

Taxing the Virtual World . . . And Beyond

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Second Life, Facebook, Groupon, and the exploding world of digitally provided content and services have thrown a wrench into tax practitioners' ability to answer some basic tax questions. These business models (and models that are still incubating in the college brains of the start-up founders of tomorrow), have strained historical tax rules beyond their tensile strength. To those responsible for tax compliance in the virtual world, we wish you luck and, as 1970s as it may sound, may the force be with you.

This article provides a high-level overview of the state tax issues that arise within the virtual world — from avatars to apps, from coupons of sorts to digital marketplaces, from in-game pizza delivered to your real-life door to videos delivered on handheld devices and beyond. These new business models call into question traditional notions of when and where income should be taxed; raise doubts about the application of sales tax rules to modern transactions that may involve multiple parties and locations; highlight issues regarding the taxation of virtual currency exchanged for tangible or virtual goods or services; and pique the interest of unclaimed property administrators who knew what property was before the digital age. We explore a few of the virtual world's more interesting business models and discuss their tax issues below.

I. Business Models 2.0 (or Maybe 3.0)

A. Virtual Worlds and Currencies: Monetizing Play, From Avatars to Zombies

When we talk about the virtual world, we are discussing everything delivered or accessed electronically. One of the business models in that world is the virtual economies that have developed around massive multi-player online games such as Second Life. These economies involve a series of transactions: transactions as a player enters the world, transactions within the world, and transactions on the way out. In assessing the tax issues involved in virtual economies, we will skim the surface of the virtual worlds and transactions that take place within them.

"Virtual world" is generally understood to mean a persistent online gaming or social environment in which a large number of people interact with each other as their fictional representatives, or avatars.¹ Persistence implies that the world exists regardless of whether a participant is logged in to the game, much like the real world. These virtual worlds, like the real world, continue to exist and change with or without any one individual's participation.

Regardless of the type of game or social environment involved, virtual environments generally allow participants to buy and sell virtual goods and services by using some form of virtual currency. And the transactions amount to big money, both for the game developers and for some in-world entrepreneurs. Second Life reported that its economy grew 65 percent from 2008 to 2009 to total \$567 million, and that amount appears to have more than doubled in 2010 to exceed \$1 billion.² These transactions are

¹Steven Chung, "Real Taxation of Virtual Commerce," 28 *Va. Tax Rev.* 733, 736 (Winter 2009).

²Dean Takahashi, "Second Life's Economy Grows 65% to \$567 Million," *VentureBeat*, Jan. 19, 2010; Nelson Linden, "Second Life Economy in Q4 2010," available at <http://community.secondlife.com/t5/Featured-News/The-Second-Life-Economy-in-Q4-2010/ba-p/674618> (last viewed Apr. 17, 2011).

conducted by use of Linden dollars (L\$), which can be bought and sold for U.S. dollars on a currency exchange called LindeX, thus allowing participants to cash out earnings from Second Life. That ability to earn real income has already caught the eye of the IRS, with a spokesperson noting in 2007, "Any time someone wins a tangible prize or award, the value is reportable as taxable income. An accumulation of 'points' would not result in tax consequences, but redeeming or selling them for money, goods, or services would."³ In the European Union, the VAT already is imposed on any transaction between Linden Lab (owner and developer of Second Life) and consumers, although Linden Lab makes clear that VAT is not collected on consumer-to-consumer transactions.⁴

Within a virtual environment, players may purchase virtual goods such as clothing, weapons, and tools. Video games are generally considered pre-written computer software, so these virtual goods may be characterized as software. Increasingly, services are also being sold within virtual environments. A quick survey of the Second Life Marketplace reveals virtual services such as portrait painting, dating services, home decorators, and adult entertainment.⁵

Although Second Life's participating membership is relatively small, numbered in the millions, Facebook is taking virtual economies to a whole new level. Facebook, a leading social network in the United States and worldwide, allows game developers like Zynga Inc. to offer their games to Facebook users throughout the world. Some games, like FarmVille, are offered for free, but users must purchase virtual animals, tools, and other goods to interact within the game.⁶ Zynga was most recently valued at \$10 billion by venture capitalists, and its games are played by more than 120 million online players.⁷

Facebook made news when it announced that it would eventually require Facebook gaming platform developers to use "Facebook credits" as its exchange currency, rather than game-specific currency or credit cards, which are currently used.⁸ In FarmVille, players purchase tractors and such with "Farm coins." Under the new system, Facebook will

require the use of the Facebook credits and take a 30 percent cut of the transaction in which the player purchases the credits. With Facebook membership in excess of 500 million and projected to eventually exceed 1 billion, Facebook has the potential to create a new virtual economy with real-world implications.⁹

