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STATE AND LOCAL TAX FORUM

VANDERBILT UNIVERSITY LAW SCHOOL

Cryptocurrency…NFTs… the Metaverse…and Taxes!

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What is the Blockchain?

- Blockchain is essentially a decentralized digital ledger that is powered and operated by numerous computers, or nodes that work to record transactions on the ledger.
- Network participants verify and update transactions through complicated consensus mechanisms, including proof of work.
- Once a transaction is verified along with other transactions, this block of transactions is added to the blockchain.
- Virtually "unhackable" due to the widely spread storage of the data and mathematical functions used in the consensus mechanism.
- Blockchain technology is most associated with cybercurrencies or cryptocurrency but also supports the exchange of NFTs.

What is the Blockchain?

- As the name implies, blockchain is a linked body of data, made up of units called blocks that contain information about each and every transaction, including date and time, total value, buyer and seller, and a unique identifying code for each exchange.
  - Entries are strung together in chronological order, creating a digital chain of blocks.
  - Bitcoin and other cryptocurrencies such as Ethereum are built on the blockchain, the distributed digital record described above.
- It can be useful to think of a blockchain like a running receipt of every transaction that's ever taken place in the cryptocurrency.
  - Computers in the network verify the transactions and ensure the integrity of the data.
  - "Once a block is added to the blockchain, it becomes accessible to anyone who wishes to view it, acting as a public ledger of cryptocurrency transactions," says Stacey Harris, consultant for Pelicoin, a network of cryptocurrency ATMs.
- Blockchain is decentralized, which means it's not controlled by any one organization.
  - "It's like a Google Doc that anyone can work on," says Buchi Okoro, CEO and co-founder of African cryptocurrency exchange Quidax.
  - "Nobody owns it, but anyone who has a link can contribute to it. And as different people update it, your copy also gets updated."

What is cybercurrency or cryptocurrency?

- Digital asset that is created using cryptographic techniques that enable people to exchange them securely
- Supported by blockchain technology
- Cryptocurrency transactions are pseudonymous
  - Transactions on blockchain are verified using alphanumeric public and private keys allowing the transaction to occur without the actual identity of the account holder being revealed to other users on the blockchain.

What is cybercurrency or cryptocurrency?

- Cryptocurrency is a form of payment that can be exchanged online for goods and services.
  - **Many companies have issued their own currencies, often called tokens**, and these can be traded specifically for the good or service that the company provides.
  - Think of them as you would **arcade tokens or casino chips**.
  - You'll need to exchange real currency for the cryptocurrency to access the good or service.
- How many cryptocurrencies are there?
  - **Nearly 15,000 different cryptocurrencies are traded publicly**, according to CoinMarketCap.com, a market research website. And cryptocurrencies continue to proliferate.
  - The total value of all cryptocurrencies on Nov. 29, 2021 was more than **$2.5 trillion**, having fallen off an all-time high above $2.9 trillion weeks earlier.
  - **The total value of all bitcoins, the most popular digital currency**, was pegged at about $1.1 trillion.

What is Bitcoin (Crypto) Mining?

- Crypto mining
  - is the process of creating and validating new coins in the blockchain**.**
  - requires powerful equipment and a lot of computational energy
  - Involves solving complex mathematical puzzles in order to verify and validate transactions within a cryptocurrency network and miners receive rewards.

- In a proof-of-work ecosystem, like the Bitcoin blockchain, miners are paid in bitcoins (BTC).

IRS view on virtual currencies

The IRS deems that virtual currency transactions are taxable by law just like transactions in any other property.

- Taxpayers transacting in virtual currency may have to report those transactions on their tax returns.
- Virtual currencies are a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.
- In some environments, they operate like “real” currency (i.e., the coin and paper money of the U.S. or any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in the U.S.

The IRS defines cryptocurrency as a “type of virtual currency that utilizes cryptography to validate and secure transactions that are digitally recorded on a distributed ledger, such as a blockchain.”

- Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible” virtual currency. Bitcoin is one example of a convertible virtual currency.
- Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

Tax Consequences: the IRS deems the sale or other exchange of virtual currencies, or the use of virtual currencies to pay for goods or services, or holding virtual currencies as an investment, generally has tax consequences that could result in tax liability.

- The IRS issued IRS Notice 2014-21, IRB 2014-16, as guidance for individuals and businesses on the tax treatment of transactions using virtual currencies.
- The IRS also published Frequently Asked Questions on Virtual Currency Transactions for individuals who hold cryptocurrency as a capital asset and are not engaged in the trade or business of selling cryptocurrency.

Infrastructure Act

Infrastructure Act signed into law in the U.S. in November contains new broker tax reporting requirements in respect of transfers of digital assets (Sec. 6045)

- Broadly defines "broker" to include persons who regularly provides a service "effectuating transfers of digital assets" on behalf of another person
- Digital assets includes "any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary"
- Cost basis reporting will be required for digital assets acquired on or after January 1, 2023
- Transfer Reporting: In addition to reporting on sales of digital assets, the Act would also require reporting on transfers of digital assets to another broker (customer account and asset transfers) and to non-broker addresses (*e.g.,* private wallets)
- The scope of these provisions may be better defined once regulations are issued
- Effective for returns filed after December 31, 2023

Section 6050(i)

- Section 6050(i) requires any person who receives more than $10,000 in cash in the course of their trade or business to file Form 8300, and to provide a written statement to the payor.
- Violation of 6050(i) carries civil and CRIMINAL penalties.
- The 2021 Infrastructure Act broadens 6050(i) by treating digital assets as "cash"
- Effective starting January 1, 2023
- Digital assets ("cash) includes "any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary"

State Income Tax Guidance

- New Jersey
  - New Jersey's Division of Taxation issued a technical advice memorandum in March indicating it would conform to the primary Internal Revenue Service guidance applicable to Bitcoin and other cryptocurrencies, including IRS Notice 2014-21, Rev. Rul. 2019-24, and IRS Chief Counsel Memorandum 202114020.
  - Those guidance statements generally view virtual currencies as property and require taxpayers to determine the fair market value of convertible virtual currency in US dollars as of the date of payment or receipt for tax calculation purposes.
- New York
  - The New York State Department of Taxation and Finance clarified July 1 in final draft regulations on apportionment that cryptocurrency and similar digitally delivered assets fall within the definition of digital products. Transactions involving a "digital product" must be sourced to the state the same as other products delivered via wire, cable, fiber-optic, laser, microwave, radio wave, satellite or similar media.

State Income Tax Guidance

- Arizona
  - The value of cryptocurrency and non-fungible tokens that are sent for free to digital wallets won't be subject to Arizona income tax based on H.B. 2204 signed into law in July 2022. The changes take aim at "airdrops," a promotional tool to distribute tokens to customers at no cost.
  - Airdropped assets are treated like stocks by considering them as gifts. Taxes would still apply to gains made by selling them.
  - The new law also allows taxpayers to subtract transaction fees, known as "gas fees," on gains or losses from cryptocurrency sales.
  - The law takes effect Jan. 1, 2023.

Overview of Non-Fungible Tokens (NFTs)

NFTs are “non-fungible tokens”

- Fungible assets – goods that are freely exchangeable or replaceable for another of like nature or kind (e.g. currency, bitcoin, etc.)
- Non-fungible assets – unique, irreplaceable, and non-interchangeable assets

