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The Evolution of NFTs and the Complexities of State Sales Taxes

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Washington is the only state so far that has provided specific guidance on the taxability of non-fungible tokens for sales tax purposes. As other states develop guidance, NFT sellers should address state sales tax liability early in the process, rather than later during a sales tax audit, says Marcum LLP's John Bonk.

Non-fungible tokens are digital code on a blockchain that can represent real-world items such as art. It is important to note that while digital art is likely the most common type of digital code, there are many different types of NFTs that each a unique use.

States already have the ability to impose sales tax on NFTs. However, there are many complexities when trying to apply sales tax to NFTs that are not present in normal physical transactions. Most states haven't directly addressed the taxability of NFTs.

Furthermore, NFTs are commonly purchased with cryptocurrency, and the NFT itself is a digital item, so there is no customer billing address or physical shipping location to which sales can be sourced. It can be difficult or impossible for a seller to determine the location of the customer. This presents a substantial challenge both for sellers and for state taxing authorities.

Taxability

Washington released RCW 82.32.730(1) on July 1, offering detailed guidance around its treatment of NFTs [a]nd explaining taxability of NFTs and common issues in applying sales tax. Pennsylvania released REV-717(SU) on May 22, providing guidance for in-state retailers and identifying NFTs as being taxable. But unlike Washington, Pennsylvania offered no specific guidance or explanation as to how it expects a taxpayer to apply tax to NFT sales.

Virtually no state other than Washington has provided specific guidance on NFT taxability for sales tax purposes. NFT sellers are forced to rely on each state's taxability conclusions with regard to digital products or on computer software to decide if NFTs are taxable in a given state. More than half of the 50 states tax digital products and electronically delivered software, so a large number of them could potentially tax NFTs.

Historically, states have interpreted existing statutes to expand the reach of their sales tax to cover new technologies. Tax agencies in states that tax digital products and computer software might take a similar approach with NFTs; even though the specific wording of their statutes do not expressly apply to NFTs, the state could interpret their broad taxability of digital products or computer software to apply.

States could expand current law to include taxation of any downloaded material that can be seen or heard by customers. The risk to a company selling NFTs is in states where sellers must rely on their own research; taxpayers run the risk of being held liable for non-collection of state sales tax.

Sourcing

When physical goods are shipped, it is easy for a retailer to identify the location of the customer, since they are delivering tangible goods and have supporting documentation and a delivery address. When selling NFTs, there may be limited or no information about the location of the customer. Since NFTs are commonly purchased with cryptocurrency, there isn't a billing address. And since the NFT is a digital item, there isn't a shipping address.

Washington provides a roadmap for how to address this issue by providing a five-step process to determine the location of a sale. The first four steps all refer to the location of the customer. If this information is unavailable, the seller of the NFT would move to step five, which reads as follows:

"The location shall be 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 defined as a retail sale under RCW 82.04.050 was provided, disregarding for these purposes any location that merely provided the digital transfer of the product sold."

This last step takes an origin approach for sourcing the NFT. Therefore, if a seller of NFTs doesn't collect location information with regard to their sales, at least for Washington purposes, they would have to source the sales to the company's home state. For a Washington-based company, this would mean that if they don't have customer information, all NFT sales would be subject to Washington sales tax, even though the customers may be located in other states or countries.

One way sellers may obtain more information about their purchasers is through know your customer procedures. KYC allows a seller to understand customer risk and is a legal requirement to comply with anti-money laundering laws. It allows a seller to know certain additional information about their customers and exists to protect sellers from getting involved with illegal activity such as money laundering or terrorist financing. KYC is used by some—but not all—crypto exchanges and NFT marketplaces. Having this KYC information will likely allow sellers to identify their customers for proper sales tax treatment.

Nexus and Marketplace

When a taxpayer is selling NFTs on their own platform, they need to understand their nexus status. Nexus is created when a company has enough of a connection to a state that it is becomes subject to the tax collection and remittance requirements of that state.

Sales tax nexus can be created via physical presence in a state or, for out-of-state sellers, by exceeding the state's sales thresholds. The most common thresholds for sales tax compliance are $100,000 of sales or 200 transactions in a state, over a 12-month period. In the absence of nexus, a retailer isn't required to collect sales tax on transactions. Instead, the responsibility is shifted to the consumer in the form of use tax.

Many NFTs are sold on online marketplaces. Marketplace facilitator rules require the marketplace to be responsible for sales tax collection and remittance. However, if the marketplace is not collecting, the seller can still be responsible for the tax. A taxpayer should be aware whether the marketplace they are selling through is collecting sales tax so they can correctly address their sales tax responsibilities.

Conclusion

NFTs are a new commodity that is continuing to evolve. As time passes, it is reasonable to expect additional and more detailed guidance from states with regard to their taxability and how to source NFTs. Sellers of NFTs should discuss with their tax advisers how to address their sales tax liability and to keep up to date with changing guidance. It is better for a seller to address the issues at the beginning of NFT sales as opposed to later under a sales tax audit.

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