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Gamers Beware: Level 99 Boss...Taxes!

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Background

It has been 36 hours since you last slept and ate something other than a preservative-laden product disguised as food in the form of perhaps a microwavable burrito. This was all worth it because you are about to finally beat that raid boss and have a chance to roll against other party members for his loots. If you understood the last two sentences, then you have probably ventured into the land of Massive Multiplayer Online Role-Play Game (“MMORPG”) at some point. The world of MMORPG has an intriguing gameplay system, a complex economic system and social hierarchy that at times mimic the real world. Players are represented through customized avatars that become increasingly more powerful through the completion of tasks and defeating high-level monsters, colloquially known as “Bosses”. The appearance of a valuable in-game item is the usual concomitant reward to the defeat of a Boss. The probability of the appearance of a particular in-game item is the drop rate. Lower drop rate for an item indicates its rarity and potential desirability. Striving for wealth, power or popularity motivates players to dedicate countless hours. For many players, the world of MMORPG is no longer just a hobby; instead its influence is leaking into the real world, blurring the boundaries of reality, and becoming a lifestyle. Global spending in MMORPG games exceeded \$12 billion in 2012 and was projected to reach \$17.5 billion in 2015.¹ In the game World of Warcraft (“WoW”), each player spends a daily average of 3.1 hours in game, which translates to approximately 20 hours per week or 1,040 hours per year.² This burgeoning market therefore carries high potential for new tax revenue. What if the hours you spend in the virtual game world have taxable consequences? Will you have second thoughts before you acquire that super rare Kraken Club or conjure up diabolical plans to amass large amounts of in-game currency?

Introduction

In recent years, virtual currency transactions have become gradually more pervasive in the economy, exerting their influence on various industries and individuals. Tax authorities are still searching for more definitive and structured methods to regulate these transactions. As a result, the Government Accountability Office (“GAO”) issued a report on this subject that studied the tax implications of virtual currency transactions.³ The GAO divides the virtual exchange systems into three categories: closed-flow system, hybrid system and open-flow system. The categorization of these three systems depends on three components:

1. Interaction between U.S. dollar and virtual currency.
2. Interaction between real goods and services and virtual currency.
3. Interaction between virtual goods and services and virtual currency.

¹ “Global MMO Games Spending Exceeds \$12 Billion – SuperData Research.” SuperData Research. N.p., (12 Jul. 2012. Web. 05 Jul. 2016). <https://www.superdataresearch.com/blog/global-mmo-games-spending-exceeds-12bn/>

² Tarng, Pin-Yun, Kuan-Ta Chen, and Polly Huang. “An Analysis of WoW Players’ Game Hours.” Department of Electrical Engineering, National Taiwan University, n.d. Web. 05 July 2016. http://www.iis.sinica.edu.tw/~swc/pub/wow_player_game_hours.html

³ U.S. Government Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional I.R.S. Guidance Could Reduce Tax Compliance Risks (2013). <http://www.gao.gov/assets/660/654620.pdf>

In a closed-flow system, exchange of virtual currency, goods and services is limited to the virtual world and has no measurable economic impact in the real world. An example is a small game with no secondary market for its in-game currencies. In a hybrid system, economic exchange can impact the real world if the players choose to engage in transactions that convert in-game assets to real currency or goods and services, albeit potential limitations posed in the End User License Agreement (“EULA”) by the game distributor. An example is the aforementioned WoW. Players can then use third-party websites to facilitate the exchange of in-game currency “Gold” and items between sellers and buyers and set different exchange rates according to the supply and demand of each server. Blizzard, the owner of WoW, expressly prohibits such trades in its EULA and they enforce it by banning violating player accounts. Other similar games have comparable EULAs in place to curb this type of behavior. Despite these efforts, IGE, a third-party website that specializes in selling virtual currency and avatars for various MMO games, estimated the volume of real money trade (“RMT”) secondary market was approximately \$880 million in 2004.⁴ In another example of a hybrid system, Second Life, players earn “Linden Dollars” for services performed or goods sold in its virtual domain and Linden Dollars can be readily cashed out by converting Linden Dollars to USD within the game itself at a set rate. According to the GAO report, players exchanged \$150 million worth of Linden Dollars in the third quarter of 2010 alone. Based on the above facts, we can conclude there is a fairly lucrative secondary market for virtual currency and items in hybrid systems. In open-flow systems, virtual currency is freely exchanged with government issued legal tender and goods and services without the confines of the virtual world in hybrid and closed-flow systems. One example of an open-flow system currency is Bitcoin, which is mined by users through mathematical algorithms and is widely accepted as an alternate form to cash.