Banking analysts predict that virtual currencies will become "a very real part of the way people trade and sell information, collaborate on ideas and value various products and services."¹⁰ Indeed, the Chinese government has already become so concerned about the impact of virtual currency trading that it banned the trading of virtual currency for real goods or services.¹¹ QQ coins, issued by Tencent.com, are the most prevalent virtual currency in China. At the time of China's action, Tencent.com had approximately 220 million members, far fewer than Facebook.¹²

All of this points in one direction: the emergence of virtual economies that currently fly largely under the radar when it comes to our domestic tax regime. Although the IRS has acknowledged virtual transactions, no formal steps have been taken to provide guidance on the taxation of in-game business transactions and the income earned. State and local governments have no visibility into the sales of goods and services that take place among participants and entrepreneurs within the virtual environment. And what happens to the currency credits abandoned by players who drop out of the virtual world? These questions will eventually be answered, but for now, we are left struggling to apply prehistoric law to the postmodern world.

B. Everything Is Local: The Group Coupon Model

One of the fastest growing business models is group voucher sales. Two major companies offering these coupons are Groupon and LivingSocial and Facebook is launching a similar program in key test markets. The business model has proven very successful, with Groupon growing so rapidly that it was dubbed the "fastest-growing company in Web history" by Forbes.com.¹³ This business model generally involves the coupon vendor offering specific

³Grace Wong, "Second Life's Looming Tax Threat," CNMoney.com, Mar. 9, 2007.

⁴Value added tax, available at <http://secondlife.com/corporate/vat.php>.

⁵Second Life Marketplace, available at <https://marketplace.secondlife.com/> (last viewed April 15, 2011).

⁶Douglas MacMillan, "Zynga and Facebook: It's Complicated," *Bloomberg Businessweek*, Apr. 22, 2010.

⁷Evelyn M. Rusli, "Zynga Nears Deal Valuing It at Close to \$10 Billion," *The New York Times*, Feb. 17, 2011; Douglas MacMillan, "Zynga and Facebook: It's Complicated," *Boomborg Businessweek*, Apr. 22, 2010.

⁸MacMillan, *supra* note 6.

⁹Venessa Miemis, "The Bank of Facebook: Currency, Identity, Reputation," available at <http://emergentbydesign.com/2011/04/04/the-bank-of-facebook-currency-identity-reputation/> (last viewed Apr. 18, 2011).

¹⁰*Id.*

¹¹Thomas Claburn, "China Limits Use of Virtual Currency," *InformationWeek*, June 29, 2009.

¹²*Id.*

¹³Christopher Steiner, "Meet the Fastest Growing Company Ever," *Forbes.com*, Aug. 12, 2010, available at <http://www.forbes.com/forbes/2010/0830/entrepreneurs-groupon-facebook-twitter-next-web-phenom.html>.

deals from third-party companies that are communicated to a subscriber population through e-mail or other electronic notification formats. Groupon takes a cut of the price paid for the voucher, and the third-party vendor is paid the remaining amount. For instance, a new restaurant may want to rapidly increase its customer base by offering a voucher for \$50 worth of food for a price of \$25. The consumer purchases one or more of these vouchers through the Groupon website by use of a credit card. The consumer then redeems the voucher for the good or service, with no money exchanged between the vendor and the consumer. However, sales tax collection obligation may exist and how that transaction is taxed and the valuation of the transaction present challenges for the group voucher seller, the third-party vendor, and the consumer.

C. The Bizarre New Bazaars: Apps. Apps? Apps!

As Americans move from the desktop to mobile computing models, software developers are interacting more frequently with customers through mobile application stores. Customers use digital stores or marketplaces to purchase apps for use on their smartphones, tablets, and other devices. The apps can be used to quickly and efficiently access the Internet, play games, use productivity software, check e-mail, or do almost anything that can be done on a computer. No matter what device a customer uses, you can bet the customer is accessing and purchasing apps.

When an app is first downloaded, it may be free or it may be sold for a nominal cost. These purchases are typically made directly using the device, or can be purchased through the Internet and downloaded to the device at a later time, increasing the complexity of the transaction for tax purposes.

For games, streaming video apps, or newspapers or magazines, there may be advertising embedded in the app. For other apps, a customer may need to make ongoing purchases, such as in-game items that facilitate continued play of the game, receipt of new issues of magazines or newspapers, or the purchase of real-world products through mobile retail apps. These purchases may be made with credit cards, though a number of companies are moving toward a points-based or virtual currency system. Although these business models may seem to fit into a traditional model of taxation, the complexities of the transactions will make it difficult at best for the parties involved to sort out the tax ramifications.

