How State Remote Sales and Use Tax Statutes May Impact Crypto Assets

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States are updating their sales and use tax laws to collect taxes against a new world of frequent remote transactions. With the popularity of internet commerce and efficient interstate mails and wires, commerce increasingly occurs online, and across state and national boundaries. These new state tax laws may impact cryptocurrency and crypto asset trading and sales in unexpected ways. In some instances, certain crypto-facing businesses may be considered marketplace facilitators, and thus be responsible to remit sales and use tax for transactions conducted by others acting as marketplace sellers on their platforms.

This article discusses whether certain common cryptocurrency and crypto asset-related businesses may be subject to state sales and use taxation under these new remote nexus sales and use tax laws.

ICO-Created Marketplaces

Tokens sold in initial coin offerings, or ICOs, often represented a token holder's right to participate in and benefit from the seller's future business. Many ICO issuers sold tokens to be used to buy and sell products or services sold by third parties on a marketplace expected to be created by the token issuer after its fundraising was completed. See, for example, the "ecosystem" to be created in the Munchee token offering, or Sentinel—an existing, operational distributed marketplace for computing resources and decentralized applications (i.e. dapps). These platforms allow parties to negotiate transactions and pay each other using the issued token as a payment instrument, presumably with payment from buyer to seller in that native token flowing across the issuer's blockchain network.

Under certain states' versions of the remote sales and use tax law, these platforms may be obligated to collect and remit sales tax for their customers' transactions, provided sufficient transaction frequency or value thresholds are met. To determine whether these new remote nexus laws would require payment of sales and use tax for a given transaction, we analyze whether the platform qualifies as a marketplace facilitator, whether the sellers qualify as marketplace sellers, and whether the sale at issue qualifies as a taxable transaction.

Sample Analysis

Under Florida's remote sales and use tax bill, these companies would probably be considered marketplace facilitators. The platforms facilitate the sale of others' products through a marketplace for payment, provide a virtual currency that buyers can use to purchase products from sellers, and may be understood (depending on what functions are provided by the marketplace) to provide payment processing (by allowing parties to transmit the virtual currency on the blockchain), product listing (by creating opportunities to sell on the platform), or order taking (by facilitating the offer and acceptance of the purchase by buyer and seller on the platform) services to sellers.

In this context, however, applicability of a number of terms used in the statutory definition to the conduct of a blockchain- and token- mediated market are unclear. The Florida definition of marketplace seller requires an agreement between the seller and the marketplace facilitator and pertains to "retail sales of tangible personal property or services taxable under this chapter."

Given the variety of items sold on these platforms (including products that look like hybrids of goods and services, such as computing power and digital storage), it is not clear whether the sale is a qualifying "retail sale" or a sale of "tangible personal property" or "taxable services." These definitions will vary state by state. Likewise, payment processing may have a specific definition in the context of money transmission law (although the Florida bill does not define the term or refer to a definition found in any other statute) and thus may be susceptible to multiple interpretations.

"Listing" itself sounds simple, but in this context may not be. A platform may not engage in "listing" if the seller can unilaterally indicate its desire to sell an item or service on the platform, but may be "listing" if the platform's cooperation (technical or otherwise) is needed for a seller to list item or service for sale. That the transaction must be completed by a buyer indicating assent to purchase via the issuer's platform may satisfy the "order taking" element. Given that these terms may be undefined, these ambiguities will likely be resolved via subsequent legislative action, guidance by the implementing regulator, or argument in court.

Under Hawaii's law, even hybrid technology assets/services would appear to fall within the scope of taxable transactions. The marketplace would probably qualify as an "electronic forum." Given the novelty of these marketplaces, it is unclear whether the marketplace actually "collects payment from the purchaser," or whether using a marketplace facilitator's blockchain network to transmit value in the form of crypto assets from buyer to seller satisfies the requirement of "collecting payment."

