eBook

The Sales Tax and Digital Asset Dilemma: Advice for Legislators & Regulators

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With a few jurisdictions already on the record, including Belgium, Spain and Switzerland, and with Puerto Rico and Washington poised to issue official guidance, it seems extraordinarily likely that within a few months a substantial number of states will have issued opinions on the application of sales tax on digital assets transferred on blockchain. With this new technology, states have a unique opportunity to issue thoughtful and comprehensive tax rules that can apply (almost) from its inception. In this ebook we will explore some of the critical questions states should consider as they commence crafting sales tax requirements for this new industry.

Historical perspective

The sales tax challenge facing state legislators and regulators with regard to digital assets is by no means unprecedented. There have been many past occasions where sales tax has been asked to rise to the challenge of understanding evolving technologies. In recent history, though, it’s fair to say that sales tax has consistently been one step behind technology.

To this day, states are still working to understand the proper tax treatment of digital goods such as digital books, movies and music. For example, West Virginia purports to not tax digital goods, but in a recent publication it pronounced that streaming entertainment services are fully taxable. While there are not necessarily any publications directly on point, Kansas appears to take a similar position. Let’s hope that states learn from past experiences as they begin to write on this new blank slate.

Getting the terminology right

In common parlance, the term “non-fungible token” (NFT) is often used to describe what we are talking about, but that’s not quite correct. A “token” is simply a representation of a “thing” on blockchain technology, and there are all sorts of tokens that represent all sorts of things that transact on blockchain. Cryptocurrencies, like Bitcoin, are a type of token. However, cryptocurrency tokens are intended to be used as a store of value and a medium of exchange and are in fact fully fungible (one Bitcoin is identical to any other), while NFTs represent a unique (non-fungible) item, more accurately referred to as a digital asset. It’s the digital asset that stands behind the token, and not the token itself, that has perceived value and is potentially subject to sales tax when bought and sold.

What the heck is blockchain?

Blockchain is a computer network that provides a system for recording information in a way that makes it virtually impossible to alter. Think of it as a “digital ledger” of transactions. Details of each transaction conducted over blockchain technology are distributed across a peer-to-peer network of nodes. Node operators, or miners, use cryptographic algorithms (i.e., hashing) to convert the data into unique strings of text. This ultimately forms the “block,” which is then added to the end of the blockchain. Every time a new transaction occurs, its details are distributed across the entire network and another block is formed and added. This technology is considered particularly secure because the cryptographic hashing functions are practically impossible to reverse.

Blockchain transactions are executed through smart contracts, which are essentially computer programs embedded into the token that ensures that the terms of the deal between the buyer and the seller are enforced. Smart contracts allow for buyers and sellers to agree to uniquely enforceable contract terms. For example, a creator can restrict the buyer from subsequently selling their digital asset, or alternatively, could automatically retain a royalty in the form of a percentage of any subsequent sales price should the buyer re-sell the item.

