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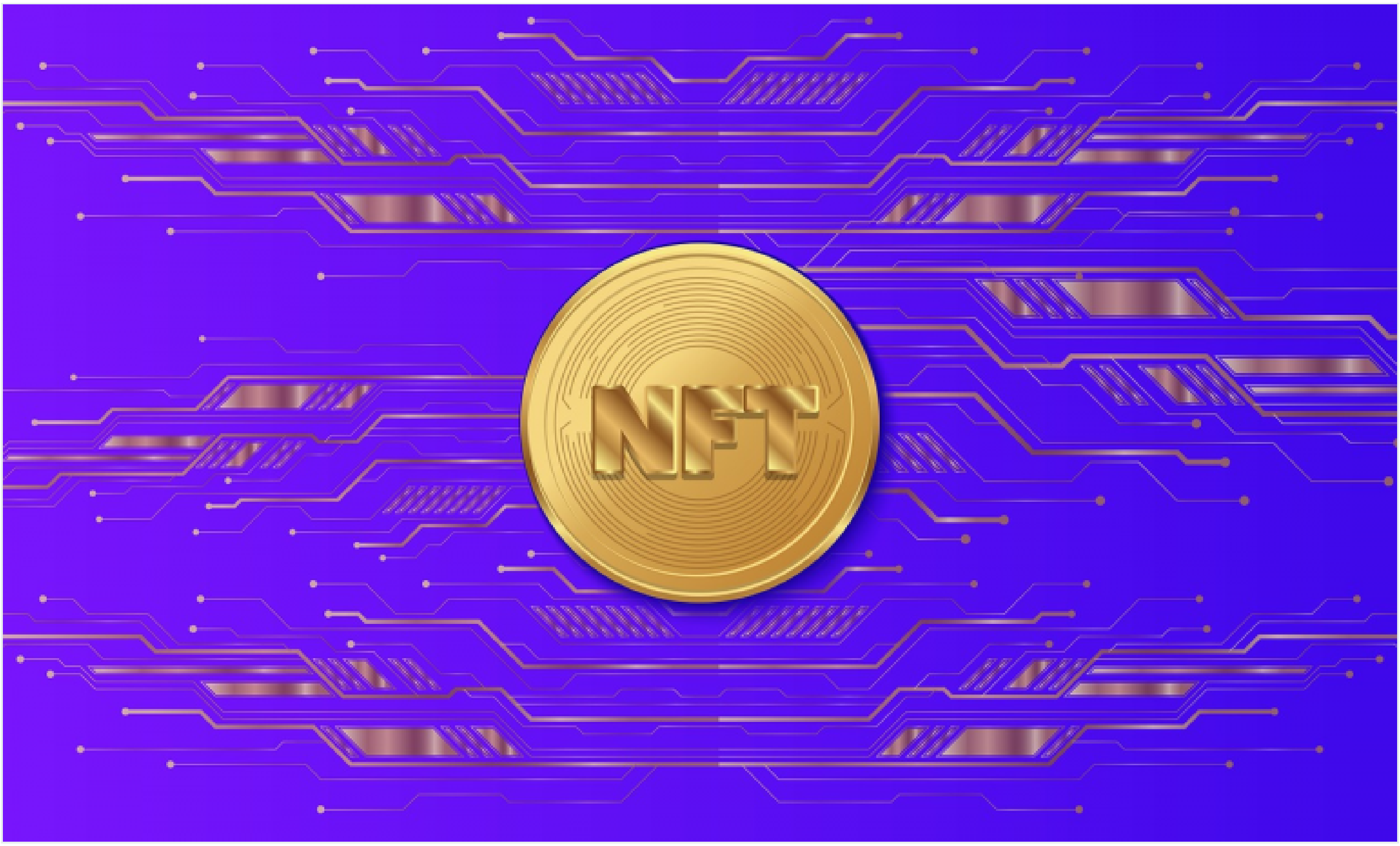
specific exemption or exclusion), most states haven't yet clarified which sales tax laws apply to sales made in the metaverse. When will they start?

Gail Cole • Jan. 26, 2022



If "cities begin in the mind" and "very large social units are always, in a sense, imaginary," as David Graeber and David Wengrow propose in The Dawn of Everything: A New History of Humanity, perhaps the metaverse isn't all that different from the world in which we live. While it may be easier to transform ourselves and our settings in virtual realities, we still interact with others and, increasingly, engage in commercial activity. For there's money to be made in the metaverse. That's surely why many people are there.

And where there's money, sooner or later there will be taxes. However, many states

how to approach taxing it."

