

States Will Soon Be Looking to Collect on NFT Sales

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In this article, the authors examine the concept of non-fungible tokens, analyze some of the key sales and use tax issues that have emerged regarding their sale, and provide first steps for NFT marketplaces and sellers to take to protect themselves in potential sales tax disputes.

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In March 2021 the sale of a work of art through the auction house Christie's surprised many observers in both the art world and the general public. The artwork was a collage of digital images created by the artist Mike Winkelmann, better known as Beeple. The sale was notable because it represented the first time that digital art was auctioned off as a non-fungible token (NFT). The price paid by the winning bidder was stunning — the artwork sold for \$69.3 million.¹ Although NFTs started to gain popularity in 2017 with the sale of images of digital punks and virtual cats that could be traded in an online game, many people were still unfamiliar with the concept at the time of Beeple's record-breaking sale. Throughout 2021, however, NFTs became red-hot, and by the end of the year, sales of NFTs would grow to an estimated \$25 billion.² Some of the most popular NFTs included images of bored apes that provide access to an online social club (Bored Ape Yacht Club) and NBA highlight reels that are sold in packs, just like virtual trading cards (NBA Top Shot).

Today, everyone from artists and brands to political campaigns, social media platforms, and start-ups is viewing NFTs as a potential new source of revenue. Another group that may also be considering the revenue implications of NFTs is state taxing authorities. Sales of NFTs raise several questions from a sales and use tax perspective because they represent the sale of what, in some cases, may be a taxable item. Thus far, however, it appears that no states have released official guidance on the issue. In this

¹ Scott Reyburn, "JPG File Sells for \$69 Million, as 'NFT Mania' Gathers Pace," *The New York Times*, Mar. 11, 2021.

² Elizabeth Howcroft, "NFT Sales Hit \$25 Billion in 2021, but Growth Shows Signs of Slowing," *Reuters*, Jan. 11, 2022.

article,³ we will examine the concept of NFTs and analyze some of the key sales and use tax issues that have emerged regarding their sale.

What Is an NFT?

Unless you are already a collector of NFTs, you may be wondering what exactly NFTs are and how they work. To begin, it is helpful to differentiate between fungible and non-fungible items. A fungible item is one that is identical and interchangeable with another item. A good example of a fungible item is currency: The dollar is a fungible item because one dollar is indistinguishable from another dollar and can serve the purpose of any other dollar. On the other hand, non-fungible items are unique, irreplaceable, and can't be interchanged. An original work of art is an example of a non-fungible item because there is no other work of art in the world that has the exact same qualities. There may be prints, reproductions, and efforts to mimic, but the original piece of art is non-fungible. Non-fungible tokens are a new type of asset that uses blockchain technology to establish the uniqueness of a particular item and to facilitate its exchange.

Blockchain technology is most associated with cryptocurrency, like bitcoin,⁴ but the technology also underpins the exchange of NFTs. A 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 one called proof of work.⁵ Once a transaction is verified along with

other transactions, this block of transactions is added to the blockchain. If someone tries to manipulate the blocks on the blockchain, the blockchain will break because of the underlying mathematical functions used in the consensus mechanism.⁶ For this reason, bitcoin and other cryptocurrency transactions are often said to be immutable and are therefore more secure (at least theoretically) than transactions recorded on a ledger maintained by a central authority.

Another unique aspect of bitcoin and other cryptocurrency transactions is that the entries on the blockchain are pseudonymous. Cryptocurrency transactions operate using public keys (comprising a long string of alphanumeric characters) with corresponding private keys that are often generated based on algorithms. A private key is used to digitally "sign" a cryptocurrency transaction, and the network's participants use this information to verify the transaction's validity. The identity of the private key's user (that is, the account holder) is not disclosed on the blockchain, however. In other words, since transactions on the blockchain are verified using alphanumeric public and private keys, they can occur without the actual identity of the account holder being revealed to other users on the blockchain.

As cryptocurrency grew in popularity, it became clear that blockchain technology had many other potential use cases. A decentralized ledger can be used to verify not only the authenticity of transactions involving cryptocurrency, but also exchanges of other types of assets. Almost any type of commodity can be tied to a blockchain by being paired with a token, and by doing so, the owner of the good can establish its uniqueness and authenticity. The token can also be used to track the sale and exchange of the good between parties. To understand the value of NFTs, consider that if Beeple creates a digital work of art, anyone can view it on a website, and even copy the art for their own private use. However, without the authentication that the blockchain provides, that person merely owns a copy of the work of art — like a digital photo of a painting the person saw

³The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

⁴The uppercase Bitcoin is generally used to identify the protocol and payment network, whereas the lowercase bitcoin is generally used to identify the currency.