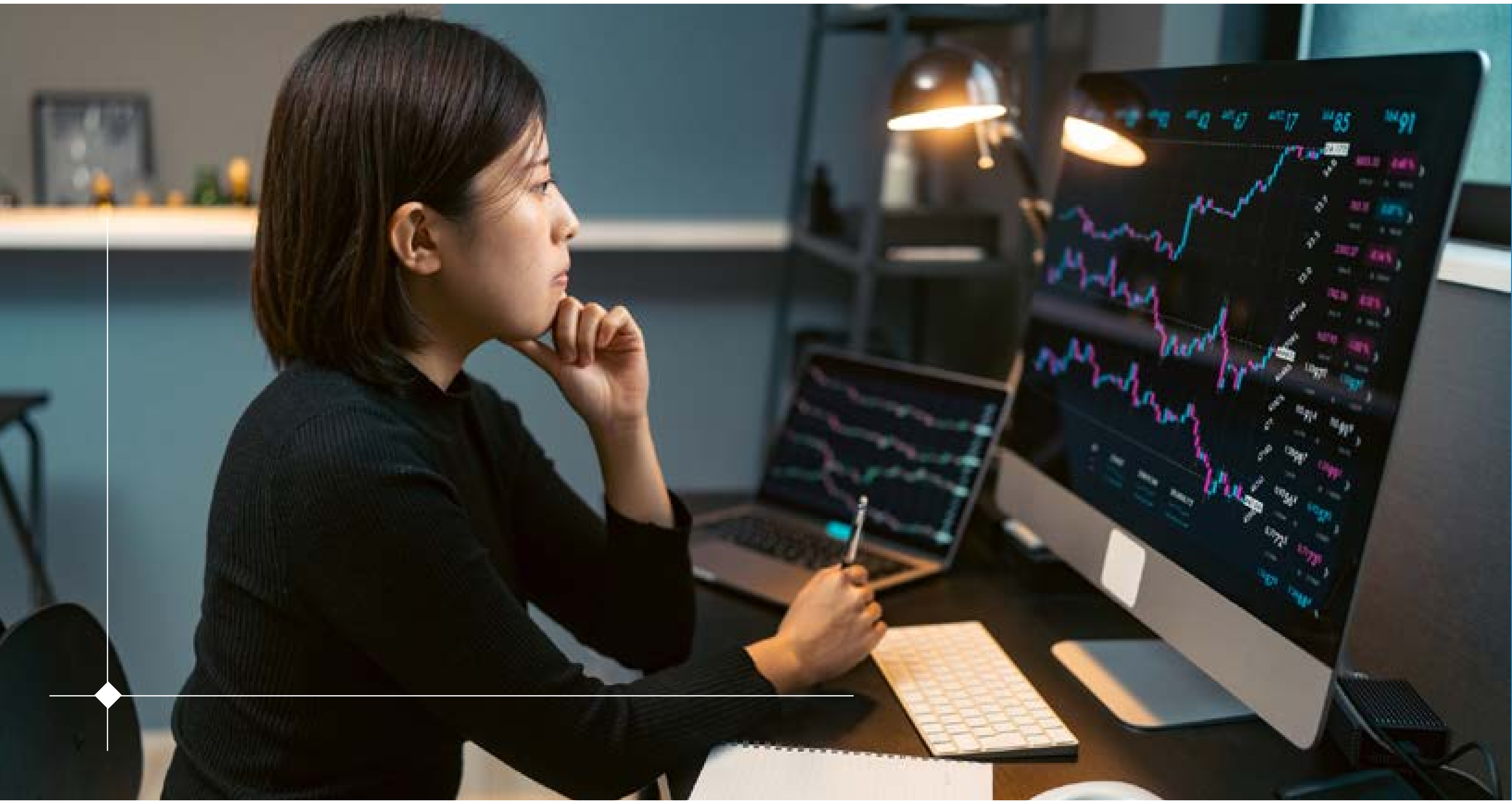
Digital assets are “minted” on blockchain. For example, digital assets represented by NFTs are minted predominantly on the Ethereum blockchain. The form and function of these assets are only constrained by the imagination of their creators. When most people think of NFTs, they think of digital art. However, almost anything can be represented by an NFT including but not limited to photos, videos, audio clips, GIFs, memes, experiences, and even interests in actual tangible personal property or even realty. From a sales tax perspective, the ability to bundle endless combinations of things (e.g., a ticket to a sporting event, a commemorative poster, and a beverage or two from the concession stand) adds an additional (but a well-understood) layer of complexity from the sales tax perspective.

The role of marketplaces

While there is no single, all-encompassing sales approach, digital assets are often sold through online marketplaces. Much like their ecommerce cousins, NFT marketplaces are platforms where digital assets can be displayed and traded. The marketplace provides advertising services for the creator and when the item is ultimately sold, facilitates payment between the buyer and creator, including subsequent royalty payments on later transfers, if applicable.

A buyer using a marketplace establishes a digital wallet and funds it with Ethereum cryptocurrency (ETH). ETH can be purchased on most mainstream cryptocurrency exchanges and then transferred to the marketplace wallet address. Most marketplaces offer NFTs through an auction system where you put in a bid for the asset.

Today, every state with a sales tax has accompanying rules placing collection and remittance obligations on ecommerce marketplace facilitators that perform a payment processing and marketing function for marketplace sellers. It’s possible, but by no means certain, that these rules could be extended to cover at least some NFT marketplaces.



The sourcing challenge

Transacting over blockchain means that the identity of the buyer or their location is not necessarily known. Once the NFT is minted, the smart contract addresses points to the location of the NFT on blockchain, but the assets are stored on the web through a file sharing system. Wallet addresses do not identify the physical owners of assets, which is what makes blockchain technology so secure.

