Tax Clinic

Cryptoasset transactions: State corporate income tax implications .

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STATE & LOCAL TAXES

Many businesses that once considered cryptoassets a highly speculative investment have been won over by the secure, real-time, peer-to-peer nature of cryptoasset transactions and now use cryptoassets as a part of their overall strategy to fund operations and to engage in day-to-day business transactions with customers.

Such businesses will need to keep a watchful eye on the state tax, as well as federal tax, implications of such transactions. For example, businesses will need to consider timing and valuation issues related to income and/or gain recognition, sourcing issues related to mined cryptoassets, recordkeeping issues related to acceptance/utilization of cryptoassets in the regular course of business, issues related to the periodic conversion of cryptoassets to fiat currency for the purpose of making domestic and foreign tax payments (e.g., sales and use tax, value added tax), and income classification and revenue-sourcing issues related to buying and selling cryptoassets through virtual currency exchanges.

This discussion examines how state corporate income taxation applies to virtual currency exchange transactions. The specific focus is income classification and revenue-sourcing issues, with California law used to illustrate how states may address such issues.

Cryptoassets as ‘property’ for tax purposes

The IRS has indicated that taxpayers must treat cryptoassets (which it generally refers to as virtual currency) as property and that the general tax principles applicable to property transactions also apply to cryptoasset transactions (Notice 2014-21). Accordingly, corporate taxpayers that use cryptoassets must apply these principles when calculating their taxable income for federal tax purposes.

Because federal taxable income is generally the starting point for calculating taxable income for state corporate income tax purposes, the federal tax principles that apply to cryptoasset transactions are baked into taxable income for state tax purposes, unless such principles are modified under state law. It does not appear that any state has decoupled from or modified these federal tax principles, and at least one state, Wisconsin, has expressly adopted them. Specifically, in Tax Bulletin No. 213 (April 2021), Wisconsin informed individual and business taxpayers that the state follows the federal treatment of cryptoasset transactions and also clarified that taxpayers must treat cryptoasset transactions similar to transactions involving other types of intangible property. Illinois also

expressly classifies cryptoassets (specifically referring to Bitcoin, a type of cryptoasset) as intangible personal property for state tax purposes (IT21-0004-GIL (August 2021)).

Business income vs. nonbusiness income classification

How taxpayers treat the sale, use, or exchange of cryptoassets depends on whether the transaction is properly classified as business or nonbusiness income. What constitutes business income varies slightly by state, but a significant number of states apply the Multistate Tax Compact definition, which provides that business income is income "arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations" (Art. IV, Para. 1(a)).

Under this definition, the sale, use, or exchange of cryptoassets is properly classified as business income if a taxpayer acquires, maintains, and disposes of the cryptoasset as an integral part of its regular trade or business operations. Nonbusiness income is generally defined as all income that is not business income. Understanding income classification is critical to proper compliance, as business income is subject to apportionment among multiple states whereas nonbusiness income is generally allocable to a single state (in the case of nonbusiness income derived from the sale of intangible personal property, this is generally the taxpayer's state of commercial domicile).

Apportionment and revenue assignment

Apportionment is the method by which multistate taxpayers divide their incomes or losses among the various states in which they have a taxable presence. The states are free to develop their own apportionment methodologies as long as those methodologies pass constitutional muster. The majority of the states apply a single sales factor method of apportionment, which means the state taxes a share of the corporation's total profit that is based on the share of the corporation's nationwide sales occurring in that state. Some states, however, continue to use a multifactor formula that considers the multistate taxpayer's property and payroll as well as sales. Multifactor formulas can be weighted in a variety of ways (e.g., equally weighted, double-weighted sales, etc.). As state taxation is trending toward the single sales factor method of apportionment and considering that payroll and property factors are not generally affected by intangible property, the remainder of this discussion focuses on how cryptoasset transactions are treated for sales factor apportionment purposes.

The sales factor for any particular state is a fraction consisting of the taxpayer's sales attributable to that state in the numerator and the taxpayer's total sales in the denominator. What constitutes "sales" for this purpose varies by state. Several states have updated their definitions of "sales" or "gross receipts" (based on changes to the Multistate Tax Compact definition) to (1) include only receipts from transactions in the regular course of the taxpayer's trade or business, except (2) excluding receipts from hedging transactions and/or treasury operations, and, importantly here, (3) excluding receipts from intangibles unless the intangible is a government license, geographic license (e.g., cable TV, FCC), etc.