Finally, under South Dakota's law, the marketplace would appear to facilitate the seller offering for sale "products transferred electronically" or "services for delivery into [the] state"; it is not clear whether the platform's conduct qualifies as "collecting payment from a purchaser and transmitting the payment to the marketplace seller" if the buyer directly transfers a crypto asset to the seller using the issuer's blockchain.

Given that the legal classification of certain crypto assets may be uncertain, it is unclear whether tokens, for instance, qualify as "intangible personal property," "securities," or a contingent right to receive services. However, it is possible that the issuance of crypto assets that are intended to be used for payments and the operation of blockchains to facilitate transactions between users of the blockchain system may or may not fit squarely within existing definitions of terms like "retail sales," "payment processing," and "collecting payment," among others.

ERC721-based assets, like CryptoKitties, may credibly be viewed as "goods" or "intangible personal property" or "products transferred electronically." Likewise, a token that acts both as a funds equivalent and a utility, like Ethereum's ether, may credibly be classified as "intangible personal property," "services," or "products transferred electronically."

It remains unclear how a regulator may interpret certain products or activities. Activist states may attempt to collect sales and use taxes from these entities based on their interpretations of the statutory language and their application to the various types of products sold thereon. Under laws like those passed in Hawaii or South Dakota, a state may have a strong argument to tax this type of transaction platform.

Crypto Exchanges

Crypto exchanges are platforms that allow their users to buy and sell various types of crypto assets using a variety of different logical, technical, and business models. Crypto exchanges must examine whether they are marketplace facilitators under various state laws and determine whether their users' trading of crypto assets is subject to state sales and use taxation under these new laws.

The first prong of the existing or proposed Florida, Hawaii, and South Dakota remote sales and use tax laws each require that the actor "facilitates the sale of a [marketplace] seller's product through a marketplace for payment." Crypto exchanges are typically websites or web-accessible networks that provide their users with access to marketplaces to buy and sell various crypto assets. Crypto exchanges operate the technology that facilitates transactions between buyers and sellers, and they usually provide a technical interface to list a trade, and to communicate offer and acceptance between buyer and seller.

A crypto exchange typically matches bids and asks for trades of various asset pairs on its platform. Most exchanges conduct

their users' trades "off chain," meaning that they track user balances and trade activity internally, and only reconcile trades by actually transmitting assets when the user withdraws; trades "on exchange" are simply updates to lists maintained by the exchange of what each user has transferred to the exchange, and what each user may withdraw from the exchange. These platforms usually require their users to agree (via browsewrap or clickwrap agreement) to pay the exchange a percentage of each transaction, or a fee upon withdrawal of assets.

Depending on how the terms are defined, cryptocurrency exchanges may be viewed as providing payment processing, payment collection, payment transmission (exchanges facilitate transactions of cryptocurrencies and accept and send wires of fiat currency), order fulfillment, storage (especially for centralized exchanges), listing services (most exchanges determine what assets are offered for trade on the platform, but others, like EtherDelta, for instance, may allow sellers to list assets of their choice, as long as they are technically compatible), order taking, and, in a limited fashion, customer service.

Based on these facts, we can assume that most crypto asset exchanges may be considered marketplace facilitators.

Traders using crypto exchanges to sell crypto assets are likely to be considered marketplace sellers. Most crypto exchanges require their customers or users to agree to terms of service, and require them to pay some fee to the exchange platform. Thus, most cryptoasset traders will probably meet the varying statutory definitions of marketplace seller, assuming that the sale of crypto assets are the type of sales for which state sales and use tax may be collected, and that those users' sales activities meet the state's thresholds.

The legal classification of crypto assets remains an open and contentious issue. All crypto assets are not functionally or legally the same. Some are legally classified as securities, while others are more properly considered funds equivalents or commodities. If the instruments sold are securities, these transactions probably do not qualify for state sales and use tax; if the instruments sold are personal property or commodities, they may qualify as taxable retail transactions.

