watkinson in 2017, where they wanted to create software capable of generating thousands of unique avatars. They eventually produced 10,000 avatars (Rees, 2021).

The avatars were inspired by the British punk scene of the 1970s, which reflected the rebellious and anti-establishment nature of the rise of the Blockchain. Although each avatar in the collection is unique, some are considered rarer than others. This depends on the unique line of code used to generate each avatar. More than 9,000 avatars are human women and men, but a few are in the form of aliens, zombies and even apes. As with the Meebits, these avatars with stranger shapes that set them apart from the rest are more valuable. Another feature that makes them more valuable is the number of accessories the avatar has, with the maximum being seven, so the more they have, the more expensive become. Also, because of the status they have achieved due to the fact that they were practically the first collection of NFTs to explode into popularity, simply being part of the collection already gives them a high value that is unlikely to drop except in the event that the NFTs lose their public appeal and their value diminishes.

To learn a little more about the characteristics that make one CryptoPunk worth more than another we look at the four most expensive CryptoPunks to date.

CryptoPunk 5217 - \$5.559 million, is the fourth most expensive CryptoPunk to date and is one of only 24 punk apes in the collection which all have a very high market value and has only two attributes. The attributes are a knitted cap, which only 419 Punks have, and a gold chain, which only 169 CryptoPunks have. According to the Rarity Tools website, which measures the rarity of NFTs (in this case CryptoPunks), it ranks in #34 in rarity within its collection (Dilks, 2022).

The third most expensive CyptoPunks is CryptoPunks 7804 - \$7.56 million. At the time of its sale, it broke the collection record and marked a consolidation of Blockchain technology and digital art collections. It is one of the nine CryptoPunk aliens in the collection and features three attributes. A forward-facing cap that is shared by only 254 other CryptoPunks, a feature of small shades of colour that only 378 punks in the collection have and finally a pipe coming out of his mouth that 378 other punks. According to its buyer Dylan Field, CEO of Figma, this Cryptopunks is like the smooth monkey in the digital world of NFT.

The second most expensive is CryptoPunk 3100 - 7.67 million dollars. Within the group of the most expensive punks, it is the simplest due to the fact that it is one of the 9 alien punks and has only one attribute which is a headband that 333 other punks also have. It was bought in March 2021 and its previous owner bought it for only \$2127 in 2017.

The most expensive CryptoPunk to date is Cryptopunks 7523 - \$11.75 million. It is like one of the 9 alien punks and has three attributes. He wears a knit cap, a trait he shares with 419 other punks, a medical mask he shares with 175 other punks and a gold earring, a trait he shares with 2459 other punks in the collection. The attribute that makes him special is the mask as he is the only one of the nine alien punks to have it and perhaps due to the pandemic and the common use of masks this feature (due to the current situation) makes collectors value this punk higher.

Looking at these CryptoPunks, we see that the value of these punks lies primarily in their history as it was the first collection of collectible NFT that was successful. To determine which ones have more value we have to differentiate them by groups separating between the human, zombie, monkey, and alien forms among others. The rarer they are and the fewer units they have, the higher value they reach. Once the groups have been identified, the more accessories and the rarer these accessories are, the higher value they will give to the NFT. Even sharing accessories with higher valued NFTs could be another feature that give a human form Punk a higher value than initially perceived.

Finally, it must be considered that there are many Punks that have not yet been sold by their first owners so that, at any moment, due to the rise of NFTs, they could be sold for millions of dollars, which could cause a chain effect that would bring greater value to other NFTs that share characteristics and are not currently so valuable (*Dilks, 2022*). So, even if we do not have the objective of buying a particular Punk, if we want to invest in it, it is necessary to analyse all the possible ones and value them according to certain criteria.

4.3. Bored Ape Yacht Club

The Bored Ape Yacht Club was created by four founders through their company called Yuga Labs, in 2021 and they were inspired by the CryptoPunks to create their collection. The collection consists of 10,000 NFTs in the shape of bored apes and has managed to become very popular among NFT collectors, even people who are not interested in this world know of its existence due to the hype they have had where even famous people, such as footballer Neymar, bought an NFT from the collection in this case for almost 1.1

million dollars. Many other celebrities such as Post Malone, Snoop Dogg, Eminem, and others have an NFT from the collection (*Fernades, 2022*).

As with Meebits and CryptoPunks we can know which NFTs from the collection are most valuable as the key factor is their rarity. For example, only 5% of the dull apes have red skin and 3% have the biker waistcoat. The main characteristics on which their rarity is measured are their background (gold being the most valued), their fur (gold and psychedelic being the most valued), their hat (psychedelic hat and crown being some of the most valued), their mouth, earrings, expression, eyes, clothes, etc; (*Granados, 2021*).