⁵Simon Chandler, "Proof of Work Is at the Core of the System That Manages Bitcoin Transactions and Secures the Network," *Insider*, Dec. 16, 2021.

⁶Kevin Doubleday, "Blockchain Immutability — Why Does It Matter?" *Medium*, Nov. 27, 2018.

in a museum. The true owner of the art has a digital “certificate of authenticity” that the blockchain provides. Skeptics may say at this point that a copy of a work of art is just as good as the original if no one can tell the difference. To some, this may be true, but to others, the blockchain creates scarcity and authenticity. Only the owner of the token linked to Beeple’s collage of images can claim to be the true owner of the work of art. And the rising popularity of NFTs shows that they have value because the market has decided that they have value.

For our purposes, the key points to remember with NFTs are that they are digital entries on a blockchain ledger, and that they can be associated with digital assets, like Beeple’s digital works of art, and a wide range of other types of products, including tangible personal property, tickets to an event, or even land. For example, a New York restaurant recently announced that it would sell NFTs that would allow purchasers to gain access to the restaurant — essentially making it a private dining club.⁷ One type of membership token would get you in the door, while a more exclusive token would provide access to a private dining room serving omakase (a Japanese sushi dining experience). Token owners would be free to sell or lease them to other interested parties. Similarly, people that wish to exchange tangible property, such as a vintage car, could also use the blockchain to facilitate an exchange. The appeal of assets exchanged as NFTs is the additional layer of uniqueness, authenticity, and perhaps status the blockchain provides.

There are two other considerations with NFTs that are noteworthy for sales tax purposes. The first is that NFTs are often sold on marketplaces — platforms or websites that bring third-party buyers and NFT sellers together. A marketplace may be associated with a particular blockchain network, such as ethereum, which has its own cryptocurrency, and parties may or may not use cryptocurrency in their transactions. The second point is that NFTs sometimes use blockchain technology called “smart contracts,” a type of software program

that automatically executes once conditions have been satisfied. With NFTs, the creator (or even another party, like a marketplace) can set up a smart contract so that the creator receives a royalty whenever the NFT is subsequently sold by one buyer to another.

NFTs and Sales Tax

With the growing popularity of NFTs, it’s only a matter of time until state and local tax issues begin to emerge. There is little if any published guidance on the sales tax treatment of transactions involving NFTs, but answering standard sales tax questions about what is being sold and where the sale is taking place can be helpful in thinking about the sales tax issues likely to arise. More specifically, the initial questions to be addressed would include:

- What is the classification of assets exchanged as NFTs?
- Where is the transaction involving the NFT sourced for sales tax?
- What are the tax responsibilities of parties that use marketplaces to exchange NFTs?

Classification

In the absence of new guidance or legislation, taxpayers should consider how a state could impose tax on an NFT transaction within its sales tax regime. All states with a sales tax impose tax on sales of tangible personal property, and most states impose tax on sales of enumerated services. Sales tax does not generally apply to the sale of intangible property, such as stocks or bonds, or to revenues received from royalties from intellectual property. When an intangible is so closely associated with tangible personal property, however, some states have held that the intangible is subject to tax. For example, an appellate court in Louisiana held that the lease of anodes used in chlorine production under technology and patent license agreements constituted the sale of tangible personal property rather than intangible property.⁸

The court stated that “it is clear that the transfer of technology without the tangible

⁷ Emily Heil, “An NFT Restaurant Opening in New York Will Serve Up Status With a Side of Seafood,” *The Washington Post*, Jan. 15, 2022.

⁸ *McNamara v. Electrode Corp.*, 418 So.2d 652 (La. Ct. App. 1982).

personal property is worthless and therefore the technology (intangible item) is merely incidental to the tangible item” and therefore subject to sales tax.⁹ Similarly, when analyzing the taxability of an NFT — the digital entry on the blockchain — it seems that most states would consider this to be a form of intangible property. Because NFTs represent ownership of another asset, however, an NFT transaction would likely be considered by states to be the sale of the underlying asset. In other words, the taxability of the transaction would follow the underlying asset rather than the intangible token on the blockchain.

