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COURT OF APPEALS UPHOLDS USE TAX LIABILITY AGAINST MICHIGAN COMPANY FOR ITS DIRECT MAIL ADVERTISEMENTS DISTRIBUTED INTO MICHIGAN EVEN THOUGH PROCESSED, PRINTED AND MAILED OUT-OF-STATE BY A THIRD PARTY

In a published opinion issued June 20, 2024, in the matter of *AAA Life Insurance Company v Michigan Department of Treasury* (Docket No. 365613), the Michigan Court of Appeals affirmed the Opinion and Order issued by the Court of Claims (Docket No. 21-000242-MT), which had granted Treasury's motion for summary disposition and denied the Taxpayer's motion for summary disposition.

The legal issue in this case was whether AAA Life Insurance Company ("Taxpayer"), a life insurance company headquartered in Michigan, "used" direct mail advertisements in Michigan so that it became liable for tax under the Use Tax Act ("Act") for the direct mail allocated to Michigan even though a Missouri marketing company ("Marketing Co") processed, printed, and mailed those advertisements on behalf of Taxpayer outside Michigan.

The Court described the following relevant factors, based on the Act and caselaw, that determine taxability under the Act: (1) tangible personal property must be involved; (2) the taxpayer must exercise a right or power incident to ownership of that tangible personal property; and (3) the exercise of that right or power must occur in Michigan. The Court emphasized that under *Auto-Owners Ins Co v Dep't of Treasury*, 313 Mich App 56, 70 (2015), the "key feature" in determining whether a party exercised a right or power over tangible personal property is whether the party "had some level of control over that property." While noting that there were only two binding cases dealing with use tax in relation to a product produced out-of-state and then distributed in Michigan by another company (e.g., *Sharper Image Corp v Dep't of Treasury*, 216 Mich App 698 (1996) and *Ameritech Publishing,Inc v Dep't of Treasury*, 281 Mich App 132 (2008)), the Court explained why the results in those decisions differed by observing that in Sharper Image the plaintiff had no control at all once the catalogs were delivered to the postal service outside Michigan, whereas in *Ameritech Pub* the plaintiff maintained at least some control after the directories were picked up from the out-of-state printer.

In addition, the Court not only distinguished *Sharper Image* and *Ameritech Publishing* from the facts of this case (e.g., by noting that in both of those cases, the plaintiff was either based outside Michigan or the location of plaintiff was not known), it also emphasized that *Ameritech Pub* focused on contractual rights and responsibilities as the basis for its ruling. Accordingly, the Court rejected Taxpayer's argument that its rights under its contract with Marketing Co were irrelevant and ruled that it is proper to consider those rights to determine

continued on page 2

IN THIS ISSUE

Page 1-2
Court of Appeals Upholds Use Tax Liability Against Michigan Company for its Direct Mail Advertisements Distributed into Michigan Even Though Processed, Printed and Mailed Out-Of-State by a Third Party

Page 2
Recently Issued Guidance from Treasury

Page 3
Court of Appeals Holds Corporate Officer is Responsible for its Former Limited Liability Company's Unpaid Withholding Taxes

Page 3-4
Court of Appeals Affirms That a Taxpayer Holding Real Estate Mortgage Investment Conduits Cannot Exclude Excess Inclusion Income from Federal Taxable Income Used in Computing Tax Base Under the Corporate Income Tax

Page 5
About Treasury Update

Page 5
Court of Claims Denies Taxpayer's Claim that Medical Items Qualify as Exempt Prosthetic Devices

Pages 6
Non-Fungible Tokens (NFTs)

continued from page 1

whether Taxpayer had sufficient control to establish a taxable "use" of the direct mail advertisements in Michigan.

The Court also concluded that it is proper to consider the fact that Taxpayer is headquartered in Michigan and that the relevant work of its employees was being performed in Michigan, such that Taxpayer exercised control in Michigan, even if Marketing Co was executing its contractual obligations outside Michigan. While Taxpayer conceded that it controlled the design stage in the preparation of the direct mail advertisements, Taxpayer argued that (by focusing on this design-stage control) the trial court had applied an improper test to determine whether a taxable use had occurred. The Court disagreed with Taxpayer on this point as well. The Court pointed out that the record reflected that Taxpayer drafted a "creative brief" in Michigan and Marketing Co developed an "advertisement draft" which it submitted to Taxpayer for review in Michigan. Since both were early versions of what eventually became the final advertisement (i.e., tangible personal property) sent into Michigan, the Court rejected the claim that Taxpayer only exercised control over the product while it was in an intangible form.