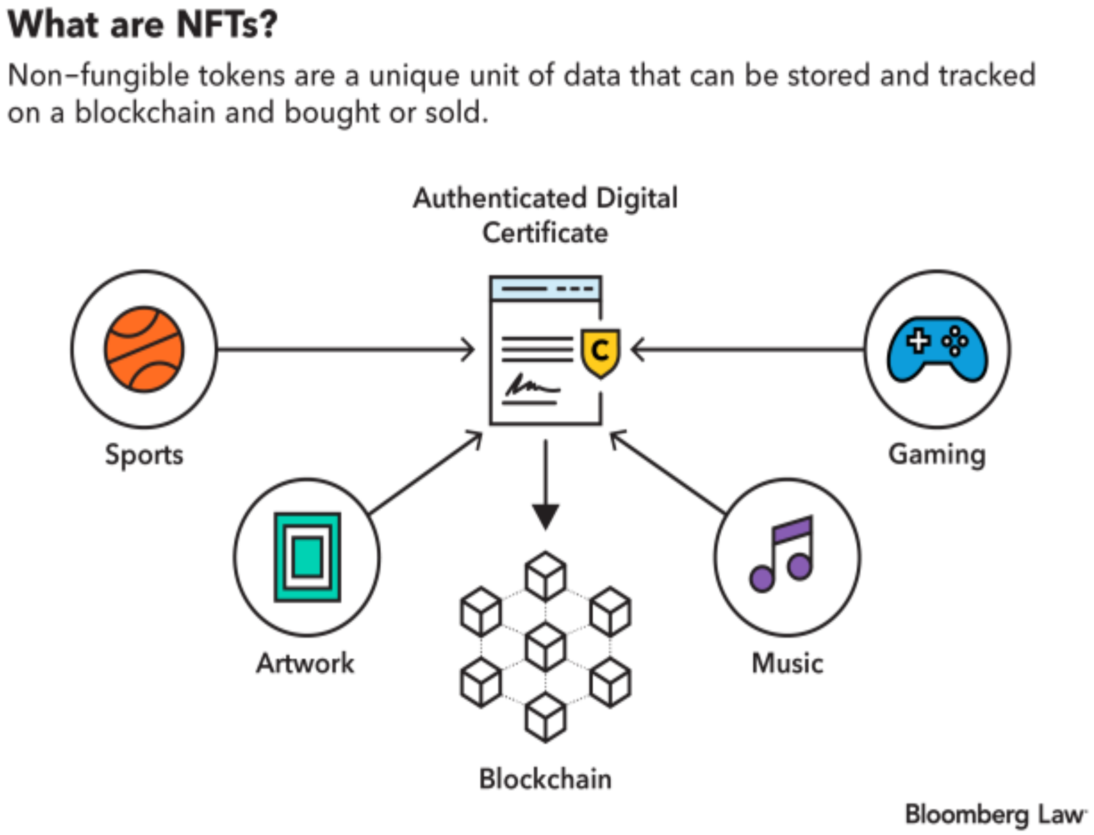
NFTs are tokens that can be used to represent ownership of unique items, like:

- digital artwork,
- a piece of artwork or manuscript
- your own personal medical records
- concert tickets
- tangible items, like a car, jewelry or luxury items
- real property or
- legal documents

Overview of NFTs

NFTs are digital entries on a blockchain

- Blockchain is a shared digital ledger providing security, pseudonymity, and authentication
- The blockchain record acts as a digital certificate, theoretically allowing NFTs to be bought, sold, and traded more efficiently while reducing the probability of fraud
- Movement and ownership of NFTs can be tracked and maintained on the blockchain, enabling creators to create new revenue models, including post-sale revenue through secondary markets and use of “smart contracts”



Overview of NFTs

Smart contracts act autonomously and can direct payments from one party to another. Smart contracts are activated / deactivated based on simple if/then logic.

For example, a smart contact can simultaneously, (i) prove authenticity / ownership of a luxury good, and (ii) embed a royalty agreement whereby the original produce is to receive 10% of any resale.

The NFT thereby provides a future revenue stream for the producer in the secondary market that never existed beforehand.