If the assets sold are considered funds equivalents, they may also be treated differently and under certain state laws, excluded from sales and use taxation. It is difficult to generalize what types of transactions are included in state sales and use taxation; state definitions vary widely and are subject to a multitude of complex state-specific exceptions. However, assuming that there is no specific exception for virtual currency or crypto assets, given that bitcoin (and perhaps less unanimously, Ethereum's ether) are likely to be considered either property or a commodity, a sufficient number of sales or trades of U.S. dollars for bitcoin or ether, or trades of bitcoin for ether, may be considered the sale of "intangible personal property" or "products transferred electronically" and thus subject a trader with sufficient trading activity to state sales and use tax obligations.

This result may lead to the somewhat unusual situation in which states tax a sale of an item using its sales and use tax, while the federal government subjects the same asset to payment of capital gains.

Thus, although uncertainty exists as to how various state tax authorities will interpret certain crypto asset-related activity, and as to the interpretation of certain terms included in various state laws, crypto exchanges that allow users to buy and sell assets classified as personal property or commodities on their platforms may be required to collect and remit sales taxes for those transactions if their users engage in sufficient transactions to satisfy the state nexus-producing jurisdictional minimums.

Anonymous Marketplaces

Certain cryptocurrency and cryptocurrency-enabled exchanges and marketplaces allow parties to transact anonymously and, in certain cases, without recording the amounts of assets transacted. Although many remote nexus sales tax laws include a safe harbor intended to protect the marketplace facilitator from liability if the seller provides wrong or incomplete information, it is doubtful that this protection would extend to a marketplace designed to provide anonymity and to obscure information needed for reporting.

In that case, it would appear that the platform could itself be viewed by regulators as an improper attempt to avoid tax compliance and could potentially subject both the principals in control of the marketplace facilitator and marketplace sellers (if they could be identified) to civil or criminal penalties.

Ethereum

The Ethereum system, taken as a whole, may be viewed as a marketplace facilitator and its users, as marketplace sellers, which may then subject transactions occurring upon the Ethereum system to state sales and use taxes.

Again, the first inquiry is whether Ethereum "facilitates the sale of a marketplace seller's product through a marketplace for payment," and is paid a fee. Although it remains unclear whether Ethereum is a software system or an unincorporated association operating a collective business venture, it is universally understood that the operating Ethereum system allows sellers to create and sell assets (i.e., ERC20 tokens or ERC 721 NFTs) via the Ethereum software/platform in exchange for payment of ether, and allows Ethereum users to sell computing services to other Ethereum users in exchange for payments of ether.

Looking at Ethereum as mere code, it would not likely qualify as a marketplace facilitator. Looking at Ethereum as a business platform, it would appear to satisfy the first prong of most state remote sales tax bills and laws. This determination will depend on how states' tax authorities interpret Ethereum. States looking for comparisons may find similarities between Ethereum and cloud computing and cloud data storage platforms. If paying for the use of Amazon Web Cluster, Microsoft Azure, and other similar cloud computing providers is considered by a state to be a transaction subject to its sales and use tax, both purchasing tokens and smart contract execution would likely be handled similarly.

Next, a state may analyze whether Ethereum provides a forum in which sellers list or advertise property for sale, whether it transmits offer and acceptance, owns or operates infrastructure that brings together buyers and sellers, provides a virtual currency, or provides software R&D related to a seller's products.

It may be argued that Ethereum communicates offer and acceptance in transactions for the purchase of ERC20 tokens by users of its system. In that case, payment of ether and delivery of the ERC20 token occurs and is recorded on-chain in exchange for a payment of ether to the seller of the ERC20 token, which is likewise recorded on chain. These activities may be considered to be the transmission of offer and acceptance on the Ethereum system's own infrastructure.

Less clear is whether there exists an "Ethereum" itself, and whether that legally identifiable "Ethereum" owns or operates any infrastructure. Arguably, there is a small control group who owns most of the Ethereum ether, another small group that dominates the system's technical development, and yet another group of people who dominate its mining, any of whom could be argued to "control" Ethereum.

Arguably, Ethereum is broadly decentralized, and no person or group controls it. (The authors take no position as to the truth or impact of claims of decentralization; "decentralized" itself means different things to different people and may refer to political control, actual technical control, mining control, governance control, etc.)