The IRS has made some efforts in addressing convertible virtual currencies, namely Bitcoin, categorizing it as property, and not currency, in Notice 2014-21.⁵ This notice expands the scope of convertible virtual currency to include either:

1. A virtual currency that has an equivalent value in real currency, or
2. A virtual currency that acts as a substitute for real currency

This article focuses on classification and tax implications of virtual assets in Second Life and WoW under newly issued IRS Notice 2014-21.

Income Realization

The GAO report begins its analysis by comparing virtual currency transactions to the bartering system. Barter is when two parties exchange goods or services without exchanging currency. An example is when a house painter paints an accountant’s house in exchange for the service of filing his tax returns. According to IRS Publication 525, bartering transactions are reported on 1099-B, or a similar statement and taxed at the market value of the goods or service received by both parties. The logic behind taxing barter transactions is the definition of income. According to IRC Section 61, “... income is from whatever source derived [.]” Over the years, income has been defined to include various forms and methods of receipt. Income can be in forms of currency, currency equivalent or services. It can also be received through various methods: constructive, prepaid or

⁴ Lehdonvirta, Vili. “How Big Is the RMT Market Anyway?” Virtual Economy Research Network. (02 Mar. 2007. Web. 15 Apr. 2016). https://virtualeconomyresearchnetwork.wordpress.com/2007/03/02/how_big_is_the_rmt_market_anyw/

⁵ IRS Notice 2014-21.

assigned. Virtual currency transactions in hybrid systems are comparable to the bartering system because they involve exchanges of goods or services with real world currency value. Here are two cases to illustrate in-game transactions.

Case One: Judy spent 10 hours per week for the last 5 months completing various tasks in WoW to level up her avatar to obtain more value creating tools. At the maximum level of 65, she started to join raids of high-end dungeons and acquired a re-sellable item with an extreme rare drop rate of 0.1%. That item is worth approximately \$2,000 on eBay and other third-party websites. Along with that rare item, she also accumulated 30 million Gold which can be sold to third-party website at an exchange rate of 1 million Gold to \$20. In addition, as a high level crafter, she was able to craft items for other players in game for a nominal fee. She had total convertible in-game assets estimated at \$2,600, which she had accumulated over 200 hours of playtime.

Case Two: George developed virtual real estate for Second Life as a hobby. He purchased plots of virtual land within the game, built houses on the land and sold the finished product for a profit to other players. Last year, he received 50 million Linden Dollars for his services as a virtual real estate developer. According to a previously published conversion rate, 50 million Linden Dollars was worth approximately \$185,185.⁶ In addition, he held virtual real estate property worth 20 million Linden Dollars. He chose not to convert the Linden Dollars to USD in that tax year because he was waiting for a more favorable rate.

Should their virtual assets be taxed? If taxed, when is the appropriate time?

To answer these questions, let us define these types of virtual assets and explore various income recognition possibilities. The two types of virtual assets in question are: virtual currency and virtual assets such as in-game items or virtual real estate. As mentioned before, Linden Dollars should be considered a convertible virtual currency under IRS Notice 2014-21 and thus taxed as property like Bitcoin. In contrast, non-convertible virtual currencies are those intended specifically to a particular virtual domain and cannot be exchanged for real currency under the governing rules of that particular domain.⁷ At first glance, Gold falls within the definition of a non-convertible virtual currency because its original purpose under the EULA is only for economic transactions within the game. The Financial Action Task Force (“FATF”) mentions one exception to the general definition of non-convertible virtual currency: if the virtual currency has an unauthorized secondary market. WoW players are able to purchase or sell Gold through facilitation of third party websites, giving Gold value in real currency and thus effectively changing its characterization to convertible virtual currency. Due to the convertible nature of Gold and Linden Dollars, they both should be treated as property for tax purposes. By and large, players, as individuals, are cash basis taxpayers and report income when cash or property is actually or constructively received. Gold and Linden Dollars are properties so they should be reported at fair market value at time of receipt, barring any exceptions, since they can be traded for real currency through third party websites. However, for these types of virtual assets earned, the issue of receipt becomes an issue for tax purposes – in particular the issue of constructive receipt. The constructive receipt rules state that income items that are not actually received are nonetheless constructively received in the taxable