In addition, it is worth noting that they have incentives that are not shared by other popular NFT collections. Bored Ape are the cornerstone of an elite movement called the Bored Ape Yacht Club, where if you obtain an NFT from the collection it serves as a membership card to the Yacht Club that grants certain benefits to its members.

To understand what factors make this collection so expensive, it should be noted that this NFT is not only valuable as digital art but also because of the commercial usage rights that come with it. Once you acquire one you can not only resell it for profit, but you can also sell derivative products based on your NFT art. For example, the owner of the cheapest boring ape in the collection at the time created a Twitter account for his ape creating a story behind. In 2021 he signed with an agency to explore the possibility of publishing books, podcasts, films, etc. Many brands are exploring this opportunity offered by this NFT. Adidas, for example, bought one with the intention of developing a character and story for their bored ape (*Erinfolami, 2022*).

It is also important to note that, for owning a Bored Ape, each holder was allowed to purchase an NFT canine for only the price of the transaction processing fee on the Blockchain. Thus, the Bored Ape Kennel Club was born and used \$1 million raised to help animal shelters. These NFT canines became worth around \$17,000. These benefits of owning a Bored Ape should be considered as they offer you the chance to get new high-value NFTs for very little money. Another example is that, in August 2021, they released 10,000 mutant apes to the public which sold out in an hour and the owners of a dull ape were given the possibility to mint new mutant apes from the existing apes they had, which they could then sell and profit. This new collection has a great value, but the first one is the most valuable of all. In March 2022, they launched a cryptocurrency (APE currency) and for owning a bored ape you could claim approximately 10,000 ApeCoin per user, which equated to approximately \$100,000 for each user. (*Erinfolami, 2022*)

These aspects make us argue that a collection that unites a community and works to incentivise users to purchase their NFTs is a factor that should be considered when selecting which NFT collections to invest in.

BAYC #8817 was the most expensive of the collection, selling for \$3,408,000 USD. As a distinguishing feature, its gold colour was shared by only 1% of the collection, and its appearance and gold background were one of the reasons why one investor paid that amount of money to acquire it.

4.4. What to look for in an NFT

Looking at the characteristics that have led to the success of the collections explained above, we can see that the first thing we have to analyse is which collections we should invest in. We will look for those that give us added value. There will undoubtedly be collections that only for their digital art their works have a great value, but membership incentives or commercial rights (as in the Bored Ape Yacht Club) are aspects that will have to be taken into account. Also, its usefulness in virtual worlds with great potential (as the Metaverse and in video games) is an aspect to take into account due to the constant technological development that occurs. As we have seen in the Meebits, its usefulness in the form of avatars and skins in video games and Metaverse is a very important quality. If your digital art is of poor quality and does not add value over other collections, it will not be a good collection to invest in. In the CryptoPunk we have analysed that its value lies in being the first major NFT collection. So, the first popular collections that emerged will have a great value and possibly if the NFT market continues to evolve, in the long term these early collections will have a great market value as a collectible. Another important aspect we have observed is knowing the artists of the NFT works. We have observed that CryptoPunk creators have been successful in later collections, so it is another aspect to keep in mind. We have seen in both CryptoPunks and Bored Ape Yacht Club that the first collections tend to be the most valuable.

Once we know which NFT collection we want to invest in, we will have to analyse the rarity of its works, as those with the most unique characteristics will, in principle, be the ones that will bring us the most value. So, before we venture to buy the first potential work, we will have to know how to identify those that may have more value so as not to fall into the error of selecting a work of little value driven by the hype that a collection may represent.

5. NFT RENTAL

Another way to earn income in the NFT market is by renting NFTs. A user who has an NFT that provides membership, or another type of utility can rent it out when he is not going to enjoy the benefits of this asset. By renting, he can earn passive income. For example, the American entrepreneur Gary Vaynerchuk, has a private restaurant that can only be attended by those who have a Flyfish Club NFT, since obtaining one gives you the necessary membership to enter the Flyfish Club, and therefore be able to enter the restaurant (*Pandey, 2022*). A user who has an NFT from this collection and is not going to enjoy its benefits for a while, can rent it so that people who want to go to the restaurant can do so without having to buy an NFT, which can be very costly for many users.

There are two types of NFT rental, secured and unsecured loans (*Song, 2022*).

- In secured loans, to protect the owner of the NFT, the borrower must post collateral. The collateral is usually worth more than the underlying asset and the borrower will also have to pay a certain rental fee. This is set out in a contract and at the end of the lease, the owner gets back the NFT and the borrower gets back the collateral.
- In unsecured loans, the difference is that the actual NFT does not enter into the contract, but a version of the original NFT is minted. The borrower is not required to put up any collateral, but only to pay the rental fee. At the end of the lease, the original NFT version is automatically returned to its owner and destroyed.