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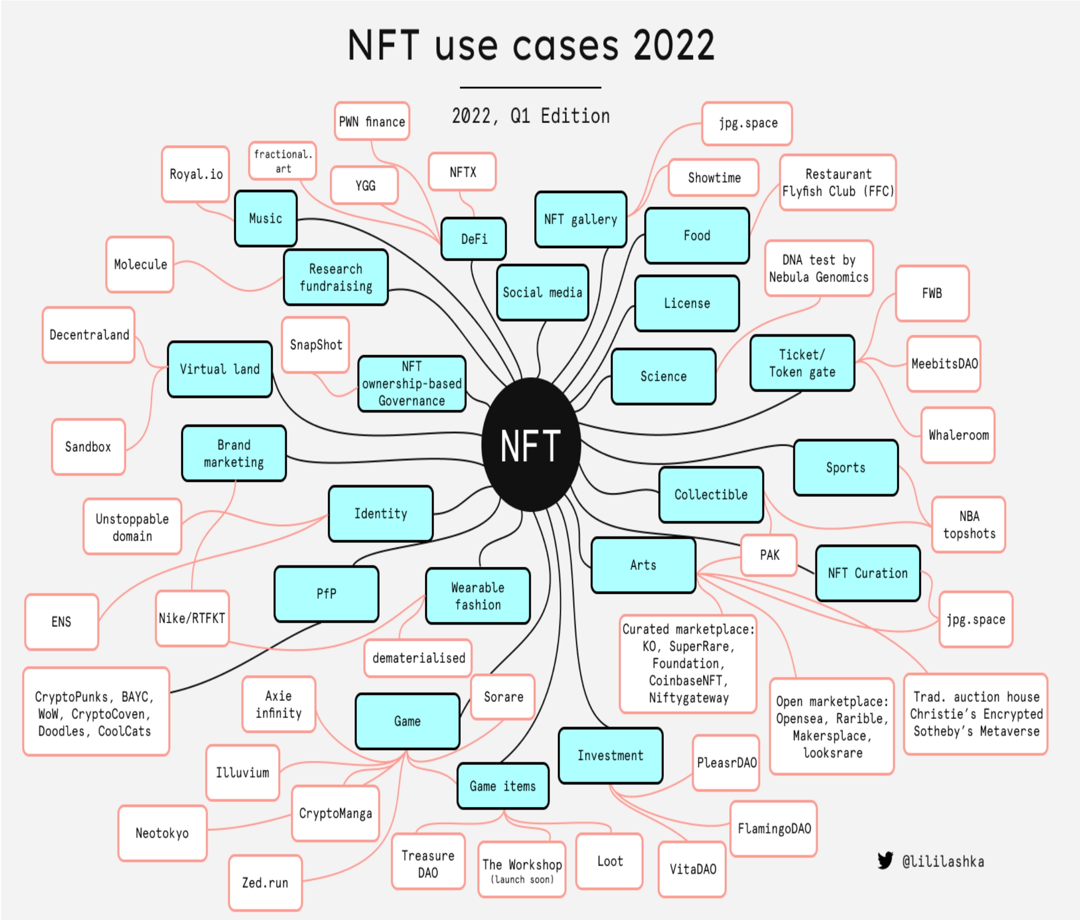
Overview of NFTs



CURRENT INITIATIVES / EXPERIENCES

- Ticketing
- Loyalty Programs
- Membership
- Digital Goods <> Physical Goods
- IP Licensing + Royalties
- Fantasy Sports
- Pre-Sales
- Virtual Real Estate
- IRL Real Estate
- Metaverse

NFT Sales Tax Issues - Classification

How will states classify NFTs?

- States and businesses should understand what property and/or rights are associated with an NFT
- Since an NFT may represent ownership of another asset, it would make sense for taxability to follow the underlying asset
- Since NFTs can theoretically be tied to different types of property (TPP, digital products, real property), not all NFTs should be considered the sale of a digital product

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NFT Sales Tax Issues - Classification

How will states classify NFTs?

- Assuming the NFT is linked to a digital product, not all states tax digital products, or every type of digital product
- If the transfer of an NFT is bundled with multiple products or rights, it may be considered a “bundled transaction” that is subject to tax if any component of the bundle is taxable
  - True object test may be an option
- The delivery method of NFTs should also be considered – whether NFTs are “delivered”, “transferred”, or simply “accessed” online

RTFKT Digital Sneakers

NFT Sales Tax Issues - Sourcing

How should sales of NFTs be sourced?