Legally, the consortium of actors operating Ethereum (developers, node operators, miners, smart contract developers, etc.) may be viewed as a collective legal actor, i.e., a general partnership or an unincorporated association, which may subject each of the various participants to co-extensive liability. This is a major issue affecting virtually all decentralized systems facilitating commerce that remains unresolved. Given the questions underlying control and operation of public network systems, it is unclear whether a public blockchain such as Ethereum would qualify as a marketplace facilitator.

Unquestionably, Ethereum provides its own virtual currency for its users to buy and sell products on its platform; the ether crypto asset is used to buy or sell, among other things, ERC20 and ERC721 assets from others. It is less clear whether increments of ether sold as "gas" to purchase computation services provided by the Ethereum platform qualifies as a taxable sale, as the gas is paid to those who mine Ethereum, not to a centralized, monolithic "Ethereum" entity or other easily identifiable seller.

Finally, states will attempt to determine if Ethereum provides payment processing, or collects payment and transmits payment, or provides fulfillment, storage, and listing services. Depending on how states interpret those terms, it is possible that Ethereum could be viewed as providing payment processing, listing, storage, collection, and transmission for sales of ERC20/ERC721 assets, and potentially for the execution of smart contracts as well. Both the sale of an ERC20 token and

the payment for the execution of a smart contract requires payment of "gas," which would appear to fulfill the "payment for service" element as well. Ignoring whether there is a central "Ethereum" entity to respond, Ethereum may qualify as a marketplace facilitator.

Individual users of Ethereum may be considered marketplace sellers. Although users accept a licensing agreement before operating any Ethereum software, a user is not required to accept a license to buy or sell ether (or any other asset) on an exchange or from another person. However, an agreement between a user and "Ethereum" may be inferred or implied by conduct when a user transacts assets across the Ethereum blockchain.

Transactions using the Ethereum blockchain require payment of value, or "gas" to Ethereum. This implied agreement to pay the Ethereum system in order to transact upon it may be viewed as a contract with a platform that pays fees to the platform for transactions. It is plausible that a taxing authority may conclude that Ethereum users have agreements with Ethereum and pay for use of the platform, and thus could be considered marketplace sellers.

Depending on the specific statutory language, certain states' remote sales and use tax laws may include purchases of ERC20 or ERC721 tokens and smart contract execution as transactions that qualify for sales and use tax. Both the purchase of a digital collectable and payment for the execution of smart contract code may qualify as "intangible personal property" or "products transferred electronically," or a taxable service, which depending on the state statutory language, may qualify as a transaction for which state sales and use tax may be required to be paid.

Assuming a state decides that Ethereum is a marketplace facilitator that allows marketplace sellers to sell taxable goods or services, which would then obligate Ethereum to collect and remit state sale and use tax, it is unclear which group of legally accountable entities should be held responsible for payment of state sales and use tax Some have argued that the "decentralized" nature of Ethereum suggests that no identifiable person or group can be held responsible. Others have suggested that miners who are paid to confirm transactions made by others should pay these taxes out of the mining fees collected. A cottage industry may emerge for the development of compliance tools to allow Ethereum miners or node operators to stay in compliance by withholding amounts from block rewards to pay a pro rata share of sales and use tax.

Proponents of "decentralization" would claim there is no central monolithic "Ethereum" to pay any sales tax. However, Ethereum's founder and spiritual leader, Vitalik Buterin, recently suggested that the Ethereum community could adopt a norm wherein wallet companies could be paid tips; he could similarly suggest a norm that includes compliance with sales tax laws and suggest that miner rewards be diverted in part to pay sales tax obligations. Unfortunately because, these systems are so new, and issues of decentralization remain unresolved, we're left with more questions than answers.

Crypto-related businesses that are concerned they may have sales tax obligations as a result of these new remote nexus sales and use tax laws should retain the advice of qualified counsel and perhaps consider seeking an advisory opinion from the taxing authority in the appropriate locality.

For more information, read parts 1 and 3 of the series.