Finally, the Court noted the following "markers of control" by Taxpayer over tangible personal property in Michigan that constituted a taxable "use" under the Act: (1) Taxpayer had the power to change the advertisements that were printed and had the power to authorize no printing at all; (2) Taxpayer reviewed the proofs to determine whether they complied with insurance laws and that they contained accurate rates; (3) Taxpayer contributed to the data that went into deciding the customer mailing list; and (4) Taxpayer's Michigan-based employees received sample advertisements in order to evaluate how smoothly the process was moving. Because the exercise of only "some level of control" is needed to find a taxable "use," the Court concluded that there was sufficient control to warrant assessment of the use tax in this case.

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RECENTLY ISSUED GUIDANCE FROM TREASURY

Revenue Administrative Bulletins

RAB 2024-7 Sales and Use Tax – Industrial Processing Exemption, Approved May 14, 2024

RAB 2024-10 Corporate Income Tax (CIT) Penalty and Interest for Underpaid Estimated Tax, Approved July 9, 2024

RAB 2024-11 Sales and Use Tax Exemption Claim Procedures and Formats, Approved July 18, 2024

RAB 2024-13 Sales and Use Tax - Food for Human Consumption, Approved August 20, 2024

Notices

- **Notice Regarding Firearms Safety Devices, Published May 10, 2024**
- **Relief Available Upon Request in Counties Impacted by Severe Storms and Tornadoes, Published May 28, 2024**

Statement of Acquiescence/Non-Acquiescence Regarding Certain Court Decisions

In each issue of the quarterly Treasury Update, Treasury will publish a list of final (unappealed), non-binding, adverse decisions issued by the Court of Appeals, the Court of Claims and the Michigan Tax Tribunal, and state its acquiescence or nonacquiescence with respect to each. "Acquiescence" means that Treasury accepts the holding of the court in that case and will follow it in similar cases with the same controlling facts. However, "acquiescence" does not necessarily indicate Treasury's approval of the reasoning used by the court in that decision. "Non-acquiescence" means that Treasury disagrees with the holding of the court and will not follow the decision in similar matters involving other taxpayers.

ACQUIESCENCE: None this quarter.

NON-ACQUIESCENCE: ***Bed, Bath & Beyond, Inc v Treasury* (unpublished) (COA Docket Nos 352088 and 352667)(July 8, 2021) (lv den March 23, 2022). See also *AAA Life Insurance Co v Dep't of Treasury*, ___ Mich App ___ (No. 35613)(June 20, 2024).**

COURT OF APPEALS HOLDS CORPORATE OFFICER IS RESPONSIBLE FOR ITS FORMER LIMITED LIABILITY COMPANY'S UNPAID WITHHOLDING TAXES

In *Mertz v Dep't of Treasury*, unpublished per curiam opinion of the Court of Appeals, issued June 13, 2024 (Docket No. 365480), the Michigan Court of Appeals affirmed the Michigan Tax Tribunal's January 31, 2023, decision upholding Treasury's assessment for corporate officer liability under MCL 205.27a(5) against Mr. Mertz for the 2016 unpaid withholding tax liability of Howard Finishing, LLC.

In order for an officer to be held personally liable for the tax debts of a business that person must be a "responsible person." A "responsible person" is a person that:

1. Was an officer of the business;
2. Controlled, supervised, or was responsible for the filing of returns or payment of taxes;
3. Was an officer during the "time period of default;" and,
4. "Willfully" failed to file a return or pay the tax due.

Prior to assessing a responsible person, Treasury must first produce prima facie evidence or establish a prima facie case that the person is a responsible person. See RAB 2015-23 for more information regarding corporate officer liability. Additionally, if Treasury has information that clearly identifies a purchaser or succeeding purchaser liable under MCL 205.27a(1) that would satisfy the entire liability, Treasury must first assess that purchaser or succeeding purchaser.