6. ACCOUNTING AND TAXATION OF AN NFT

The explosion of cryptocurrencies and NFTs raises a great deal of doubt as to how to account for them because there is no specific accounting guidance for cryptocurrencies as there is for other types of assets. Therefore, the general rule is that crypto assets are treated as intangible assets but the underlying substance of what an NFT represents could affect its accounting treatment. Also, a user entering the world of crypto assets should be aware of the tax aspects of buying and selling NFTs (*Labeabogados, 2021*).

Regarding the purchase and sale of NFTs, we have to know what taxes have to be paid, because the payment of taxes occurs both in the purchase and the sale of NFTs. When you sell an NFT, it is subject to indirect taxes such as VAT or Transfer Tax (ITP). The difference between the two is determined by who makes the sale. In the business environment, when a businessman or professional acting within his economic activity sells an NFT, the sale should be subject to VAT. It should be noted that a problem arises

due to the fact that VAT is a regional tax, so in order to know what VAT rate to apply and how to apply it, we will need to locate the operation in some region. This will depend on the information we have at the time of the sale, who is involved, what is transferred and the context in which it is carried out, so there is no single answer when it comes to locating and applying the specific VAT rate (*Afiris, 2021*).

In all other transactions, with a few exceptions, it will be subject to the transfer tax ITP. Therefore, the tax will be paid by the person who buys the work of art in digital format, so that any user who buys an NFT will have to pay one of the two taxes explained above, either the VAT or the transfer tax ITP (*Labeabogados, 2021*).

Regarding the type of taxation that applies to them, the law distinguishes between immovable assets, movable assets, and rights in rem. To know in which category we should include NFTs, a case-by-case analysis would have to be carried out, since depending on the NFT it could belong to one category or another. For example, if the NFT sold is a photography, it would be a movable asset, which means that a tax rate of 4% will be applied. This example shows how important is to be aware of the tax aspects of the purchase and sale of NFTs.

The taxes discussed above on the purchase and sale of NFTs represent only a part of the taxation of NFTs. The other part is referred to the income tax. The sale of an NFT should be included in the personal income tax. A person (or artist) who directly engages in an activity related to NFTs will consider the revenue from selling NFTs an income from his economic activity. On the other hand, a private individual who does not directly dedicates to the activity of selling NFTs will treat these revenues as a capital gain (but not as income from his activity) for a transfer of an element of their assets. Depending on the amount of the gain, the tax rate would vary between 19% and 26% (*Navas & Cusí, 2021*):

- If the net taxable income is between 0 and 6,000 euros, it will be 19%.
- If the taxable income is between 6,000 euros and 50,000 euros, it will be 21%.
- If the taxable income is between 50,000 euros and 200,000 euros, it will be 23%.
- If the taxable income is greater than 200,000 euros, it will be 26%.

It will also be important to know how form 720 works, which is the informative declaration on assets and rights located abroad, (Definition of tax agency headquarters) and also the Corporate Tax, which is the tax on the income of companies (Definition of tax agency headquarters). If a user has a NFT worth more than 50,000 euros, he would have to

present this form 720 to inform the Tax Authority that he is the owner of that asset. In the case of corporate income tax, if a firm is the owner of the NFT, the income obtained will be included in the economic result of the company (*Labeabogados, 2021*).

Regarding the accounting framework for NFTs, due to the popularity of these assets, specific legislation should be created on which regulation NFTs belong, since it can currently be seen that it is still under construction and may pose some problems for users and companies that start in this recent market. Questions regarding how to account for NFTs not only affect users who buy and sell NFTs, but also consulting and accounting firms that must provide their services to help those who need to know the process.

CPAs (Licensed Professional Accountants) need to ensure that they have sufficient knowledge to be able to handle the accounting of crypto assets. So, it will be critical that accounting firms, due to the growing interest in the cryptocurrency and NFT market, adapt to these changes. Not all accounting firms will be in contact with these assets, but those that will be advising clients who are in contact with these assets will have to be constantly informed of the tax updates that are produced. As these are such novel assets, CPAs will need a great deal of time to acquire the necessary expertise, but it is an opportunity that accountants need to consider deeply, also given the context of uncertainty and volatility that defines these crypto assets. In 2021, NFTs became an approximately \$40 billion market. According to research by Chainalysis, more than 75% of the market is represented by transactions of less than \$10,000 because NFTs have introduced a large number of retail investors. There are even companies using NFTs as collateral for loans. These examples can give us an insight into the potential that NFTs can have in numbers of issues that present a huge opportunity for accounting firms. (*INAA GROUP, 2022*).