From a sales tax perspective, this reality creates a unique sourcing challenge. What jurisdiction is entitled to apply tax to a particular transaction? Is it based on the location of the server where the digital asset is stored? Probably not. In many states, taxable digital property is taxed based on the address of the purchaser as reflected in the books and records of the seller that are maintained in their ordinary course of business or obtained during the confirmation of the sale.

Today, some sellers of digital property collect zip code information from their customers as a means of confirming the buyer is using a valid payment instrument. Many, though, only collect zip code data to serve this same purpose. While not perfect across the country, a five-digit zip code does provide at least some clarity on the location of the buyer for taxation purposes. A nine-digit zip code provides even more relevant information. However, it remains far from clear whether NFT marketplaces facilitating payments from anonymous customers using cryptocurrency will have the inclination or ability to collect any location data from their customer. They don’t necessarily need it to complete the sale and sometimes the buyer does not want to provide it.

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When is tax due?

Common sales tax requirements suggest that tax becomes due and payable upon the passage of title or possession, whichever happens first. However, when does someone possess a digital asset? For some assets, the answer is likely straight forward. "Possession" passes when the asset is acquired by the buyer and tax and at that moment of time, tax becomes due based on the value the buyer paid.

Of course, value is generally paid in cryptocurrency, meaning that states should clearly articulate where to find the applicable "exchange rate" for at least the most common forms of crypto. While Ohio briefly experimented with the idea of allowing tax payments in crypto, most states still expect payments in U.S. dollars. After all, states rely on tax revenue to fund their government and likely have no interest in the wild fluctuations that can be experienced in the cryptocurrency market.

Additionally, it's possible for creators to earn additional revenue if the digital asset is re-sold by the initial buyer or subsequent buyer. Since most of these sales will happen over a marketplace, the tax compliance obligations of the marketplace facilitator, if any, with respect to these subsequent sales will need to be detailed.

To make things even more complex, how will states evaluate digital assets that can be exchanged for tangible property or services? Is this type of asset better treated as a sophisticated gift card? Imagine a digital asset that can be redeemed for a night's stay at a large global hotel chain. At the time the asset is purchased, no one knows in which hotel the stay will occur or the prevailing room rates at that location. In that case, is tax better deferred until the asset is redeemed?

Words of advice to regulators and legislators

In the absence of official guidance, the possibility of abuse unquestionably exists. The flexibility offered by blockchain and smart contracts could be used by tax-savvy bad actors to circumvent traditional sales tax requirements as they clearly exist and apply today. For example, the transfer of a token representing the right to obtain a kitchen appliance, should (ultimately) be taxed identically to the sale of a kitchen appliance. Given the possibility of abuse, when combined with the notoriety generated by the sale of high-priced assets, legislation and regulation in this space is inevitable. However, before states start writing statutes and rules into this new blank slate, we offer the following words of wisdom:

1. Know what you are regulating. If the topics of blockchain, smart contracts and NFTs feel daunting, consult with the experts. Understand the technology before you start articulating new rules. Tax rules always work best when they reflect business reality as opposed to a regulator's conception about how businesses operate

2. Apply all new rules and requirements prospectively. Remember, in the seminal Wayfair decision, states were given the authority to depart from standard physical presence nexus restrictions and apply their sales tax requirements on remote sellers. But this was only if their tax compliance obligations do not represent an undue burden on interstate commerce. In fact, in the Wayfair decision, the Supreme Court specifically noted that South Dakota was not seeking to apply its economic nexus standard retrospectively. Any state opting to retroactively apply the tax to this new industry is arguably creating an unfair and undue burden on the taxpaying public. Asking a seller or a marketplace to have known they are responsible for sales tax compliance seems facially unjust.