The Tribunal concluded that Treasury had presented a prima facie case for liability based on signatures on tax returns before and after the period of default and on Mr. Mertz's level of involvement in the company's tax and accounting matters. It also found that Treasury had assessed Beacon Park after assessing Mr. Mertz and that no one had provided Treasury information clearly identifying a successor until after Mr. Mertz had already been assessed. The Tribunal denied a motion for reconsideration, and Mr. Mertz appealed. See Treasury's May 2023 Newsletter at p. 4 for a full discussion of the Tribunal's opinion.

On appeal, Mr. Mertz first argued that the Tribunal had erred because Treasury had not established a prima facie case that he was responsible: he contended that he was not an officer of Howard Finishing during the period of default and that there was no evidence to support a conclusion that the failure to pay taxes was willful.

The Court of Appeals affirmed the Tribunal's decision. It concluded that the Tribunal was correct in its conclusion that Treasury had presented a prima facie case for responsibility and that Mr. Mertz had presented little evidence to counter this conclusion: Treasury had bookended the period of default with express admission of tax responsibility in the form of signed tax returns, as well as strong evidence of Mr. Mertz's close involvement in the company's tax matters during the period of default. Moreover, Mr. Mertz had presented no evidence to conclude that his responsibility changed during the period in which the company failed to meet its responsibility to report and remit the withholding tax.

Regarding willfulness, the Court observed that Mr. Mertz knew that Howard Finishing had the duty to file returns and pay the taxes shown due and yet failed to pay the 2016 withholding taxes. He had testified that he knew the taxes were in arrears and his duties included solving the outstanding tax debt. Moreover, it was clear from his testimony and the company's bank records that the company was paying other debts, including a $500,000 loan obligation to Mr. Mertz, himself, during the period when Mr. Mertz was aware of the outstanding tax debt to the State. Accordingly, the Court of Appeals concluded that the Tribunal had not erred in its conclusion that Mr. Mertz bore responsibility for Howard Financing's unpaid taxes.

Mr. Mertz also argued on appeal that the Tribunal had erred in concluding that Treasury was not required to pursue collection from Beacon Park, the purchaser of and successor to Howard Finishing, before assessing him. The Court rejected this argument. It observed that Howard Finishing had not received any form of tax clearance at the time of the sale and that the clearance it requested did not identify the purchaser, Beacon Park. It also observed that in response to Howard Finishing's tax clearance request, Treasury informed Howard Finishing that no clearance would be forthcoming while taxes remained unpaid. The Court concluded that Treasury was not aware of a successor at the time it assessed Mr. Mertz and that the Tribunal had not erred in granting summary disposition to Treasury.

COURT OF APPEALS AFFIRMS THAT A TAXPAYER HOLDING REAL ESTATE MORTGAGE INVESTMENT CONDUITS CANNOT EXCLUDE EXCESS INCLUSION INCOME FROM FEDERAL TAXABLE INCOME USED IN COMPUTING TAX BASE UNDER THE CORPORATE INCOME TAX

On May 16, 2024, in an unpublished decision, the Court of Appeals affirmed the Court of Claims that ruled in favor of Treasury in the matter of *Credit Suisse Holdings (USA) and Subsidiaries v Michigan Dept of Treasury*, holding the taxpayer could not exclude excess inclusion income (EII) from federal taxable income (FTI), which is the starting point for computing the tax base under the corporate income tax (CIT), and the amended returns filed were properly rejected.

Credit Suisse, the taxpayer, held interests in real estate mortgage investment conduits (REMICS) and reported EII on its federal returns as required under the internal revenue

continued on page 4

continued from page 3

code (IRC). The IRC provides that EII generated from a REMIC cannot be offset by any net operating loss (NOL). EII is essentially the minimum income that must always be reported as such and is included in FTI that is subject to taxation. However, a taxpayer is permitted by the IRC to carry those losses forward to subsequent years. Therefore, even if a taxpayer has significant losses in a tax year, it cannot use those losses to completely offset the EII in that year.

On its 2018 CIT return, rather than reporting EII as FTI the taxpayer attempted to claim federal NOL as a business loss deduction. Because federal NOL and CIT business losses are not the same, Treasury disallowed the unsupported business loss deduction. The 2015-2017 CIT returns previously filed, properly reported EII and had no CIT business losses that could be deducted. Thus, the business loss claimed on the 2018 return was not supported.