The complicating factor with NFTs is that the underlying asset can take a variety of forms. NFTs may involve anything from digital images (Beeple’s artwork), to videos (NBA Top Shot), to club memberships (access to a private sushi restaurant), to video game characters (Axie Infinity),¹⁰ and more. Because states have different approaches concerning what is included in their sales tax base, taxpayers buying and selling NFTs need to carefully analyze what exactly is being sold in an NFT transaction. If the NFT is linked to tangible personal property, it would seem likely to be subject to sales tax. Many states also tax the sale of “specified digital products,” such as digital audio works, digital audiovisual works, and digital books.¹¹ The sale of an NFT that is linked to a video would appear to be a type of work that is taxable in several states. A digital audiovisual work is often defined as “a series of related images that, when shown in succession, impart an impression of motion, together with accompanying sounds, if any.”¹²

As for digital images, many states do not consider this to be a type of specified digital product that is subject to tax. Taxpayers should be aware, however, that as an alternative to taxing specified digital products, some states

impose tax on products transferred electronically,¹³ and this may include digital images. Regarding sales of NFTs associated with a special experience or a club membership, some states tax the sale of admissions or access to entertainment.¹⁴ And if the sale of an NFT involves multiple types of property or benefits (for example, a digital image that allows the owner to access a private club or party), then the true object of the transaction — and the character and taxability of each component — should be analyzed because the taxability of one component could cause the entire transaction to be taxable. When smart contracts are associated with NFTs, the royalties that creators or other parties receive should also be analyzed to determine whether the royalty revenue represents a taxable sale.

The bottom line is that appropriately characterizing the nature of an NFT transaction can be complicated. In many cases, taxpayers may need to carefully review their contracts and collateral material to assess the full scope of the benefits and property associated with a particular NFT sale.

Sourcing

One of the complications with imposing sales tax on NFT transactions is that blockchain transactions are not only transparent and immutable, but also pseudonymous. Even though a blockchain transaction’s authenticity can be verified, the parties involved in the transaction are not commonly identified. For sellers of NFTs, the lack of information that the blockchain provides about purchasers could create issues regarding the sourcing of NFT sales. For sales tax purposes, the interstate sale of property is generally sourced to the buyer’s location. The rule presumes that a seller is delivering tangible personal property or a service to a buyer, and that the seller has information or knowledge regarding the delivery location. With NFTs or transactions involving cryptocurrency, the seller may not necessarily have this information. If there is no

⁹ *Id.* at 662.

¹⁰ Julian Dossett, “NFTs Are Coming for Your Video Games. Players Get Ready,” *CNET*, Jan. 21, 2022.

¹¹ See, e.g., Ind. Code sections 6-2.5-1-26.5; 6-2.5-4-16.4.

¹² See, e.g., Ark. Code section 26-52-103(10).

¹³ See SSUTA section 332(C).

¹⁴ See, e.g., N.C. Gen. Stat. section 105-164.4(a)(10).

way for an NFT seller to acquire the identity or even the location of a buyer, then how can the seller appropriately collect sales tax on the transaction?

One possibility is for a seller to follow the sourcing framework used by the Streamlined Sales and Use Tax Agreement. Under SSUTA, the sale of a product is sourced based on a series of hypotheticals beginning with whether the seller delivered the product at its own business location.¹⁵ If not, the rules continue through several hypotheticals, including whether the purchaser's delivery address is available from the seller's business records.¹⁶ Finally, SSUTA provides a default rule that may apply when a seller lacks sufficient information to apply the previous rules, in which the sourcing of the sale is essentially based on the origin of the product (for example, the location from which a digital product was first available for transmission by the seller).¹⁷

Although the SSUTA rules may be helpful for some sellers, not every state is a member of the agreement or provides a similar sourcing framework. Regardless, it would be a good practice for sellers to collect basic information about their purchasers, including their physical location. Although this information may not be required to complete a blockchain transaction (especially if cryptocurrency is involved), there may not be an easier or better way for sellers to source their NFT sales and determine whether they have a sales tax remittance obligation in a state. Taxpayers should also note that they may soon be required to collect this information as part of changes made by the recently enacted Infrastructure Investment and Jobs Act.¹⁸ That law contained two new information reporting regimes for (1) brokers who are responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person, and (2) persons with a trade or business who receive more than \$10,000 in digital assets in a transaction, or two or more related

transactions.¹⁹ Although commentators have raised concerns regarding these new requirements,²⁰ taxpayers involved in buying or selling NFTs (or operating NFT marketplaces) should analyze any forthcoming IRS guidance on the issue and consider how these requirements may complement their state sales tax compliance requirements.