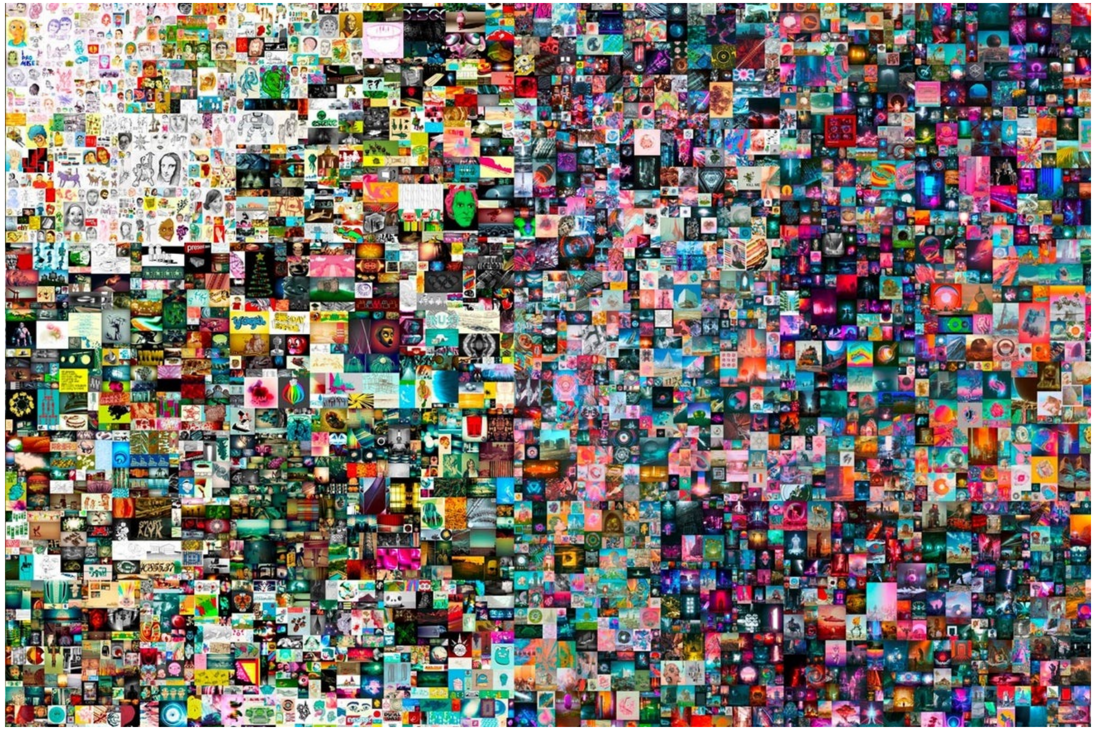
- Although transactions on the blockchain are transparent and immutable, they may also be anonymous or pseudonymous – in other words, the identity and location of a buyer may not be known
- Without knowledge of the location of a buyer, sourcing a sale may be difficult for a seller
- Sellers may need to request basic information from their buyers

Randomly generated images of CryptoPunks, one of the earliest NFT projects

NFT Sales Tax Issues - Sourcing

How should sales of NFTs be sourced?

- SSUTA sourcing framework could apply in SSUTA states
  - SSUTA framework seeks to source sales based on where a product was received by the buyer, and considers the information and records available to the seller
  - SSUTA catch-all rule applies origin-based sourcing
  - Does this incentivize NFT sellers to locate in states that do not have a sales tax (e.g., Delaware)?
- Federal regulation could also impact sourcing if regulations require brokers and/or sellers of digital assets to collect certain information about their buyers



The First 5000 Days by Beeple (Mike Winkelmann)

NFT Sales Tax Issues – Marketplace Considerations

An image of a bored ape from the popular NFT collection “Bored Ape Yacht Club”

What about NFT marketplaces?

- There are a number of popular peer-to-peer online marketplaces for exchanging NFTs
- Marketplaces often take a percentage of every transaction that occurs on the marketplace
- Sellers can also set up royalties, meaning they earn revenue every time their NFT sells on the marketplace
- Could NFT marketplaces be considered marketplace facilitators?
  - Are NFTs included in the type of product that marketplace facilitators are required to collect?
  - Some state marketplace laws only apply to certain sales – such as sales of tangible personal property
- If NFT marketplaces are considered marketplace facilitators, are there any waiver or contracting options available in a state?
- What is the tax base for an NFT sale on a marketplace?