The taxpayer appealed the adjustment made to the 2018 return to the Court of Claims. Before this matter was decided, the taxpayer filed amended returns for 2015-2017. Those amended returns did not report minimum EII as required under the IRC for federal returns; instead, the returns reported NOL equal to the business adjustment that was reported on the 2018 return under MCL 206.623(4). Treasury rejected the amended returns because the returns failed to start with FTI that is the starting point for calculating tax base. Treasury moved for summary disposition arguing the returns filed failed as a matter of law. The Court of Claims agreed and dismissed the cases. The taxpayer sought reconsideration that was denied, and the issue was appealed.

The Court of Appeals stated the main question presented on appeal was whether the taxpayer properly completed its CIT amended returns and the 2018 return. Agreeing with the Court of Claims, the Court stated the issue was one of law and that there were no material facts in dispute. The returns were already filed, and the numbers spoke for themselves.

Turning to the language of the CIT, the Court concluded that the Court of Claims did not err by determining that the CIT amended returns did not support the 2018 return because the taxpayer used the incorrect starting point for its FTI.

The Court noted business income is defined to be FTI under the CIT. MCL 206.603(3). FTI is defined in relevant part as "taxable income as defined in section 63 of the IRC . . . ." MCL 206.607(1). Section 63 of the IRC provides that "the term 'taxable income' means gross income minus the deductions allowed by this chapter (other than the standard deduction)." 26 USC 63(a), as amended by PL 116-260.2 and the federal rules for REMICs and EII are contained within Chapter 1. See 26 USC 860E. Under these rules, "NOLs cannot outweigh the EII, which means that holders of REMICs must list at a minimum their EII as income on their federal tax returns in Line 30, even if their losses for that year were greater than the EII; however, the losses can be carried forward. See generally 26 USC 860E."

The Court then noted that the CIT requires a taxpayer to adjust business income to arrive at its tax base that is subject to a 6% tax rate.

> (2) The corporate income tax base means a taxpayer's business income subject to the following adjustments, before allocation or apportionment, and the adjustment in subsection (4) after allocation or apportionment:
>
> * * *
>
> (c) *Add any carryback or carryover of a net operating loss to the extent deducted in arriving at federal taxable income.* [Emphasis added.]

Under former Subsection (4), a taxpayer could "[d]educt any available business loss incurred after December 31, 2011," and a business loss was defined to be "a negative business income taxable amount after allocation or apportionment." MCL 206.623(4) (emphasis added), as amended by 2014 PA 13. Such losses were to be "carried forward to the year immediately succeeding the loss year as an offset to the allocated or apportioned corporate income tax base, then successively to the next 9 taxable years following the loss year or until the loss is used up, whichever occurs first." MCL 206.623(4), as amended by 2014 PA 13.

Reading these statutory provisions, the Court held the starting point for the CIT amended returns is the FTI from the federal return subject to the explicit adjustments before or after allocation or apportionment to Michigan. None of these adjustments include one for REMICs or EII. The Court concluded that, "the Court of Claims' was correct that, on its face, former MCL 206.623 provides no support for plaintiff to make the adjustments that it did for the REMICs and EII before reporting its business income, i.e., prior to the FTI starting point." Thus, the CIT amended returns were improper and necessitated their rejection by Treasury and the 2018 return that relied on those returns would necessarily need to be rejected as well. Further, the Court clarified that federal NOLs are not the same as the CIT business loss adjustment and the CIT was clear on how the adjustments were to be reported. Federal NOLs are an addback adjustment before apportionment. MCL 206.623(2)(c) requires an adjustment before allocation and apportionment to Michigan, to "[a]dd any carryback or carryover of a net operating loss to the extent deducted in arriving at federal taxable income." Therefore, if a NOL was deducted in determining federal FTI, this must be added back in the calculation of CIT tax base. The Court noted the taxpayer did not do this and instead improperly reported the federal NOL as FTI on the amended returns instead of the EII. Further, CIT business loss is negative business income reported on CIT returns after proper adjustments are made in computing tax base. These amounts are then allowed as a deduction in subsequent years as an offset in subsequent tax years.

Finally, the Court concluded the legal issue resolved all remaining claims and affirmed the dismissal of the taxpayer's claim for penalty relief.

