coinbase

Tax Whitepaper

From: Coinbase Tax

Subject: Non-Fungible Tokens (NFTs) and Indirect Taxes (sales taxes and VAT/GST)

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Tl;dr There is a *lack of certainty regarding the application of indirect taxes to transactions that include Non-Fungible Tokens (NFTs), specifically U.S. sales tax and Value Added Tax (VAT). However, some jurisdictions have started to impose transaction level taxes to sales of NFTs and that will expand. In the interim, there are some reasonable solutions for marketplaces to mitigate some of the risks for themselves and NFT sellers. This includes determining exposure through the use of IP addresses. Ultimately and inevitably, smart contracts will need to include transaction taxes in future sales.*

The following memo explores:

- *An introductory summary of NFTs and how they are sold or exchanged*
- *Tax considerations regarding U.S. state sales tax and global VAT/GST*

I. Introduction

Unlike cryptocurrency, which is fungible, non-fungible tokens (NFTs) are unique digital assets that are not interchangeable. NFTs are stored on blockchains like the Ethereum network, but also, on other networks as well. They can be created, bought and sold directly on the blockchain, via auctions or marketplaces. NFT marketplaces are making access to NFTs easier by providing a platform to bring buyers and sellers together.

The nature of an NFT will vary depending on its subject and its purpose. An NFT can include[1]:

- *Collectibles*

  NFT collectibles are items that are considered rare or in short supply, just as collectibles outside of the blockchain are considered such.

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[1] See PwC. (2022, January). *Non-fungible tokens (NFTs): Legal, tax and accounting considerations you need to know*. PwC. https://www.pwchk.com/en/research-and-insights/fintech/nfts-legal-tax-accounting-considerations-dec2021.pdf.

- *Gaming*
  Items of ownership or certificates of achievements in a virtual world that can be traded/sold (for example, the blockchain game Axie Infinity has Axie which are digital creatures within the game that can be bought, sold and bred).

- *Real Estate*
  Proof of ownership for physical assets like land and buildings.

- *Physical Artwork*
  Verification of ownership relating to a specific piece of art.

- *Music/Digital Art*
  Albums and bonus tracks.

- *Tickets and any form of access authorization*
  Tickets to concerts, theater events, etc.

- *Education and research*
  Certificates to prove educational achievement. Protection of research property.

Recently, NFTs have become very popular as individuals, including celebrities and athletes, create, collect, promote and sell their own NFTs. In fact, monthly NFT trading volume in January 2022 reached over $6 billion.[2]

This memo will discuss tax considerations regarding U.S. sales tax and Value Added Tax (VAT) to NFT sales. This memo will not discuss income tax considerations. For more information on individual U.S. income tax considerations when buying/selling a NFT see How are NFTs taxed? A guide for creators, collectors, and investors.

II. Tax Considerations

A. U.S. Sales Tax

U.S. states and certain localities apply sales tax (transaction taxes) to the sale or lease of certain goods and services subject to their jurisdiction. Each state (and locality) has its own definition with respect to applicable goods and services subject tax and the percentage of tax that is required to be applied.

[2] See Manoylov, MK. (2022, January 29). *Monthly NFT trading volume reaches all-time high of $6 billion in January.* The Block. https://www.theblockcrypto.com/linked/132323/monthly-nft-trading-volume-high-6-billion-january.

Currently, there is no consistent multi-state consensus on the sales tax treatment of digital assets, including NFTs. Each taxing jurisdiction varies as to whether the tax applies to digital assets and to the percentage of tax applicable to transactions that include digital assets. While the term "digital asset" can mean both financial and non-financial electronic representations, states generally use the term "digital assets" in the sales tax setting to mean digital representations of music, videos, images, etc. For purposes of this discussion, the term digital asset is being used in reference to an NFT described above and is not intended to cover cryptocurrency such as Bitcoin or Ethereum. [3]

Does that mean then that NFTs are not subject to U.S. state sales tax? No. States with very broad definitions of digital assets can and intend to capture transactions that include NFTs. And, these states will expand the enforcement mechanism for collecting these taxes to any marketplace that acts as a marketplace facilitator.

The liability of the taxpayer regarding sales tax may vary according to state sales tax rules. If a marketplace facilitator is not involved or chooses not to collect and remit sales tax, the sales tax is imposed upon the seller who is responsible for remittance. The seller may then pass the tax liability onto the buyer. In other circumstances, the sales tax may be imposed upon both the buyer and the seller responsible for collection and remittance. Or, in some states, the tax liability may be shared between the buyer and the seller.[4]

Currently, thirty-two states impose state sales tax on digital products (assets) and many have broad enough definitions of digital products (assets) to capture NFTs if their content can be viewed or heard.[5]

For example, the Texas Tax Code applies sales tax if the digital item would be taxable if delivered in physical form as tangible personal property. The definition of tangible personal property is broadly written in Section 151.009 of the Texas Tax Code as:

"'Tangible personal property' means personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner, and, for the purposes of this chapter, the term includes a computer program and a telephone prepaid calling card."