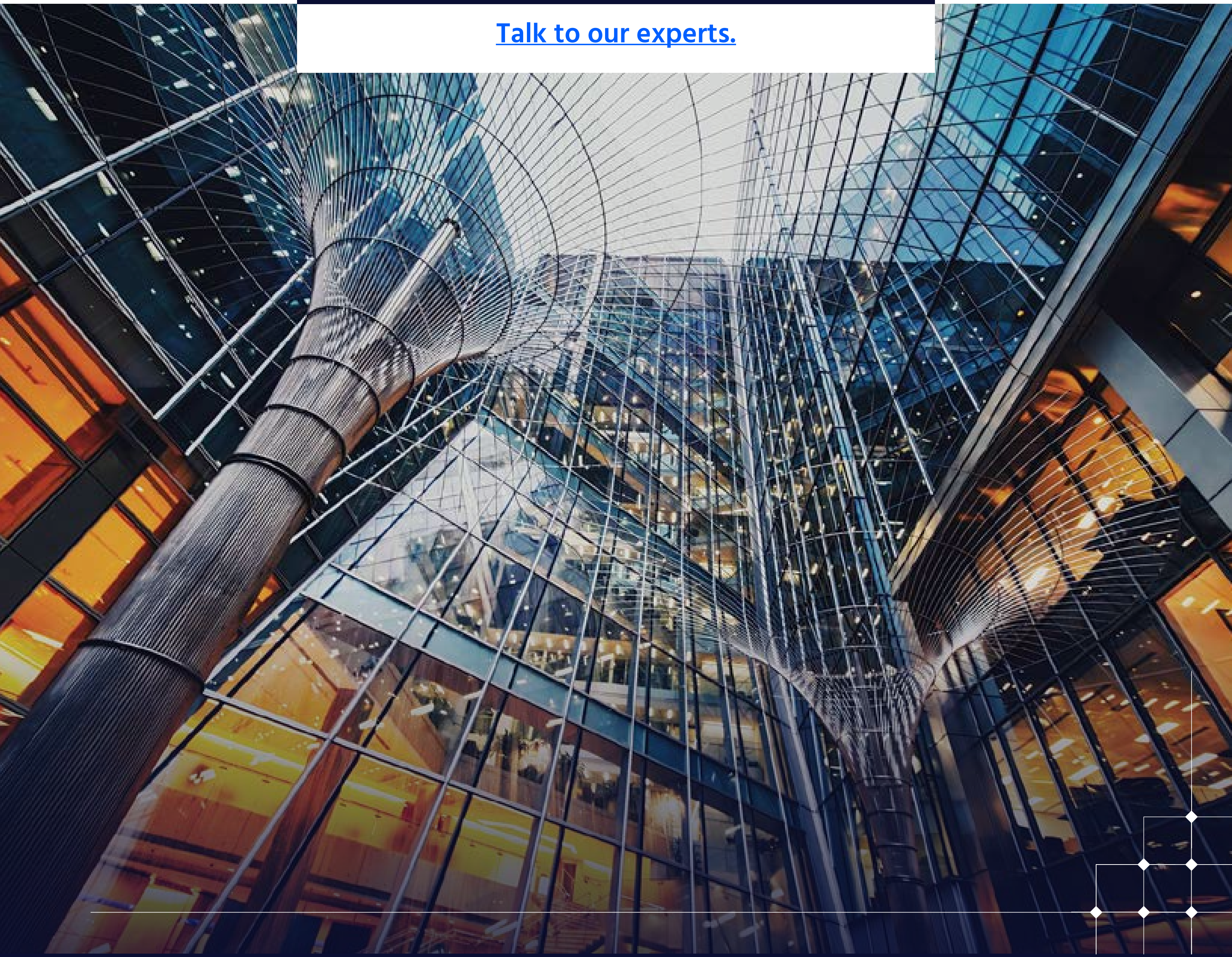
3. Don't try to shoehorn. As noted above, some states have laws on the books as it relates to digital products. Many of the 24 member states of the Streamlined Sales Tax Agreement have definitions for specific digital products and other products transferred electronically, including digital audio works, digital audio-visual works, digital books, and digital codes. Digital assets transferred on blockchain are not necessarily analogous to "traditional" digital products as we know them today and they are worthy of their own clear rules and requirements.

4. This is likely not a passing fad. It's possible, if not tempting, to dismiss digital assets as the latest trend, destined to go the way of the Beanie Baby. However, the flexibility of blockchain and the certainty of smart contracts means that we are likely at the beginning of a new sales channel that doesn't necessarily replace, but stands alongside traditional brick and mortar and ecommerce channels.

For the most part, sellers and marketplaces stand ready to comply with reasonable and well-articulated sales tax compliance requirements. The key to writing such requirements is rooted in a thoughtful and comprehensive understanding of the industry. Here's hoping states take a moment and adopt this best practice, before diving headfirst into blockchain.

Learn More

[Talk to our experts.]



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