⁶ Wong, Grace. “How Real Life Money Works in Second Life?” CNN. (02 Dec. 2008. Web. 15 Apr. 2016).

http://money.cnn.com/2006/12/08/technology/sl_index/index.htm?section=money_technology

⁷ “Virtual Currencies Key Definitions and Potential AML/CFT Risks.” Financial Action Task Force. N.p., (Jun. 2014. Web. 10 Jun. 2016).
<http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>

year during which the income item is credited to the taxpayer's account or otherwise made unconditionally available so the taxpayer may draw upon it at any time without substantial limitations or restrictions preventing the taxpayer from receiving the income.⁸

In the first case, Judy earned \$2,600 worth of convertible virtual currency (Gold) and a virtual, rare item through 200 hours of playing time over five months. In reference to the analysis of convertible virtual currency in the previous paragraph, her Gold should have been recorded at fair market value at receipt and taxed in the year of its receipt in her account. However, her access to the income for the rare item was limited by the EULA that expressly prohibited selling or trading of in-game items for cash. Cashing out her in-game item would directly violate the EULA and jeopardize her account status. She would potentially have to surrender a substantial right, the ownership of her avatar (the rare item) and ability to participate in the game, if her activities were detected by Blizzard. Substantial limitations and restrictions such as this are at the heart of the exceptions to constructive receipt and this restriction could arguably prevent Judy from constructively receiving income associated with that rare, in-game item.

In the second case, the fact pattern is slightly different. Virtual asset attributes remain equal to those in the first example. Linden Dollars, as a convertible virtual currency should be taxed in the same manner as Gold. However, the EULA did not limit George's ability to engage in selling virtual assets for cash. The virtual real estate was credited to George's account and available for him to withdraw upon or dispose of as he chose. George's access to the income had no substantial limitations. His choice of not withdrawing the income should have had no bearing on the inclusion of it as constructively received.

If the IRS chooses to enforce the above tax implications then there are three major issues to consider: compliance enforcement, administrative burden and valuation of virtual assets. Tax compliance enforcement of the above transactions is difficult partly due to the transient nature of virtual currency. The responsibility of reporting and documentation ultimately lie with the administrator of the virtual currency especially if the administrator is subject to the rigorous reporting standards outlined in the Bank Secrecy Act, which aimed to prevent money laundering.⁹ Moreover, Blizzard and Linden Lab will be obligated to issue Form 1099 if the player earns an aggregated amount over \$600 in that tax year.¹⁰ The administrative burden and costs associated with reporting and documenting virtual transactions of each player will undoubtedly be significant. The valuation of virtual assets at fair market value has a limited basis that is possibly dependent on the secondary market if it is available to that particular virtual item. For example, George receives a customized in-game sofa from a friend as payment for service provided but it is not resellable. What is the real world value of the string of codes manifesting itself as a sofa?

Conclusion

Years ago, the idea of virtual assets and currency was probably unfathomable. In today's world, I cannot remember the last time I paid with cash for an item over \$100 or in person. Many transactions happening today are conducted through a digital medium like credit cards, PayPal or Bitcoin transfer. In addition to the digital economy, virtual reality technology is advancing rapidly,

⁸ Treas. Reg. § 1.451-2.

⁹ FIN-2013-G001.

¹⁰ Treas. Reg. § 1.6041-1.

and soon the convergence of virtual reality and reality will be inevitable. Virtual currency and assets make up a large part of today's economic transactions. Unfortunately, regulations are not keeping step with the growth of this market. As a result, the U.S. government is losing valuable tax revenue and opportunities to educate the public on the tax ramifications on non-traditional, virtual world-type activities. Politicians and tax authorities must update the tax codes and regulations written decades ago effectively and efficiently to meet the needs of a more modern economy.