This broad definition can be viewed as potentially capturing NFTs. Ownership of an NFT does not convey *all* rights with respect to the real world item , *e.g.* a piece of visual art. In most cases, the

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[3] Bitcoin and similar fungible digital assets typically are viewed as financial in scope and therefore are not subject to transaction taxes. This is the most commonly held view for purposes of applying VAT in the EU. Similarly, commissions or fees associated with the trading of Bitcoin and similar assets are not subject to transaction taxes, such as VAT. But, there are exceptions to this treatment of commissions and fees as well (e.g., Australia, Singapore).

[4] See Wolters Kluwer. (2019, December 31). Understanding your sales tax rules and obligations. Wolters Kluwer. https://www.wolterskluwer.com/en/expert-insights/understanding-your-sales-tax-rules-and-obligations.

[5] See Kirsner, Marvin A. (2022, February 15). The National Law Review. https://www.natlawreview.com/article/state-sales-tax-sale-non-fungible-tokens-nfts-questions-and-answers.

artists themselves own the copyright, and the NFT simply conveys the "original"-ness of a creation but not the right to it. Similarly, ownership of an original piece of tangible artwork does not generally convey additional rights with respect to the work, and as such, it's easy to see why some states may have the same ability to apply sales tax to the NFT as they do to tangible artwork.

B. Value Added Tax (VAT)

Value Added Tax (VAT), or Goods and Services Tax (GST), is a consumption tax assessed on the chain of value added to transactions of goods and services. Generally, it applies to goods and services that are bought and sold for use or consumption, by either businesses or end users. Most taxing jurisdictions outside the US impose a VAT or GST of some kind to transactions conducted in their boundaries, including the EU (harmonized with varying rates by countries), and many of the member states of the OECD.

There is no international consensus regarding the application of VAT to the sale of digital assets.[6] However, based on current VAT principles, the actual delivery or exchange of NFTs and associated fees could be seen as an electronically supplied service and thus, necessitate the applicability of VAT to both (which in many cases can be higher than 20% of the total price). Some jurisdictions, such as Canada and Singapore, have clarified that their VAT/GST regimes apply to NFT transactions.

While jurisdictions have begun to address cryptocurrency activities, such as trading, for purposes of VAT, they have not yet to address NFTs with clear, specific guidance. Guidance is needed to address uncertainty and manage tax risk because as PricewaterhouseCoopers states in their recent Annual Global Crypto Report:

"Whether transactions in NFTs constitute a taxable supply (in the context of VAT) may vary region by region, which means that market players cannot simply factor in a standard cost for tax in the transaction as a one-size-fits-all approach to address the tax risks.[7] "

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[6] See above footnote 3 regarding the VAT/GST treatment of digital financial assets such as Bitcoin.
[7] See PwC. (2022, January 4). *PwC Annual Global Crypto Tax Report 2021*. PwC. https://www.pwc.com/gx/en/insights/pwc-annual-global-crypto-tax-report-2021.pdf.

C. Why does this matter?

Tax Exposure

Considering the definition of digital assets can vary from state to state, municipality to municipality and country to country, lots of confusion can be created about whether the sales of NFTs are subject to sales or consumption tax.

Despite this current confusion though, there are indications that tax authorities are beginning to focus on NFTs. As mentioned above, Canada and Singapore have clarified that their VAT/GST regimes apply to NFT transactions. Also, the United Kingdom's taxing authority (HMRC), announced on February 14, 2022, that they seized three NFTs in a suspected £1.4 million VAT repayment fraud operation, suggesting further focus on the tax treatment of NFTs under the UK VAT regime.[8]

It is only a matter of time before current global tax regulations are updated to address compliance requirements for the sales of NFTs with respect to sales and consumption tax. To mitigate tax exposure for themselves and potentially reduce the burden of sellers collecting and remitting tax, marketplaces can implement a few potential solutions using technology and location identification mechanisms.

Potential Solutions

Regardless of whether we are speaking of U.S. state sales tax or VAT, identifying a buyer of an NFT is difficult, and in most cases it's the buyer's jurisdiction that determines the amount of sales tax or VAT that is ultimately applicable to the transaction. When an NFT is bought on the blockchain, it is a private transaction in the sense that specific details like buyer name, country of residence, etc. are not disclosed.

In addition, an NFT marketplace that brings together buyers and sellers of NFTs on a common platform will not know the identity of the seller. Many U.S. states have broad definitions of a marketplace facilitator and put the burden of collecting state sales tax on the marketplace facilitator itself.

To be compliant with a specific U.S. state or country's broad definition of digital assets, an NFT marketplace, which needs to capture and remit sales tax or VAT, may consider using the IP (Internet Protocol) address of the buyer. An IP address is a unique number assigned by a buyer's internet service provider to electronic hardware devices such as computers, tablets, and printers and it allows these devices to communicate with each other and a network, like the Internet.