To the extent a particular state includes gross receipts from the sale, assignment, or licensing of intangible property in the sales factor (e.g., California), determining the amount of total gross receipts to include in the denominator is relatively straightforward. However, determining the amount of gross receipts to include in the numerator (i.e., the sales attributable to any particular state) can be complex because revenue assignment rules vary by state.

California as an illustration

For example, California "sales" generally include gross receipts from the sale, assignment, or licensing of intangible personal property (see Cal. Code Regs. tit. 18, §25134(a)(1)(E)). But California taxpayers should first consider how they are using their investments in cryptoassets before automatically including such receipts in their California sales factor. Specifically, taxpayers may exclude from their California sales factor "interest and dividends from intangible assets held in connection with a *treasury function* of the taxpayer's unitary business as well as the gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of such intangible assets" (Cal. Code Regs. tit. 18, §25137(c)(1) (D), emphasis added). For this purpose, a taxpayer's "treasury function" is the "pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. … [and] includes the use of futures contracts and options contracts to hedge foreign currency fluctuations" (id.).

If taxpayers must generally include gross receipts from sales of intangible personal property in their sales factor calculation and there is no applicable exception (e.g., the treasury function provisions discussed above), the majority of states require taxpayers to assign their revenue using the most specific information possible. To make this process easier, many states have issued guidance on how to assign (or source) gross receipts from sales of intangible property. California, for example, requires taxpayers to assign gross receipts from sales of intangible property to California to the extent the property is used in California (Cal. Code Regs. tit. 18, §25136-2(d)(1)).

Taxpayers are required to determine the "location of the use" by using a cascading set of rules. First, if there is a contract between the parties that indicates that the property is used in California at the time of the sale, use of the property is presumed to be in California (Cal. Code Regs. tit. 18, §25136-2(d)(1)(A)). If there is no contract, or if the taxpayer overcomes the presumption that the property is used in California, the location of the use must be reasonably approximated (Cal. Code Regs. tit. 18, §25136-2(d) (1)(B)). Finally, if the location of the use cannot be reasonably approximated, the location of the use is in California if the purchaser's billing address is in California (Cal. Code Regs. tit. 18, §25136-2(d)(1)(C)).

In the context of a single sale of cryptoassets made to a known purchaser, California would likely deem the "location of the use" to be in California if the purchaser is located in California. Unfortunately, cryptoasset transactions seldom occur that way. Rather, the majority of cryptoasset transactions occur through exchanges where buyers and sellers

very rarely know each other. The revenue assignment analysis becomes much more challenging in this scenario where there are no contracts between the buyers and sellers and where there is an intended degree of anonymity.

In this context, California requires taxpayers to reasonably approximate the location of the use, taking into consideration all sources of available information to determine the location of the use of the intangible property. As the term "reasonably approximate" suggests, the method used to approximate the location of the use must be reasonable. California does not require any particular method; however, the state has issued guidance that applies when certain reasonable approximation methods are used.

In cases where the reasonable approximation method involves geographic locations, California requires taxpayers to include in the numerator of the approximation ratio the population of the jurisdiction where the purchaser uses the intangible property at the time of the sale and the total population of the purchaser's country in the denominator. To the extent the taxpayer can demonstrate that the intangible property is being materially used outside the United States, the populations of those other countries of use must be added to the denominator of the approximation ratio (Cal. Code Regs. tit. 18, §25136-2(b)(7)).

Given the nature of cryptoasset transactions completed through an exchange, it is unlikely that the taxpayer will have any information regarding where the purchaser is located. As such, it is likely reasonable for taxpayers to approximate the location of the use based on where the purchaser could potentially be located based on their use of a particular exchange. In theory, any particular purchaser could be located anywhere in the world; however, California would likely deem including the global population in the denominator of the approximation ratio to be unreasonable. Instead, taxpayers may wish to consider where the purchaser is most likely located.

One method for making this determination could be considering the markets in which the exchange operates (i.e., it is likely reasonable to conclude that the exchange places servers into service in markets that it heavily exploits, so including the populations of those countries in the denominator of the approximation ratio is likely reasonable and provides a more accurate result). As with any reasonable approximation method, documentation and consistency are paramount to maintaining revenue assignment positions on state corporate income tax returns.

As cryptoasset transactions become more prevalent in the business environment, the states will continue to adapt and develop rules that more clearly define how taxpayers must report income and losses resulting from those transactions. In the meantime, taxpayers should seek formal instructions from the states regarding the treatment of specific transactions or look for guidance in more well-settled areas (e.g., the California treatment of sales of intangible property described above) for guidance.

Editor Notes

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