Top Three State Tax Questions About Crypto and NFTs for Business

By Kameelah A. Kareem, Daniel B. De Jong, and Jeffrey M. Cook

Kameelah A. Kareem, Daniel B. De Jong, and Jeffrey M. Cook of KPMG LLP in Washington, D.C., discuss the most common questions they get from clients who are struggling to understand the state tax implications of digital currency.

Even though 2022 was a year marked by a crypto winter—a downturn in the cryptocurrency markets—businesses are still exploring the possibilities offered by blockchain technology, cryptocurrency, and other digital assets such as non-fungible tokens. They want to understand both the state tax and federal tax implications associated with this new technology. This article lists the top three questions we have received from our clients.

Are Cryptocurrencies and NFTs Subject to State Tax?

The sale of cryptocurrency isn't subject to sales tax. Like the federal government, states consider crypto to be intangible property, and sales of intangible property generally aren't subject to sales tax.

The states generally follow the federal treatment of crypto for income tax purposes. Under that approach, crypto transfers are treated as asset sales resulting in gain or loss determined by the difference between its fair market value at the time of exchange and the taxpayer’s basis in it. For both federal and state income tax, characterizing recognized gain or loss as capital or ordinary hinges on the purpose or use of the crypto asset in the taxpayer’s hands.

Unlike sales of cryptocurrencies, the sale of an NFT may be subject to state sales tax, but the answer depends on a couple of factors. First, the seller must determine the nature of the underlying items connected to the NFT being sold. An NFT can be associated with different types of underlying products and services, such as tangible personal property, digital artwork, or access to entertainment. Many of these are subject to sales tax, but some may be nontaxable.

Second, there's the state where the sale takes place. For sales tax purposes, sales are generally sourced to the location where the purchaser receives the products or services that were sold. With NFTs, however, sellers may have difficulty ascertaining the location of their buyer. For transactions on the blockchain, buyer location information generally isn't recorded. Therefore, a seller may need to request or acquire the buyer's location in an alternative manner to source a sale for sales tax purposes.

Sourcing issues are also important for state income tax purposes. For corporations with operations in multiple states, taxable income typically is sourced (at least in part) by a ratio of the corporation's sales in the state over its sales everywhere.

The rules for determining the sales in the state for the numerator of that ratio vary when it comes to sales of intangible assets. In many states, the sale of an intangible asset is sourced based on the location of the purchaser of the asset. As a result, there is a premium placed on the ability of an NFT seller to obtain buyer information for both sales and use tax purposes and the apportionment of state income tax.

What Are the State Tax Implications With Crypto?

Crypto is often used instead of fiat currencies, such as the US dollar, for sales of NFTs. Crypto also may be used in transactions involving other types of property or services. If a seller accepts crypto in a transaction, and the transaction is subject to sales tax, then the seller must determine how to calculate that tax.

States likely will require the seller to calculate the sales tax base in one of two ways. In the first method, the seller will need to convert the value of the crypto accepted to dollars as of the time of the transaction. The seller may need to use a crypto price index or some other method to determine its dollar value. In addition, the seller will need to maintain business records that document the value of the crypto, as well as the date of the sale, the nature of the items sold, and other basic information.

In the second method, a state may require the sales tax base to be calculated using the seller's listed or advertised price of the item sold in terms of dollars. The seller then must keep records of documents of this listed or advertised price. We would expect most states to follow this second method for calculating the tax base.

For income tax purposes, when a taxpayer exchanges property for other property or services, it's generally treated as a barter transaction. The same treatment generally applies to crypto used as a means of purchasing other assets. For example, if a taxpayer uses bitcoin to make a purchase, the transaction causes an immediate recognition of income or loss, requiring the taxpayer to determine the value of the bitcoin at the time of the transaction and the taxpayer's basis in the specific bitcoin used as payment in the transaction.

The basis of the bitcoin used by the taxpayer to make the purchase may not be easy to identify, especially for taxpayers that have made numerous purchases of bitcoin or received bitcoin from mining activities over time. Even this simple example highlights the importance of maintaining detailed information to track the basis of crypto owned by taxpayers, as this information is necessary to accurately determine the gain or loss generated from the transfer of those assets.

What Should Marketplaces Do if They Sell NFTs?

Many popular NFT collections are accessed through NFT marketplaces, which allow users to mint, or create, and sell or trade NFTs with other users. Marketplaces often impose trading fees or charge sellers with commissions, which generally are a percentage of the revenue generated from an NFT sale. Some marketplaces also charge sellers and creators of NFTs with a "gas fee," a charge to process and validate transactions on the blockchain.

NFT marketplaces first should be aware that every state with a sales tax has enacted laws that deem the "marketplace facilitator" to be the retailer required to collect sales tax on taxable sales made through the marketplace. In some cases, these laws may not apply to all types of sales, such as sales of admissions to entertainment.

Further, the definition of a marketplace facilitator in many states requires the marketplace to directly or indirectly collect or process payments made by purchasers. In blockchain transactions, it may be unclear whether the marketplace is actually involved in processing payments between the buyer and seller. The processing and validating of blockchain transactions may be handled by third-party "stakers" that have no connection to the marketplace facilitator. NFT marketplaces should review state definitions carefully to determine whether they could be considered a facilitator.

Next, NFT marketplaces may need to ensure they collect basic identifying information from their users such as addresses. As explained above, the purchaser location generally determines the sourcing of a sale for sales tax purposes. This information also can be used to determine whether the marketplace has a filing obligation in a certain state, which is generally triggered when a seller exceeds a specific sales volume or number of sales transactions to buyers located in a state. Finally, marketplace facilitators should consider the tax treatment of their fees generated for using the platform, as these fees may or may not be part of the sales tax base.

For income tax determinations, NFT marketplaces grapple with similar issues to those present in the sales and use context, especially related to obtaining and tracking information on their users.

Marketplaces that provide services to their users must identify the states in which they have activities creating a taxable presence for income tax purposes. Many states assert taxing jurisdiction over out-of-state businesses that merely have generated receipts from customers located in their state. In those states, the marketplace would need to have information on the locations of their customers to accurately determine the states in which they have a taxable presence.

For marketplaces with operations in multiple states, the tax base sourced to the states may be determined by reference to the location of the users the marketplaces charge for their services. This highlights the need for marketplaces to maintain customer data to accurately comply with their state income tax obligations but also puts pressure on the anonymity that often is present in digital asset exchanges and valued by the users of those exchanges.

Conclusion

Blockchains, cryptocurrencies, and NFTs raise novel and complex tax issues for businesses that embrace this new technology. State revenue authorities, thus far, have been slow to release detailed taxpayer guidance, but that could change in the coming months and years.

In the meantime, businesses should monitor for federal and state tax updates, and they should contact tax professionals for further assistance. Delaying consideration of these issues could result in the creation of potentially significant state tax liabilities over time.

Nicholas Carter, an intern at KPMG LLP in Washington, D.C., contributed valuable research for this article.

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