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[8] Paez, Sarah. (2022, February 17). HMRC Seizure of NFTs Shows Increase in Cryptoasset Enforcement. Tax Notes. https://www.taxnotes.com/tax-notes-today-international/cryptocurrency/hmrc-seizure-nfts-shows-increase-cryptoasset-enforcement/2022/02/17/7d6gr.

While it is possible for an IP address to be masked/disguised by a buyer, it is a reasonable method (in consideration of not having KYC or tax related identifying information) to identify the location of a buyer in order to then initiate the appropriate state related sales tax or VAT.

Another reasonable solution that could be used by a NFT marketplace would be the billing zip code of the buyer. The NFT marketplace could request a zip code when the buyer creates their marketplace profile (with perhaps periodic reminders for the buyer to confirm their zip code to ensure accuracy).

If the buyer uses a credit card to purchase the NFT, the billing zip code would indicate more accurately than IP address the location of the buyer and thus, be possibly more acceptable to tax authorities. However, the NFT marketplace would need to be within the payment flow in order to access the zip code. The NFT marketplace could be responsible for settling the payment in some fashion. Of course, depending on other facts, this may cause the NFT marketplace to be considered for U.S. tax purposes as a "third party settlement organization" (TPSO) under the US tax code, making it responsible for issuing US tax information returns on Form 1099-K to the seller.

Likewise, for purposes of VAT or GST, the NFT marketplace could be subject to marketplace supplier rules. For example, "the EU marketplace deemed supplier rules are akin to the U.S. marketplace facilitator laws for sales tax on ecommerce sales. Under new regulations, marketplaces will be liable to collect, report, and remit VAT when they facilitate certain cross-border business-to-consumer transactions on behalf of their third-party sellers.[9]" As noted earlier, both Canada and Singapore have applied GST to NFT sales under these facts.

While compliance using IP or buyer addresses may solve for potential liabilities of the seller or the NFT marketplace, it does not alleviate the economic exposure associated with compliance. Since transaction taxes range from 5% to over 20% of the NFT market value, the failure to collect these taxes from buyers, while submitting payment to taxing authorities greatly erodes the margin associated with these sales. An NFT marketplace that relies on commissions for sales, but which then remist 5% to 20% of the NFT market value as a compliant taxpayer, would bear a very substantial compliance cost well in excess of its commissions.

Ultimately, to ensure tax obligations are met, an NFT Marketplace that wishes to capture and remit sales tax or VAT will need to build into their marketplace smart contract (when it is chosen by the buyer and seller) an automatic application of sales tax or VAT using the identification methods described above or perhaps through the use of an identity token (including a tax

[9] Alexander, Kerry. (2021 June 10). *New EU Marketplace and VAT Rule Go Into Effect July 1.* Avalara. https://www.avalara.com/blog/en/north-america/2021/06/new-eu-ecommerce-vat-and-marketplace-rules.html.

identity token). A smart contract is a decentralized and autonomous coded agreement on the blockchain that is triggered when the appropriate criteria are met. A potential criteria would involve the collection and remittance of sales tax or VAT. Having the sales tax or VAT automatically applied would potentially be beneficial to a seller using the marketplace.

III. Conclusion

NFTs are very popular and continue to fascinate individuals and companies. With little regulatory guidance though, it is difficult to ascertain appropriate tax considerations. However, by examining existing regulations and guidance a “best practice” approach can be determined. With regards to U.S. state sales tax and VAT, “best practice” points to being prepared for the applicability of these taxes by considering potential buyer identification and applicable taxing solutions, as discussed above. This however is only a first and preliminary step to address the challenge of transaction taxes and NFT sales.

There will need to be a balance between tax solutions and the decentralized environment of buyers and sellers transacting directly on the blockchain with each other or through the platform of a marketplace. Sellers, whether individuals or entities, will face tax exposure if they fail to collect and remit sales tax or VAT when the NFT being sold is subject to such taxes. Sellers interacting directly with buyers would need to determine ways to identify the buyer, establish a method for collecting and remitting tax and ensure these methods are continuously updated with appropriate tax rates and guidance from relevant tax authorities. This can be difficult for sellers to do so the most practical option may be to sell via a marketplace that has built the infrastructure to collect and remit these taxes to revenue authorities.

Marketplaces on the blockchain are decentralized meaning that while they provide a platform for the seller and buyer to interact, they are not intermediaries, in the traditional sense of a marketplace facilitator. The laws associated with sales taxes and VAT have not caught up or captured the new paradigm associated with NFT sales, but the risk of non-compliance is present today and growing. **The decision to ignore this risk is a perilous one. Any applicable solution for identifying buyers and applying sales tax and VAT needs to balance that decentralized spirit of a marketplace with applying tax compliance best practices to mitigate potential exposure. The creation of identity tokens and enhancing smart contracts to collect and remit transaction taxes is a useful solution**. Continuing discussions and advocacy for more detailed regulations and guidance from tax authorities will be necessary to ensure accurate compliance.