NFT State Sales Tax Guidance

State Guidance Specific to NFTs

- Puerto Rico has issued a regulation providing that NFTs may be considered a specified digital product: a code that gives a buyer the right to obtain a digital product will be treated the same way as the specified digital product
- Pennsylvania issued sales tax guidance in May 2022 that NFTs are a digital representation of TPP
- In July 2022, Washington State issued an interim statement on the tax issues associated with NFTs
- In August 2022, Minnesota updated a Digital Goods fact sheet to provide that NFTs are taxable when the underlying product is taxable

Pennsylvania Guidance

In May 2022, the Pennsylvania Department of Revenue updated a publication, Rev-717 (SU) 05-22, which provides information for retailers and includes a listing of taxable and exempt property for sales and use tax purposes

- Under the category “Computer Hardware, Digital Products and Streaming Services”, the Department newly added non-fungible tokens as a property type and indicated that they were taxable
  - The publication states that “sales and use tax applies to any transfer of a digital product where the purchaser pays a consideration, unless that transfer is otherwise exempt.”
- “Tangible personal property” is defined by statute to include video, photographs, books, games, music, apps, canned software, and any other taxable tangible personal property electronically or digitally delivered, streamed or accessed.
- There is no effective date for the newly added taxable items, which may indicate that the Department considers NFTs to be subject to tax for prior periods as well as prospectively
- The guidance is for “informational purposes only and it is not intended to be binding on the Department of Revenue if the information contradicts statute, regulation, case law or binding letter rulings”

Washington Guidance

On July 1, 2022 the Washington Department of Revenue released an "Interim statement regarding the taxability of non-fungible tokens (NFTs)"

- The statement is intended to provide general information on the tax issues related to NFT transactions and businesses with specific questions are encouraged to request letter rulings
  - **Definition:** an NFT is "a unique digital identifier that cannot be copied, substituted, or subdivided, that is recorded in a blockchain, and that is used to certify authenticity and ownership of a specific type of product."
    - Note that the definition distinguishes an NFT (i.e., the token) from the products or services that may be received by purchasers along with the NFT, including digital goods, admissions, food, TPP, etc.
  - **Tax determination:** NFTs "are taxed based on the character of the underlying products (goods and services) included in the sale." The underlying products are viewed as the "object of the purchase"
    - Note that Washington taxes digital goods, digital codes, and digital automated services

Washington Guidance – continued

- **Tax base:** **“**The selling price of an NFT is measured by the consideration received by the seller, whether from the purchaser or a third party”
  - “If a seller receives cryptocurrency in exchange for an NFT, the value of the cryptocurrency tendered must be converted to US dollars as of the time of the sale”
- **Record retention:** NFT sellers must retain documentation to substantiate the nature and character of each sale, including documentation indicating the time and place of a sale and the consideration received
- **Mixed/bundled transactions:** Sales that include NFTs may be a “bundled transaction” (i.e., two or more distinct and identifiable products sold for one nonitemized price)
  - The seller must determine the taxability of each product included in the sale, and whether the sale meets the definition of a “bundled transaction” (which is generally subject to sales tax and retailing B&O tax unless an exception applies)

Washington Guidance – continued

- **Marketplaces:** Marketplaces that facilitate sales of NFTs and meet substantial nexus standards are required to register and collect sales tax on all taxable retail sales made through the marketplace sourced to Washington and comply with other rules applicable to marketplaces
  - The marketplace must provide sellers with a monthly report of gross sales information for Washington sales
  - The marketplace is subject to service B&O on commissions from retail sales of NFTs sourced to Washington
- **Sourcing:** sourcing of NFT sales will follow SSUTA's general sourcing rules
  - In the circumstance where the seller is without sufficient information to apply those provisions, the sourcing location is determined by the address from which the digital code was first available for transmission by the seller, or from which the digital automated service or other service was provided

