

INTRODUCTION

Discussions of the nature of virtual property have taken place since the advent of the first virtual world. These musings were largely academic, as the notion was generally precluded by the Terms of Service, (“TOS”), and End User License Agreement, (“EULA”), but it seems the IRS has found some use for the resulting analysis, and it may cost you.

In December 2008 the Tax Advocate, Nina Olson, issued the National Taxpayer Advocate Annual Report to Congress, which included a survey of the topic of taxing virtual worlds in her list of “most serious problems.” The report states, in no uncertain terms, “The IRS should proactively address emerging issues such as those arising from ‘Virtual Worlds.’”¹ Whatever comes of the debate over property rights aside, the issue of taxation is likely to be decided soon.

The Report summarizes much of the previous theory on taxation of virtual worlds and clearly outlines the varying types of worlds available to users and the implications of those differences. We are not the first nation to consider such taxation and since virtual worlds are global in nature, it is important to start with at least a brief summary of how other countries are handling the issue.

FOREIGN TAX POLICIES

The recognition of virtual currency transactions as a basis for taxation began in 2006 with a statement by a spokesperson for the Australian Tax Office claiming that “real world value of a transaction may form part of your taxable income, even if it is in Linden dollars.”²

The Chinese government followed suit a few years later, announcing that it would implement a 20% tax rate on income derived from the transaction of virtual goods. The Chinese tax code seems focused on transactions dealing with the sale of virtual currency but is unclear on whether it extends to transactions between virtual property as well. Under the Chinese tax scheme, income obtained through the sale of virtual currency that was purchased from players is taxed as income from the transfer of property. Tax payers are given seven days from the date of a transaction to present proof of the original value of the property sold and pay 20% of their profit or face a charge of three percent of the total value of the transaction.³

According to the BBC, Sweden and South Korea are taking the Chinese method of taxation one step further and laying the groundwork for taxation of transactions occurring purely within a virtual world – transactions in which no real money is transferred and no involved party turns their virtual currency into

¹ The report can be found online at:

<http://www.irs.gov/advocate/article/0,,id=202276,00.html>

² See <http://www.theage.com.au/news/biztech/virtual-world-tax-man-cometh/2006/10/30/1162056925483.html>

³ See <http://www.gamepolitics.com/2008/11/17/china-sell-mmo-gear-visit-taxman>

“real” money.⁴ In fact, Sweden’s tax office acknowledged this theory of taxation in April 2008 as a possibility under existing Swedish laws even though no such tax has been levied to date.⁵

THE U.S. TAX CODE

The U.S. Tax Advocate Report takes a broad survey of the issue and discusses a number of possible tax plans for future implementation. The Advocate argues that under existing tax code an expansive approach, including the taxation of purely in-world transaction, would be just as possible as one focusing only on exchanges of virtual property for real currency.

IRC § 61 states that a person can be taxed upon “all income from whatever source derived.” This seemingly limitless authority to tax has been interpreted to mean “undeniable accessions to wealth, clearly realized, and over which the taxpayer [has] complete dominion.”⁶ Clearly, barring any issues of property ownership and the restraint of trade imposed by some virtual world TOS and EULAs, the transaction of virtual property for real money is a taxable occurrence. For this relatively simple and straightforward situation the Advocate offers the following advice: like online auctions, bartering, and electronic businesses, if a taxpayer receives more money from an activity than spent, then the taxpayer may be required to report taxable income.

The Advocate briefly addresses legal concerns about the ownership of property in virtual worlds and delineates between structured worlds, represented by World of Warcraft, (“WoW”), and unstructured, represented by Second Life, (“SL”). Players of WoW agree to forego most, if not all, property rights in their characters, property, and even accounts as a requirement for game play. The Advocate recognizes this fact as a possible concern for future taxation but seems to rely heavily on a recent District Court decision dealing with the enforceability of End User License Agreements in Virtual Worlds.⁷ Even though there is precedent for holding certain provisions of a TOS unconscionable, the Advocate implies that the case in some way supports the theory that “since players or residents are creating significant value, scholars have speculated that such agreements might not be upheld.” In fact, the TOS in the cited case was held unconscionable because of defects with the particular clause for arbitration as well as a clause allowing the Virtual World provider to modify the agreement at will and without notice. There is nothing in the decision to suggest that the analysis of unconscionability would be extended to protect the “sweat of the brow” theory of property rights expounded in the Report. Additionally, as noted in the Report, in SL the issue of ownership is seemingly less important because “residents” retain intellectual property rights in user creations, however the possibility of the provider revoking such rights at will still exists.⁸

⁴ See <http://www.gamepolitics.com/2008/12/15/sweden-south-korea-eye-taxation-virtual-items>

⁵ See <http://news.bbc.co.uk/2/hi/technology/7746094.stm>

⁶ *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

⁷ *Bragg v. Linden Research, Inc.*, 487 F.Supp 2d 593 (E.D. Pa. 2007).

⁸ Regardless of intellectual property rights retained by users, Linden Labs holds all rights to user accounts and inventory under Section 3.3 of the TOS. The TOS can be found at <http://www.secondlife.com/corporate/tos.php>.

This analysis may ultimately be unnecessary when, and if, the United States begins to tax virtual transactions officially. While section 61 has been interpreted to require “complete dominion” over the property being taxed that phrase may not carry its plain language meaning. In *James v. United States*⁹, the Supreme Court held that embezzled money was taxable even though the defendant was required to return the funds. Since the tax code currently purports to reach all ascensions to wealth, regardless of the source, profits derived from the sale of virtual property should prove taxable even if a taxpayer is later required to return the property, or profits, based on a prior agreement with the Virtual World provider. What seems more important in a determination of whether certain profits and property are taxable is the ability of the taxpayer and the IRS to determine their value.