II. Tax Laws 0.5

A. The Virtual Economy Brought Back to Reality

Income Tax Issues

The state income tax issues related to virtual economies are the same as those involved in any set of economic transactions. Some of the issues relate to state conformity to federal tax concepts: definition and realization of income, recognition events, and characterization. Other issues are unique to state tax, including apportionment and nexus. State guidance regarding the taxation of income in virtual economies is almost nonexistent.

Federal Issues — Definition, Characterization, Recognition and Realization. Because most states use federal taxable income as the starting point for state taxable income, it would be helpful if the Internal Revenue Code specifically dealt with the taxation of income in virtual economies. The treatment of important issues, such as the definition and realization of income, characterization, and recognition at the federal level, would indicate how the state laws may be applied.

Unfortunately, the IRC does not specifically address the taxation of income from virtual economies. The national taxpayer advocate has indicated that transactions in a virtual economy are a significant issue,¹⁴ yet the IRS has not taken any action.¹⁵

Other income tax issues, such as when the economic benefit is realized and whether the income from virtual currencies would be characterized as ordinary or capital gains, have yet to be addressed at the federal level, though a discussion of these matters within academia has begun.¹⁶

If transactions that occur within a virtual economy give rise to income, one of the main issues will be determining when that income is recognized. Because of the nature of virtual economies, there will inevitably be a series of cash and non-cash transactions, making it difficult to determine when

¹⁴Nina Olson, National Taxpayer Advocate, "2008 Annual Report to Congress" (2008), available at www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_mpsp.pdf (last retrieved Apr. 18, 2011).

¹⁵See Nell Beekman, "Virtual Assets, Real Tax: The Capital Gains/Ordinary Income Distinction in Virtual Worlds," 11 *Colum. Sci. & Tech L. Rev.* 152 (2010); Adam Chodorow, "Tracing Basis Through Virtual Spaces," 95 *Cornell L. Rev.* 283 (2010).

¹⁶See Nell Beekman, "Virtual Assets, Real Tax: The Capital Gains/Ordinary Income Distinction in Virtual Worlds," 11 *Colum. Sci. & Tech L. Rev.* 152 (2010); Leandra Lederman, "EBay's Second Life: When Should Virtual Earnings Bear Real Taxes?" 118 *Yale L.J. Pocket Part* 136 (2009); G. Martin Bissinger, "Federal Tax Consequences of Virtual World Transactions," 5 *Shidler J.L. Com. & Tech* 7 (2008); Bryan Camp, "The Play's the Thing: A Theory of Taxing Virtual Worlds," 59 *Hastings L.J.* 1 (2007).

gain should be recognized. The IRC does not specifically address recognition events for virtual currencies or other types of virtual economic transactions. However, the IRS has addressed the treatment of advance payments, including gift cards, which may provide some insight regarding how the recognition question would be addressed.

If transactions that occur within a virtual economy give rise to income, one of the main issues will be determining when that income is recognized.

The IRS has taken the position that a taxpayer that sells gift cards takes the payment into income in the year of the receipt,¹⁷ or alternatively may defer the recognition to a later year if the taxpayer meets the requirements for deferral.¹⁸ Although the states are not required to follow the federal treatment, the federal treatment will be significant persuasive authority for state treatment because most states use federal taxable income as a starting point.

Apportionment. Existing state apportionment provisions do not address how to apportion income from virtual economies. Those receipts would likely be part of the receipts factor in most states and apportioned according to receipts of “other than tangible property.” There are two dominant methods of calculating those receipts: market-based sourcing and cost of performance. Both methods will present issues for apportioning income from virtual economies.

Under market sourcing, receipts are usually sourced to the place where the benefit is received. For virtual currency, that determination may be difficult. When virtual currency is issued by one party to a customer and honored by third parties, the number of ways that a benefit can be received increases exponentially with every type of service that the third parties can provide.

Under cost of performance, receipts are usually sourced to the state where the income-generating activity is performed (with some variation state to state about whether the majority or preponderance is more important). For virtual currencies, how third-party costs are treated will have a significant effect on apportionment. Many technology compa-

nies outsource to third parties parts of their businesses, such as coding, maintenance, server capacity, or customer service. Because those costs are performed across states or even internationally, third-party costs will become a significant issue.

