

NY Tax Considerations For Fund Managers Handling Crypto

By **Zal Kumar, Michael Kerman and Leah Robinson** (August 19, 2021, 2:49 PM EDT)

It is stating the obvious to note that virtual currency or cryptocurrency has become more mainstream in 2021.

As major financial institutions have begun working with cryptocurrency, it has become a more accessible asset class, and New York state and New York City tax questions have begun to arise for traders and fund managers in New York.

This article addresses potential New York City unincorporated business tax and New York state personal income tax considerations, namely, whether transactions in cryptocurrency should be considered eligible for the taxes' respective self-trading exemptions. It also addresses whether cryptocurrency should be subject to sales and use tax at the state and city level.

Overview

The federal tax treatment of cryptocurrency, together with the structure of the unincorporated business tax and personal income tax exemptions, guidance from New York state, and recent case law, supports the position that trading cryptocurrency should qualify as an exempt self-trading activity under the unincorporated business tax and personal income tax, assuming it does not occur in connection with an otherwise taxable business, such as that of a dealer.

Similarly, cryptocurrency's status as intangible property under state guidance means that it should not be subject to sales and use tax.

Unincorporated Business Tax Exemption

Unincorporated businesses, other than dealers, engaged entirely in buying and selling property for their own account are not subject to unincorporated business tax based on a statutory provision that is commonly referred to as the self-trading exemption.[1]

A partial exemption exists if the entity earns income from taxable activities, but at least 90% of its assets still meet the criteria for exemption; in that case, its business income remains taxable, but its self-trading income is exempt.[2]

An unincorporated business taxpayer determines its net income by reference to federal gross income and deductions, which means the unincorporated business tax conforms to the Internal Revenue Code where applicable.[3] The statute defines qualifying property broadly to include stocks, bonds, derivatives, commodities, foreign currencies and other securities, but it does not reference cryptocurrency.[4]

Cryptocurrency's absence from this list is not surprising given its relative infancy compared to the New York City tax code, but it raises issues for funds and traders that are trading



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cryptocurrency. If it is not a good asset, it could both generate taxable income and break full or partial self-trading exemptions, potentially rendering funds and trading entities taxable on otherwise exempt income.

The unincorporated business tax regulations, however, state that property comprises real and personal property and includes but is not limited to a series of common financial assets.[5]

This definitional structure would logically include cryptocurrency because it is personal property and a financial asset that serves an investment purpose when it is not held by a dealer for sale. This is exactly the type of asset that is intended to qualify for the self-trading exemption, and the "not limited to" language leaves the exemption open to new types of assets, such as cryptocurrency.

While New York City has not published clarifying guidance, the IRS has stated that cryptocurrency is property for federal income tax purposes; this treatment should confirm cryptocurrency's status as a qualifying asset for unincorporated business tax purposes as well.

In 2014, the IRS issued Notice 2014-21, which contains several FAQs addressing the federal tax treatment of transactions involving cryptocurrency.

The IRS recognized that cryptocurrency may be used to pay for goods or services, held for investment and digitally traded among users.[6] Thus, in response to the first question raised in the notice — how virtual currency should be treated for federal income tax purposes — the IRS answered, "virtual currency is treated as property," and "general tax principles applicable to property transactions apply to transactions using virtual currency." [7]

The IRS goes on to state in Answer 7 that a "taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer." [8] This approach should flow through to the unincorporated business tax.

The unincorporated business tax does not distinguish between capital gains and losses, but the federal treatment as property is fundamental to the calculation of income or loss from the asset, which then determines unincorporated business tax gross income and loss. The unincorporated business tax is therefore tied to the federal status of cryptocurrency as property.

Personal Income Tax Nonresident Exemption

For personal income tax purposes, a resident is taxable on all income wherever earned, and the exemption status of cryptocurrency is less relevant — that is, residents are taxable on all their income from cryptocurrency trading, and no exemption applies.

Nonresidents, including investors and partners in funds managed from New York state, however, are only taxable on income sourced to the state, either as business income or income that is specifically allocated to the state, such as salary or gains from New York real estate. In this regard, buying and selling property for one's own account is not considered to be a trade or business.[9]

Further, income from intangible property is not sourced to New York unless the underlying asset is used in a trade or business carried on in the state.[10] This means most

nonresident partners in New York managed funds are able to claim that their shares of income from the funds are not state-sourced because they do not arise from a New York trade or business and are not otherwise allocated to New York.