IN-GAME TRANSACTIONS OF VIRTUAL PROPERTY

If real money transactions are treated under the code as a sale, in-game transactions then are analogized to a trade or barter. Currently the IRS does not impose taxes on certain exchanges that do not involve currency. These situations, however, are generally limited to transfers of property with easily ascertained and recognizable rates of exchange and where taxation would not be too difficult to administer.

The IRS announced that the receipt of frequent flyer miles would not count as part of an individual’s tax obligation, unless those miles were sold, partially due to a lack of a market for miles.¹⁰ The absence of a market is largely due to airline restrictions on the transfer of such “property.” Similarly, the Advocate recognizes that under the TOS of many virtual worlds, some virtual property is nontransferable. Indeed, in WoW, as recently as January 20, 2009 a representative of Blizzard stated on the official Warcraft Forums that player accounts were nontransferable either as the result of in-game or real world exchange.¹¹ Similarly, Blizzard has taken a strong stance on accounts linked to the transfer of its virtual currency for real money, resulting in the frequent termination of numerous accounts.¹² Once again, however, Second Life is unique in that players retain property rights in their virtual property, which are freely transferable, however Linden Lab does reserve the right to terminate accounts and repossess property at their discretion. It should also be noted that a user’s rights to virtual property, if any, are generally subject to the payment of a subscription fee.

⁹ [366 U.S. 213 \(1961\)](#)

¹⁰ Ann, 2002-18

¹¹ See

<http://forums.worldofwarcraft.com/thread.html?topicId=14496620301&postId=144760883790&sid=1#9>. Also note that only a few years ago it was a common occurrence to see WoW accounts for sale online on sites such as ebay. Accounts typically sold anywhere from \$200 to \$1500 depending on the level and equipment of the characters on the account. Sellers would generally include a statement in the auction description saying that player accounts could be transferred so long as the transfer included the original game discs and all accompanying documentation. WoW’s provider, Blizzard Entertainment, has shut down most of these listings but they have recently been replaced by auctions claiming to be for the sale of character “guides” to avoid detection in searches by Blizzard employees. These listings now include language stating while Blizzard owns the account you are bidding on the right to use it.

¹² See <http://forums.worldofwarcraft.com/thread.html?topicId=59377507&sid=1>

Even with all these restrictions, transactions do occur between users for the exchange of virtual property that are allowed by the providers of the worlds. These transactions it would appear are theoretically taxable under U.S. Tax Code unless the IRS were to decide to make a specific exception.

ADMINISTRATION OF VIRTUAL TAXES

While the number of transfers between the millions of players of virtual worlds may seem astronomical they are recorded by the virtual world software, at least for some period of time, to facilitate game play. The Advocate suggests that the reporting of so many transactions, especially when most of them would lead to situations that did not require reporting may prove unduly burdensome. However, if the U.S. were to model their reporting requirement after the Chinese code and build in a consideration of the game mechanics of the affected games the system may be possible. If, for example, information regarding in-game transactions were maintained by a provider's server for 1 month a 7 day reporting requirement as used by the Chinese would require no additional record keeping on the part of the provider.

Additionally, there seems to be a robust exchange market for virtual currencies of all types of virtual worlds. Rates are tracked and recorded and could be used for taxation purposes seemingly reliably, especially if reporting were required in a short period of time. What stands as a greater difficulty for valuation is the barter and exchange of in-game items. While there are sources to approximate the relative value of certain items within a virtual world the demand of all things is governed by the role an individual chooses to play in the virtual world; some items of great value to some are nearly worthless or completely unusable by others. Especially in structured games like WoW the path a player chooses at the beginning of a game may determine what items they can use throughout their game play.

CONCLUSION

The Advocate notes that production of property is not subject to tax automatically and that a person is not immediately exposed to tax liability for the creation of new wealth. The example presented is a farmer who has grown and harvested crops; taxation is not applied before selling or exchanging them. While it is true that it is possible to participate in a virtual world acting as an island, engaging in no transactions or exchanges, this type of behavior is generally repugnant to the concept of these online experiences. If the Advocate feels that this analysis will in some way prevent "players" of virtual worlds who are only there for their own amusement from being taxed, in actuality very few users will fall into this category. Virtual worlds are social experiences and frequently encourage, and sometimes require, the interaction with other users in a financial capacity. If the IRS creates a tax scheme that is mindful of players who are not online to create real money wealth better care will need to be taken to carve out an exception for that type of use.

Currently most users of virtual worlds are not spending the majority of their time online, and only a fraction of users are using their "second life" to sustain their "first" financially. The taxation of in-game exchanges will represent the taxation of "wealth" that individuals generally are not receiving the benefits of. Until the time spent creating this wealth online rivals, and begins to detract from, time spent generating wealth offline there is no need to target these worlds as a revenue stream for the State.

As a note for future consideration, the proliferation of users in virtual worlds who are being taxed for their efforts may carry with it additional legal problems to be resolved. Virtual worlds present a unique landscape where one half of a transaction may be using taxable money they intend to transfer to real currency for a "purchase" while the other half is not. Questions such as whether these situations amount to a "use in commerce" for trademarks, and the implications of child labor and employment law, need to be addressed concurrently with the development of a possible tax structure.