Nexus. For virtual currencies, income tax nexus is another potential issue. States will likely attempt to assert economic nexus as a theory in support of taxing income derived from the sale and transactions related to virtual currencies because virtual currencies derive some of their economic benefit from intangible rights. Since there is no protection under P.L. 86-272 because these transactions do not involve the sale of tangible personal property, states may argue that economic nexus applies.

Transaction Tax Issues

Although there is no guidance specifically addressing virtual currencies and new economies in state taxation, a look at taxes on digital goods and services is useful. Historically, most states have imposed sales tax only on transactions involving tangible personal property (that is, shoes, tools, and computers).¹⁹ States generally do not tax services or intangibles unless expressly provided for by statute.²⁰ However, many states now impose tax on the sale of digital goods and services.²¹ Thirteen states impose such a tax statutorily, while another 10 states do so by administrative positions or through court decisions. The standard by which digital taxes are imposed varies widely, with some states limiting digital taxes to sales of “specified digital products,”²² while other states take a much broader approach and interpret their tax laws to reach all products transferred electronically.²³

The characterization of virtual goods and services will be important in determining the proper tax treatment. Video games are generally seen as a specialized form of pre-written computer software,

¹⁹See Calif. Revenue and Taxation Code section 6051.

²⁰*Id.*

²¹“Digital goods” is a common term used in the sales and use tax context that broadly refers to goods and services delivered or accessed electronically. Depending on a specific state’s sales tax laws, digital goods may include items such as downloadable or streaming movies and music, electronic greeting cards, digital photographs, video games, digital codes, subscriptions to digital serials, and so forth. At its broadest, the term can be read to include digitally delivered services (for example, information services, data processing services).

²²“Specified digital products” is a term defined within SSUTA. Member states may tax specified digital products, but only if they adhere to guidelines that are aimed at uniformity among the member states. For instance, a state may not impose tax on ringtones while not taxing other forms of “audio works” such as downloaded music files.

²³See, e.g., La. Rev. Rul. 10-001 (Mar. 23, 2010); Texas Tax Code section 151.010.

¹⁷Treasury reg. section 1.451-5 provides guidance for when advance payments are taken into income. Generally, they are taken into income in the year of the receipt of the payment, unless the transaction falls into an exception. Rev. Proc. 2004-34 and Rev. Proc. 2011-18 provide additional guidance on advance payments.

¹⁸*Id.*

so the products sold within the games may also be characterized as software. Characterization grows even more complicated as the links between the physical world and the transaction become more frayed. The range of goods and services available by purchase with virtual dollars highlights one of the significant difficulties of taxing virtual transactions: The virtual currency may be used to purchase a variety of goods and services that are treated differently for tax purposes — some will inevitably be taxable while others are exempt. What should vendors do when their virtual currency can be used for both taxable and exempt products?

Virtual commerce is so completely disconnected from a physical location that sourcing the sale to any one jurisdiction is inaccurate and arguably unjustified.

Once a virtual good or service is characterized, vendors must next decide where to source each digital sale. There is no comprehensive scheme governing the sourcing of sales for tax purposes. As a result, more than one jurisdiction can claim authority to impose tax on a single sale of a digital good, service, or intangible. The Streamlined Sales and Use Tax Agreement provides rules for how digital transactions will be sourced for state purposes. But for the states that are not members of the agreement, there are no standard rules.²⁴ An effort to solve the difficulties of sourcing digital transactions was addressed in the Digital Goods and Services Tax Fairness Act of 2010,²⁵ but that bill made little progress in 2010. Consequently, businesses engaged in virtual commerce will likely be subject to multiple taxation because more than one state will assert taxing jurisdiction over a particular transaction. Complicating the issue is the fact that virtual commerce is so disconnected from a physical location that sourcing the sale to any one jurisdiction is inaccurate and arguably unjustified.

Beyond the characterization and sourcing issues, however, is a more practical one: At what point in the chain of new economy commerce should a transaction tax be applied? For instance, if a Second Life account owner purchases L\$1,000 with the intent of purchasing other virtual goods and services within Second Life, is that exchange a taxable transaction, or should the tax be applied only when the L\$ are redeemed for virtual goods or services? What happens if the Second Life player can order a pizza

through online game play and a real-world pizza is delivered to the player's front door, paid for in L\$? The permutations and resulting tax complexity are endless.