Although, as we have repeatedly stated, there is no legislation in place to account for NFTs, some countries issued some recommendations about how to account for these assets. For example, under Canadian accounting standards for private companies, NFTs meet the characteristics of intangible assets with an indefinite life. However, they would not be financial assets as they do not include a right to receive cash in the future and are not equity instruments of another entity.

Following the measurements standards for intangible assets, if the carrying amount of the NFT exceeds its fair value, an impairment of the intangible asset would have to be recognised. This impairment would occur for example when the creator of the NFT falls out of favour with the public and the demand for the assets associated with this user decreases. (*Legge, 2022*). Obviously, the main problem for the valuation of the NFT

following this measurement criteria is the estimation of the fair value. This is why some academics and practitioners request a deep change in the recognition and measurement of this type of assets.

Also, it is worth noting that if the purchase/sale of NFTs is your main activity you could account for the NFTs as inventory at cost. However, to the extent broker and traders are involved it should be measured at fair value less costs to sell (*IFRS Consulting, 2022*). The concept is that this inventory was acquired principally with the purpose of selling it in the near future and generating a profit from either price fluctuation or a broker-traders' margin.

Finally, if we were to rent an NFT, the income would be registered as rental income in a revenue account. Also, in all cases (both rentals, purchases and sales), we should very careful about the processing fees outlined in section 4. These processing fees will be part of the price of acquisition of the asset when acquiring it or they will be registered as a commercial expense when disposing it.

7. CONCLUSION

Throughout this work, we have been able to identify the characteristics that we must consider when investing in NFTs.

First of all, we have been able to observe what an NFT is and what possibilities and utilities they can have. We also differentiated NFTs from cryptocurrencies since, being both digital assets, people can identify NFTs as something that is directly connected to cryptocurrencies. However, we observed that, although it is true that the cryptocurrency market can affect the value of the NFT and they do share characteristics (such as working through the Blockchain), they are far from being the same asset/market.

Throughout the work we have been able to observe the evolution of the NFT market that exploded in 2021. This explosion has created great expectations for the future but the NFT market has decreased in 2022. We should not be alarmed about this as we can expect the NFT market to stabilise over the next few years or even see a decline in value. With this perspective, all those collections and low-value assets that have emerged after the popularity of this market (trying to take advantage of investors' lack of knowledge and the popularity of these digital assets) should diminish in the coming years, to form a much more established and stable market than it is today.

We have also looked at the different types of NFTs. Currently, we can conclude that collectibles are the most profitable and have the highest volume and interest for investors. These types of assets will continue to be of interest in the future as they are arguably the essence of this market. But in the future, with technological developments in both the metaverse and the gaming world, NFTs related to these will become more important than they are today and may lead to the emergence of new markets that are not yet developed. For example, the rental of NFTs is mainly focused on the gaming world, as this is where it makes the most sense to target them.

Another very important point of the project has been to identify the value generated by NFTs and what to look for when investing in them. We can say that when identifying which collections to invest in, one of the most important aspects is the added value that NFTs offer such as who the creator is or the story behind the collection. In the Bored Ape Yacht Club collection, we have seen a clear example of how the mere acquisition of a unit of the collection gives us a lot of advantages such as membership benefits, the opportunity to get NFTs of new collections from their own creators for much less price than other users, among other advantages.

The analysis of which collection to invest in will be key when investing in NFTs. Once the collection is identified, it will be key to know which NFTs have more value, and which have less value in that collection. Currently, valuation focuses on the rarity of the asset, where those that have rarer qualities and share fewer with other NFTs are more valuable. This will be a key issue because when a highly anticipated collection of NFTs goes on sale, the prices of NFTs after the primary sale will skyrocket and many NFTs will be overvalued. It is at this point when this lesson is most important, as we will also find NFTs that may be worth more than their current selling price. Therefore, identifying the rarity qualities faster than other users will give us great advantages.

Finally, it should also be taken into account that, depending on the type of NFT, the way it is accounted for may change. This aspect should be understood because, if you invest in NFTs, although there is no specific legislation for them, there are some necessary guidelines to avoid making valuation errors. Not only do we need to be aware of this, but also of those factors that may affect the value of our NFTs, such as the risks of hacking or the fees for carrying out transactions with NFTs, among other causes.

Knowing all this information will allow us to invest in these assets more safely. For many people, the market is a big bubble that may burst in the future. In our opinion, although it is worth noting that the market is probably overvalued and has yet to stabilize, the NFT have great applications and possibilities both currently and especially in the future, where

its potential is most focused. In this market we can find a large number of assets with a virtually non-existent value that are a danger when investing, but we can certainly say that in this market you can find a large number of opportunities to achieve high returns if we know how to operate properly.

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