This holding is a reminder to taxpayers that despite unusual federal tax reporting requirements or tax situations that may be unique to a limited number of taxpayers, the CIT is clear that the starting point in computing tax base begins with FTI that is adjusted by the statutory adjustments either before or after allocation or apportionment. Further, federal NOLs are not the same as CIT business losses.

The taxpayer has appealed this decision to the Michigan Supreme Court.

ABOUT TREASURY UPDATE

Treasury Update is a periodic publication of the Tax Policy Division of the Michigan Department of Treasury.

It is distributed for general information purposes only and discusses topics of broad applicability. It is not intended to constitute legal, tax or other advice. For information or advice regarding your specific tax situation, contact your tax professional.

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COURT OF CLAIMS DENIES TAXPAYER'S CLAIM THAT MEDICAL ITEMS QUALIFY AS EXEMPT PROSTHETIC DEVICES

In its Opinion and Order issued March 1, 2024, in the matter of *Rehab & Mobility Systems, LLC v Dep't of Treasury* (Docket No. 23-000012-MT), the Michigan Court of Claims granted summary disposition in favor of Treasury and upheld Treasury's sales tax assessments except for the penalties under those assessments. In a subsequent Order issued April 25, 2024, the Court resolved the claim related to penalties under a stipulation executed by Treasury and Rehab & Mobility Systems, LLC ("Taxpayer").

Taxpayer is in the business of selling medical supplies and equipment. Relevant to the years at issue, Taxpayer sold various medical items (e.g., over-the-counter bandages, incontinence briefs, gauze, medical tape, medical gloves, wound dressing materials, personal lubricants, under pads, and body wipes) for which no sales tax was remitted. There was no dispute that these medical items were sold based on a written prescription by a licensed health professional and that a disabled person purchased the items. The dispute surrounded the Taxpayer's claim that these medical items were exempt from sales tax under former Sales and Use Tax Rule 89 (which was rescinded by Treasury along with many other sales and use tax rules while this matter was pending) and the "prosthetic device" exemption under MCL 205.54a(1)(k) such that Treasury's sales tax assessments were improperly issued.

Regarding Rule 89, the Court first noted that "[t]o the extent that former Rule 89 would allow an exemption for devices that allow a disabled person to lead a reasonably normal life, it conflicted with the statute and was invalid." This was in reference to the language in the former Rule (which is not in the statutory exemption) that allows for an exemption for tangible personal property "used to assist the disabled person to lead a reasonably normal life." The court then evaluated the exemption claim against the statutory prosthetic device exemption under MCL 205.54a(1)(k). For purposes of the statutory exemption, a "prosthetic device" is defined in relevant part as a replacement, corrective, or supportive device dispensed pursuant to a prescription that is worn on or in the body to do one or more of the following: (a) Artificially replace a missing portion of the body; (b) Prevent or correct a physical deformity or malfunction of the body; or (c) Support a weak or deformed portion of the body. MCL 205.51a(q).

Due to a lack of statutory definitions, the Court applied dictionary definitions for the terms "replacement device," "prevent," "correct," "deformed," "deformity," "support," "weak," and "malfunction." The Court ruled that the over-the-counter bandages, gauze, tape, and wound dressings did not fall within the clean text of the "prosthetic device" definition when applying these definitions. The Court reasoned that while the items together serve the function of covering injuries to protect against infection and aid in the healing process, the items are not devices designed for the special purposes described in the statute.

The Court similarly concluded that under these definitions, over-the-counter incontinence briefs, medical gloves, personal lubricants, under pads, and body wipes did not fall within the "prosthetic device" definition. Regarding these items, the Court reasoned that although they may have certain medical uses such as infection prevention, these items are not worn on or in the body of a disabled person (or, with the exception of medical gloves, worn on or in the body at all) or do not prevent or correct a physical deformity or malfunction of the body or do not support a weak or deformed portion of the body.

Taxpayer has appealed this decision to the Michigan Court of Appeals.

NON-FUNGIBLE TOKENS (NFTS)

NFTs have rapidly become a trending topic, spanning various domains like art, music, and collectibles. Their swift rise in popularity also brings into focus potential tax implications. This article aims to offer an overview of NFTs, followed by an exploration of their tax treatment. By providing foundational knowledge about NFTs, the article sets the stage for a detailed discussion on how they are assessed for tax purposes, highlighting key considerations for owners and investors in the NFT space.