B. Internet Coupon + Local Purchase = Two Taxes for One Item

Likewise, Groupon vouchers may be redeemable for tangible property, food, alcoholic products, or any type of service. They can provide access to digital goods and services, virtual interactions, or cloud-based services. In the Groupon business model, Groupon leaves the collection of sales tax to the third-party vendor. Printed on the Groupon voucher is information notifying the consumer that the voucher does not cover tax or gratuity. In other words, the consumer prepays Groupon for the good or service with no tax collected at that point in the transaction; the consumer then redeems the voucher with the third-party vendor in what is arguably a zero-dollar transaction — except for taxes that must be collected at the time of voucher redemption. The tax, if one should be applied, should be calculated on the sales price paid to Groupon — the discounted price — rather than the full value of the redeemed goods or services. The Massachusetts Department of Revenue has ruled on this issue directly and determined that the sales tax for food purchased through a Groupon promotion would be based on the amount the consumer actually pays for the meal.²⁶ From a consumer standpoint, paying sales tax to a vendor after already paying for the good or service in a previous transaction disconnects the purchase from the tax incident — a disconnect that will undoubtedly lead to customer complaints. As one thinks through these issues, the possibility arises that the transaction between Groupon and the consumer is really just the sale of an intangible — a right to something in the future — and intangibles are not generally subject to tax. If only Groupon could arrange a coupon for 50 percent off sales tax. . . . Now that would be something.

C. Zombies Don't Care Which State They Are Taxed In

The mobile app store model introduces similar taxation problems. First, app purchases are inherently cross-border and interstate. If multiple states address the same tax issues, they will inevitably have different conclusions on the tax treatment, making it difficult for taxpayers to know how to comply. A zombie survival game can be purchased from a company in California using a credit card with a billing address in New York, downloaded in Union Station in the District of Columbia from a

²⁴See generally Streamlined Sales and Use Tax Agreement sections 309, 310.

²⁵H.R. 5469, 111th Congress.

²⁶Private Letter Ruling, Mass. Dep't of Rev. (Mar. 30, 2010).

server in Virginia, and played on a train traveling through Maryland, Delaware, Pennsylvania, and New Jersey (including having the customer make additional in-game purchases while traveling north). For those transactions alone, there are seven states (counting the district) involved, each of which will have different answers for questions regarding income and sales tax nexus, taxability for sales tax, sales tax sourcing, income tax sourcing, and, if a virtual currency is used to consummate the transactions, whether income is generated from the sale of the game.

It is clear that existing tax codes of these states do not begin to contemplate the answers to these difficult tax questions. Washington state has the most complete set of laws, rules, and guidance on taxation of digital goods and services,²⁷ and even it does not provide any clarity to the rules for taxing the post-modern digital world.

D. Unclaimed Property Issues

As with almost all other intangible property, virtual property will inevitably face the long arm of unclaimed property law. Although some of the unclaimed property issues facing the digital economy were addressed in an installment of Sutherland's UPwords column,²⁸ it is worth mentioning here that no matter if it is an account in a game that is no longer used, a coupon that goes unredeemed, or an app that is purchased but not downloaded, there will be at least one state that thinks that it is entitled to unclaimed property. States should ensure that they legislatively address the important issues regarding the expansion of unclaimed property laws to the digital world including providing adequate notice to holders and owners and issuing proper guidance and forewarning about what is and is not unclaimed property. Unclaimed property laws should protect the interests of the owners, not state budgets, and these policies should be set by elected policymakers.

²⁷Engrossed Substitute HB No. 2075 (Chapter 535, Laws of 2009).

²⁸Diann L. Smith and Mark W. Yopp, "UPwords: What's UP in the Digital World," *State Tax Notes*, July 12, 2010, p. 107, *Doc 2010-14511*, or *2010 STT 132-5*.

Determining what is unclaimed property through the audit process does nothing to help owners and holders determine what is unclaimed property before the auditor walks through the door. Instead, it is likely to lead to a Team Deathmatch²⁹ firefight over an unclaimed property assessment.

IV. Conclusion

The tax issues that arise as the virtual world continues to expand its offering of goods, services, information, experience, and entertainment are no different than issues that arise in the physical world — but the very nature of the virtual economy and the difficulty of applying antiquated tax statutes to them promises to make tax reporting, collection, and enforcement a challenging proposition. Our prediction: It won't be long before the Multistate Tax Commission and some of the states open up virtual offices and hire virtual auditors to roam Second Life, Facebook, and other virtual worlds to track down virtual tax scofflaws. Until then, vendors, developers, and tax professionals will continue to face uncertainty until the law catches up with the virtual world. ☆

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²⁹Team Deathmatch is the most frequently played multi-player game type in the Halo and Call of Duty series of games, and other first-person shooters. Your goal in this mode is to earn more kills than the other team.