The personal income tax, unlike its unincorporated business tax cousin, does not define property or intangible property or provide an exclusive list of qualifying assets. This provides more flexibility than the unincorporated business tax and has generally meant that a partial self-trading exemption exists without the same strictures contained in the unincorporated business tax.

Nevertheless, the personal income tax also does not mention cryptocurrency and therefore leaves some ambiguity around its status for nonresident exemption purposes.

Fortunately, New York state has, however, conformed to the IRS approach through guidance issued by the New York State Department of Taxation and Finance. The department has stated it will characterize cryptocurrency as property, all but ensuring its status as an asset that qualifies for the self-trading exemption.[11]

The New York Tax Appeals Tribunal's recent decision in *In re: LePage* also supports this treatment.[12] The tribunal determined that for purposes of the state's mandatory S-corporation election under New York Tax Law Section 660(i), "investment income" includes gain realized on the sale or exchange of property, including goodwill.

The tribunal reasoned that the federal treasury regulations' approach to goodwill as property should determine its treatment for New York state personal income tax purposes because of the state's federal conformity rule in New York Tax Law Section 607(a).[13] The tribunal's analysis in the S-corporation election context supports applying cryptocurrency's federal status as property to the New York City and state self-trading exemptions as well.

New York Sales Tax Considerations

Trading cryptocurrency or using cryptocurrency as currency in the purchase or sale of goods or services may also raise sales tax questions.

Fortunately, the department has issued guidance on the sales tax treatment of transactions involving cryptocurrency. The department determined that because cryptocurrency is intangible property, the purchase of cryptocurrency is not a taxable transaction for sales tax purposes.[14] Thus, buying and selling cryptocurrency for investment purposes should not trigger any sales tax obligations. However, if someone uses cryptocurrency as payment for taxable goods or services, the purchaser will owe sales tax on the market value of the cryptocurrency at the time of the transaction.[15]

Nonfungible Tokens

The treatment of nonfungible tokens, or NFTs, as qualifying property likely requires a more fact-specific analysis. Unlike cryptocurrency, which is fungible and operates like a traditional currency, each NFT has a unique digital signature representing a single item, such as a piece of art, a video or even a tweet.

Whereas one unit of cryptocurrency may be exchanged for another unit, or converted into dollars, the same is not necessarily true of two NFTs. This means that each type of cryptocurrency is its own, specific type of property, but an NFT is defined by the item that it represents, which may be cryptocurrency or something else.

Thus, the tax status of an NFT may depend on the circumstances of the purchase and sale and the nature of the particular NFT in a way that is different from cryptocurrency.

Similarly, the individual circumstances surrounding the purchase and sale of an NFT may affect whether the transaction remains exempt from sales tax as intangible property pursuant to the department's guidance for cryptocurrency. Prior department guidance in a somewhat related context, however, may be helpful.

Specifically, the department has consistently determined that sales of music recordings electronically transferred or downloaded are not subject to sales tax because such transactions involve intangible property.[16]

Though NFTs may not be exactly the same as digital music downloads, they also involve the online transfer of digital property and, thus, would likely constitute intangible property that is not subject to sales tax under the Department's rationale for music downloads.

Conclusions

Cryptocurrency raises a variety of state and local tax questions. Fortunately, in New York, the existing statutory frameworks and guidance support treating cryptocurrency as an asset that can fit within current exemption frameworks.

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[1] N.Y.C. Admin. Code § 11-502(c)(2).

[2] N.Y.C. Admin. Code § 11-502(c)(4)(B).

[3] N.Y.C. Admin. Code §§ 11-506, -507.

[4] N.Y.C. Admin. Code § 11-502(c)(1)(A).

[5] 19 RCNY § 28-02(g)(3).

[6] IRS Notice 2014-21 at 1.

[7] Id.at 2.

[8] Id.at 3.

[9] N.Y. Tax Law § 631(d).

[10] N.Y. Tax Law § 631(b)(2).

[11] New York Dep't Taxation and Finance, TSB-M-14(5)C (Dec. 5, 2014); TSB-M-14(7)I (Dec. 5, 2014); TSB-M-14(17)S (Dec. 5, 2014).

[12] No. 828035 (N.Y. Tax App. Trib., May 17, 2021).

[13] Id.at 25 (referencing 26 C.F.R. § 1.61-6(a)).

[14] New York Dep't Taxation and Finance, TSB-M-14(17)S (Dec. 5, 2014).

[15] Id.

[16] New York Dep't Taxation and Finance, TSB-A-07(14)S (May 17, 2007); TSB-A-01(15)S (Apr. 18, 2001).