What are NFTs?

At a basic level, an NFT is a digital asset that links ownership to unique physical or digital items—such as works of art, music, or videos. An NFT is a unique digital identifier that is recorded on a blockchain, which is used to certify ownership and authenticity. An NFT cannot be copied, substituted, or subdivided. NFTs allow content creators to limit the number of owners of an asset to as few as one, thereby creating an element of scarcity that has never existed in the digital world. NFTs can be bought, sold, and traded like any other cryptocurrency, but they represent a unique and indivisible ownership claim to a specific asset or set of assets. NFTs are bought and sold online and are often mentioned in the same context as cryptocurrencies, such as Bitcoin and Ethereum. However, NFTs are not cryptocurrency. NFTs are largely built with the same kind of programming as cryptocurrency and cryptocurrency is often used to purchase NFTs. However, that is where the similarities end. Unlike cryptocurrencies, which are fungible, NFTs are non-fungible. Hence the name "non-fungible tokens."

The majority of the NFT market consists of digital property, i.e., digital artwork, photographs, video clips, domain names, music, and autographs. NFTs can also represent real-world items like artwork and collectibles. "Tokenizing" real-world tangible assets makes buying, selling, and trading them more efficient while reducing the possibility of fraud. Having ownership of an NFT means the buyer can prove ownership of the specific NFT and that it is authentic—like a certificate of authenticity. Tokenized assets can be easily and efficiently transferred among people anywhere in the world.

Tokenization of a tangible asset can be illustrated by liquor NFTs. When someone buys an NFT of a liquor bottle, they are not buying a digital image. Rather, they are purchasing the actual, physical bottle. The bottle is not shipped directly to the buyer upon completion of sale. Instead, the bottle is kept offsite by either the NFT platform or the distillery. The NFT acts as the certification of authentication that confirms the buyer has rights to that bottle. Here, the buyer has a few choices: hang onto the bottle for investment purposes, re-sell the rights to the bottle to a fellow investor, or drink the liquor. The latter option of drinking the liquor is known in NFT parlance as "burning." When the buyer chooses this option, the bottle comes out of storage and is shipped to the buyer. The bottle also gets pulled from the NFT marketplace for good—never to return.

Despite their versatility, NFTs all work the same. NFTs are created through a process called minting, where the information of the NFT is published on a blockchain. The minting process is essentially the creation of a new block. All tokens are minted and assigned a unique identifier directly linked to one blockchain address. Each token contains an owner and ownership information, the address where the minted token resides, and is publicly available.

The NFT Market

As of 2024, the NFT market presents a diverse landscape of growth, decline, challenges, and optimism. It peaked in January 2022 with $17 billion in trading volume, propelled by the COVID-19 pandemic which heightened online engagement, cryptocurrency interest, and digital art collectibles. Following explosive growth, trading volumes of NFTs took a rapid tumble afterwards, dropping a whopping 97% by September 2022 from its record high of $17 billion in January 2022. According to Zion Market Research, the NFT market size was valued at $36.12 billion in 2023 and is projected to reach $217.07 billion by the end of 2032, showing a compound annual growth rate of around 22.05% from 2024 to 2032. While NFTs have volatile history—there is hope.

Sales and Use Tax Treatment for NFTs

Currently over 30 states generally tax digital products (including Washington DC). Of those 30 states, only 3 states specifically address taxation of NFTs. However, other states that currently tax digital goods may already have the framework in place to tax NFTs with their existing tax mechanisms. Of course, tokenized tangible property would be subject to tax as tangible property in all states that have a sales tax.

Currently, Michigan does not tax NFTs representing digital goods nor does it generally tax digital goods. MCL 205.52(1) levies a 6% tax on the sale of tangible personal property. "Tangible personal property" is defined as "personal property that can be seen, weighed, measured, felt, or touched or that is in any other manner perceptible to the senses…" under MCL 205.51a(r). Digital NFTs do not fall within the definition of "tangible personal property". To determine whether an NFT transaction is taxable, taxpayers should first determine whether the NFT represents digital or tangible property. The NFT is not subject to Michigan sales tax if it is purely digital, such as a digital image or sound. Conversely, if the NFT represents an ownership interest in tangible personal property, such as the liquor bottle example above, the sale constitutes the sale of tangible personal property and is subject to tax.

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