Marketplaces

Another unresolved tax issue involving NFTs centers on the obligations of parties who exchange NFTs through online marketplaces. Over the past few years, several marketplaces devoted to NFTs have emerged, including OpenSea, Nifty Gateway, and Rarible. As with other types of marketplaces, an NFT marketplace is generally an online forum or platform where sellers can offer their NFTs for sale or exchange to buyers. The marketplace operator generally collects fees or a commission from the sale of NFTs conducted over the marketplace. In addition, blockchain software called smart contracts may allow marketplaces (and other parties, such as creators of NFTs) to receive a commission for each subsequent sale of an NFT.

After *Wayfair*²¹ in 2018, states began to enact marketplace laws that shifted the responsibility to collect and remit tax on marketplace transactions from the seller to the marketplace operator, effectively putting the marketplace in the shoes of the seller. Today, every state with a sales tax has enacted marketplace laws, with Missouri being the only state with a marketplace law that has not yet taken effect.²² However, marketplace laws vary from state to state; some states only tax the sale of tangible personal property sold on marketplaces while others also tax the sale of digital products and enumerated services.

¹⁹ H.R. 3684, section 80603.

²⁰ See Marie Sapirie, "Implementing the New Crypto Reporting Guidance," *Tax Notes Federal*, Nov. 22, 2021, p. 1058; Nelson Suit, Cyrus Daftary, and Phil Garlett, "Broker Crypto Tax Information Reporting Is Here, But It May Not Be Just for Brokers Anymore," 18 *J. of Taxation of Fin. Products* 3 (2021).

²¹ *Wayfair Inc. v. South Dakota*, 585 U.S. ____ (2018).

²² Missouri's marketplace law, S.B. 153 (2021), goes into effect on January 1, 2023.

¹⁵ See SSUTA section 310(A)(1).

¹⁶ See SSUTA section 310(A)(3).

¹⁷ See SSUTA section 310(A)(5).

¹⁸ Infrastructure Investment and Jobs Act, H.R. 3684, 117th Cong. (2021).

State marketplace laws present unique challenges for NFT marketplace operators. First, the marketplace must determine whether it could be considered a retailer in a state with a marketplace law. Businesses need to carefully analyze the definitions of marketplace and marketplace facilitator in states where they do business. In most states, a marketplace facilitator is generally defined as a person that facilitates retail sales by listing or advertising products offered by third-party marketplace sellers to purchasers, and the marketplace facilitator also performs additional services, such as accepting orders or processing payments.²³ If the NFT marketplace meets a state's definition of a marketplace facilitator, then it will be deemed to be a retailer that is required to register and collect tax on taxable transactions.²⁴ Note, however, that this issue is inherently tied to another challenge — the sourcing issue outlined above. To determine whether it could be considered a retailer in a state, the marketplace facilitator needs to know how to source its sales. Some marketplaces may be reluctant or unable to collect identifying information from their buyers, lest they risk losing them to another marketplace that does not require such information.

Even if the marketplace is willing and able to collect identifying information from its buyers, another problem is the classification of the items sold on the marketplace. As explained, NFTs can be tied to a variety of products, including tangible personal property, tickets, or digital products. The marketplace facilitator — an entity that is one step removed from the parties to the transaction — will likely need to know what exactly is being sold on its marketplace so that it can determine whether the sale of such an item is subject to tax. The marketplace should also consider whether any royalty fees or commissions received from subsequent NFT sales could be subject to tax.

Conclusion

Despite their popularity, it is unclear whether NFTs represent the way of the future or another fleeting phenomenon — this generation's version of the Beanie Baby. Because of the numerous complexities associated with NFTs and the rapidly changing environment, we expect that states may take their time in releasing guidance on the tax implications of NFTs. Until then, marketplaces and other sellers of NFTs should take note of the issues raised in this article and analyze how they may apply to their business model. This would include analyzing whether the business collects any identifying information about buyers, whether this information could be collected in the future, and the potential business impact of collecting this information. Marketplaces should examine whether they may be subject to state marketplace laws. Businesses taking these steps and asking these questions now should be well positioned once states start to catch up to the NFT craze and seek to enforce their sales and use tax laws on these transactions. ■

²³ See, e.g., 35 Ill. Comp. Stat. section 105/2d(a).

²⁴ See, e.g., Cal. Rev. & Tax Code section 6042.