Since tax and government officials aren't the only people baffled by the metaverse and NFTs, a brief explanation is in order. Collins Dictionary defines NFT as "a unique digital certificate, registered in a blockchain, that is used to record ownership of an asset such as an artwork or a collectible." Blockchain is "a system for storing records of transactions using digital currencies that can be accessed by linked computers."

An NFT can be a jpeg of a child's drawing (worth more in sentiment than dollars) or an original digital design by Beeple (worth more than $69 million). There are NFT sneakers by Adidas and Nike, NFT belts and handbags by Gucci, even NFT real estate. It seems the more businesses invest in NFTs and virtual worlds, the more consumers are willing to spend to enhance their own virtual experiences — or even profit from speculative purchases and resales of popular NFTs.

Indeed, resales in the metaverse can be more profitable for businesses than resales in the physical world. Retailers can get a cut every time an NFT changes hands in the metaverse by attaching a royalty agreement to the NFT. In the physical world, retailers generally have no control over what consumers do with the goods they purchase.

With NFT sales totalling $24.9 billion in 2021, tax administrators are bound to take note. And they're starting to. Addressing fellow tax administrators via LinkedIn, Special Advisor to the Deputy Secretary for Taxation at the Pennsylvania Department of Revenue Kevin Milligan says, "Admit it. You've already looked ahead. You said it. NON-FUNGIBLE TOKENS, NFTS. 'They are subject to sales tax.' Or perhaps your state/city hasn't amended its statute yet. Then your acceptable variation to the theme is, 'They should be taxable.'"

But no state has expressly come out and said NFTs are or aren't taxable. Not yet.

Scott Peterson, vice president of government relations at Avalara, says states that are

controversy that is costly and time-consuming."

Virtual transactions could be the next Wayfair moment for states

According to Lingerfelt, states that tax sales of digital property — and eventually all states likely will — have the capacity to extend their sales tax to other forms of digital property like NFTs. Indeed, he believes many states already have the authority to tax NFTs and digital property under existing statutes, though there's a clear distinction between digital property (which is a copy) and an NFT (which is an original asset). The question is, will they?

If states don't get in front of this issue soon, Lingerfelt warns, it could become another Wayfair.

Wayfair refers to South Dakota v. Wayfair, Inc., the 2018 ruling by the Supreme Court of the United States that allowed states to tax remote sales. Prior to the Wayfair decision, states were largely limited to taxing sales by businesses with a physical presence in the state (what would that even mean for the virtual world?). States tried numerous tactics to enhance remote sales tax collections as untaxed online sales rose, including affiliate, click-through, and cookie nexus laws, as well as use tax reporting requirements for non-collecting sellers. It was a confusing and litigious time, and its legacy lingers: Many businesses still struggle to understand how today's remote sales tax laws (i.e., economic nexus and marketplace facilitator laws) apply to them.

The fact that "creators of NFTs are adding physical goods as well as virtual goods and services to their NFT offerings" could further complicate sales and use tax. Which transactions would be subject to sales and use tax if an individual purchases an NFT for a pair of limited-release digital shoes, and ownership of that NFT allows them to receive a physical pair of limited-release shoes should the manufacturer produce them? Would sales or use tax apply if a purchaser of limited-release digital shoes

headquarters where it will "offer real world services that are critical to the metaverse world." According to Prager Metis CEO Glenn Friedman, "Our new Metaverse headquarters will serve as a bridge between traditional and digital and offer valuable real world financial services to the metaverse." He says the company is already seeing "every industry and type of business want to enter the world of digital assets." They'll need tax advice.

To facilitate tax compliance in a world that includes a metaverse, Lingerfelt says state and local tax policymakers may want to consider four legislative reforms to increase sales tax compliance, including authorizing and funding the creation of a blockchain for sales tax administration. He believes the groundbreaking technology used to build the metaverse could eventually help tax authorities do their jobs.

"NFTs could fundamentally change tax compliance"

"Almost no one is talking about the blockchain for tax administration," Lingerfelt says. But they should be.

"The blockchain could fundamentally change tax compliance," he explains. "It could minimize the need for audits." States would have all the information they need sitting in front of them. Sales tax questions and other issues could be worked out in the blockchain, in real time. Assessments would be generated automatically.

States aren't there yet. Some, like Massachusetts, have proposed real-time compliance measures, but resistance is strong. When it comes to digitalizing tax compliance, the United States tends to lag far behind the European Union and other parts of the world; but Lingerfelt thinks we'll get on board eventually. Read his article on LinkedIn for additional insights.

This is just the beginning

This post just scratches the surface. Taxing the metaverse will likely prove to be as

relationships with its own rules, roles and structures that are held in the mind." But virtual worlds are still part of our vast world, and as such, they must be subject to laws and, of course, taxes.

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