Washington Guidance – continued

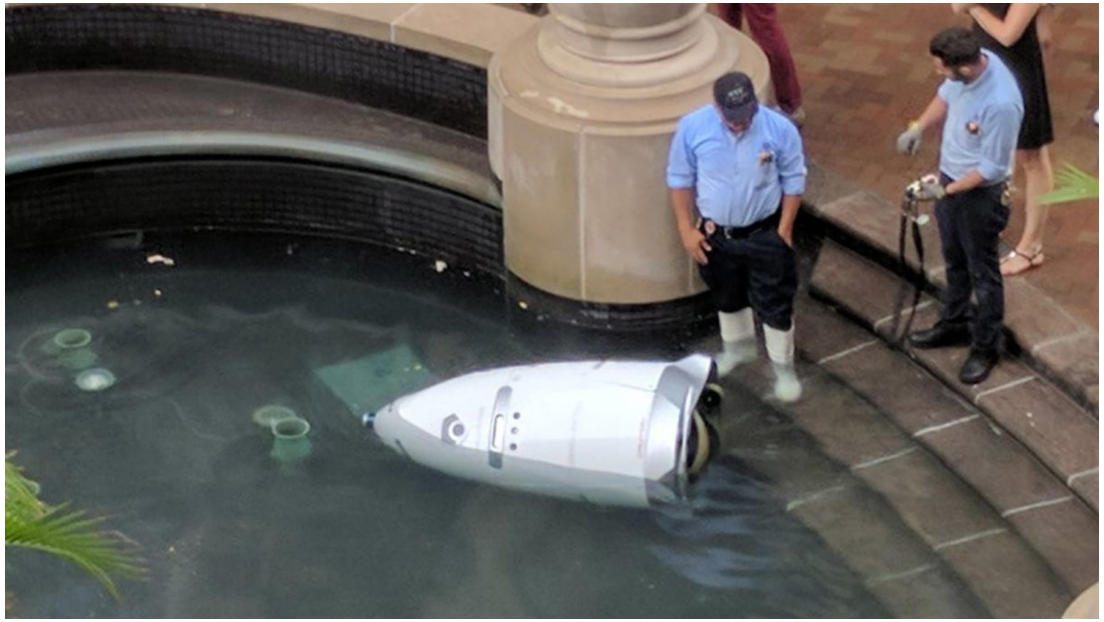
- **B&O tax:** gross income from an NFT sale may be subject to retailing B&O tax, service and other activities B&O tax, or royalty B&O tax depending on the nature of the sale
  - Note that creators and other parties receiving royalties from NFT sales are subject to royalties B&O tax
- The statement also provides a number of examples to show how sales tax and B&O tax would apply to different types of transactions

METAVERSE – Sales Tax Considerations

- Extension of the Internet of Things
- Hardware and license
- Tax base
    - Hardware provided free – use tax?
    - License – considered separate or inextricably lined to hardware?
    - Time period of license matter whether perpetual or limited?

METAVERSE – Income Tax Considerations

- PL 86-272
- Sales factor sourcing Issues
  - Sale of tangible personal property or other than TPP
  - COP states
  - Market states
    - Where is the benefit of the service *received* under California Reg. 25136-2?
    - Where is service *delivered*?
    - MTC Regs – services with respect to property
- Property factor



METAVERSE – Unclaimed Property

- 2016 Revised Uniform Unclaimed Property Act (RUUPA) defines “virtual currency” as “a digital representation of value used as a medium of exchange, unit of account, or store of value, which does not have legal tender status recognized by the United States”
- RUUPA defines “game-related digital content” as “content that appears on a video game platform as a virtual item that is a licensed element of the platform” which includes in-game currencies and “points” like gems or tokens that can only be redeemed within the platform for games

METAVERSE – Unclaimed Property

- Definition of "property"
  - Delaware SB 103 added virtual currency and cryptocurrency
  - Do broad default categories like miscellaneous property apply?
- Reporting Issues
  - Who is the owner?
  - What sourcing rule applies?
  - Valuation – e.g., WV and IL require liquidation of dormant balances 30 days prior to filing unclaimed property report
  - New discovery – e.g., California income tax return question