

THE YALE LAW JOURNAL POCKET PART

LEANDRA LEDERMAN

EBay's Second Life: When Should Virtual Earnings Bear Real Taxes?

Millions of people participate in virtual worlds¹—immersive online forums such as Second Life² and World of Warcraft (WoW).³ While some online activities lack significant economic implications, one of the attractions of Second Life, which is designed to be a commercial platform, is the prospect of making “real money.” This essay argues that profits received in the form of Lindens⁴ (Second Life’s currency) should be taxed in much the same way profits received via PayPal,⁵ a widely used electronic-payment system, are. Although Second Life profits could instead be taxed once the taxpayer sells for real money (“cashes out”), that would create a special exception for Second Life that does not exist for platforms such as eBay.⁶ It would facilitate abuse and distort economic activity.

A purely in-game economy is one thing. A Monopoly player who obtains thousands of dollars in paper money and a raft of hotels has no additional wealth—those assets are returned to the box once the game is over. If user agreements that state that all of the virtual property belongs to the world’s owner are upheld, games like WoW resemble Monopoly.⁷ WoW’s economy is

-
1. For example, Second Life has 16.4 million total “residents,” of whom 1.38 million logged in within the last sixty days. See Second Life, Economic Statistics, http://secondlife.com/whatis/economy_stats.php (last visited Dec. 15, 2008).
 2. Second Life, <http://secondlife.com> (last visited Dec. 15, 2008).
 3. World of Warcraft, <http://www.worldofwarcraft.com> (last visited Dec. 15, 2008).
 4. Second Life, <http://secondlife.com/whatis/economy.php> (last visited Dec. 15, 2008).
 5. PayPal, <https://www.paypal.com> (last visited Dec. 15, 2008).
 6. eBay, <http://www.ebay.com> (last visited Dec. 15, 2008).
 7. See Leandra Lederman, “*Stranger Than Fiction*”: Taxing Virtual Worlds, 82 N.Y.U. L. REV. 1620 (2007).

not designed to interact with the real world. Instead, its publisher prohibits real money exchanges and sales of accounts, avatars, and items.⁸

Second Life, by contrast, is structured to facilitate commerce.⁹ It provides tools for participants to build creations they can sell for Lindens. There is no prohibition on exchanging Lindens for money or other property; in fact, Second Life provides the LindeX, a currency exchange, to support the purchase and sale of Lindens.¹⁰ Second Life is thus intentionally commodified.

As a policy matter, how should transactions within virtual worlds be treated for federal income tax purposes? Part I examines the cash-out approach. Part II analogizes sales for Lindens to sales for PayPal payments. Part III makes a policy recommendation based on the similarities between Lindens and PayPal.

THE APPLICATION OF OLD LAWS TO NEW TECHNOLOGIES

Existing tax laws were not developed with virtual worlds in mind. Nonetheless, it is widely accepted that if a U.S. taxpayer profits in real money from virtual world activities, that profit is subject to federal income tax.¹¹ For example, if Ava purchases a WoW account online for \$200 and subsequently resells the account for \$300, Ava has \$100 of taxable profit. Similarly, if Ava purchases a virtual sword for \$20 and resells it for \$25, Ava has a \$5 taxable gain. It may not be easy to enforce the law in this regard, but that does not negate the existence of the tax liability.

The policy question of whether tax should be due before the gamer cashes out is important, particularly in light of doctrinal uncertainties. A cash-out rule links taxation to a highly salient event. It also would be rarely, if ever, overinclusive. Certainly there is no logical later point at which to tax profits from virtual worlds.

However, a cash-out rule can be underinclusive and subject to manipulation: A taxpayer might accumulate substantial funds online, even intentionally deferring cashing out in order to postpone taxation. Where the

8. World of Warcraft Terms of Use Agreement para. 11, <http://www.worldofwarcraft.com/legal/termsofuse.html> (last visited Dec. 15, 2008).

9. See Theodore P. Seto, *When is a Game Only a Game?: The Taxation of Virtual Worlds*, 77 U. CIN. L. REV. (forthcoming 2009), available at <http://ssrn.com/abstract=1220923>.

10. Second Life, Currency Exchange, <http://secondlife.com/whatis/currency.php> (last visited Dec. 15, 2008).

11. See I.R.C. § 61 (2000); Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 HASTINGS L.J. 1, 45 (2007).

funds are similar to cash, as this essay argues Lindens are, deferral creates distortions. Deferral is quite valuable for taxpayers and costly to the government. Moreover, under current law, deferral can become complete exemption from income taxation if the taxpayer dies before the amounts are included in income.¹²

Some argue that virtual worlds exist in a “magic circle,” so purely in-world activities should not be subject to real world laws.¹³ The magic circle metaphor, however, is unpersuasive for federal income tax purposes.¹⁴ U.S. taxpayers are taxed on their worldwide income,¹⁵ and virtual world activities occur within that space. Income from an activity or location generally is taxed even if funds do not leave that activity or location. For example, profits earned in France by a U.S. taxpayer are subject to federal income tax even if they are not repatriated.¹⁶ And profits earned in a venue like eBay are taxed regardless of whether they are reinvested there.

THE PAYPAL ANALOGY

As online activities have become routine, people have become more comfortable transacting in electronic means of payment. On eBay, for example, people engage in domestic and international exchanges. Profits on eBay transactions are subject to federal income tax, just as they are if the items are sold through an advertisement in the newspaper or on Craigslist.¹⁷ Of course, some sales result in a loss, not a profit. If the item was for personal use, such as a sofa from the seller’s family room, the loss is not deductible.¹⁸

-
12. See I.R.C. § 1014(a)(1) (providing for fair market value basis at death), (f) (scheduled to terminate on December 31, 2009); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 § 901(a)(1), (b), 115 Stat. 38, 150 (sunset of termination on December 31, 2010).
 13. See Edward Castronova, *The Right To Play*, 49 N.Y.L. SCH. L. REV. 185, 185, 201-05 (2004); cf. Bryan T. Camp, *supra* note 11, at 60-61 (linking magic circle concept with theater’s “fourth wall”).
 14. Cf. Joshua A. T. Fairfield, *Anti-Social Contracts: The Contractual Governance of Online Communities* 17-19, 54-55 (Washington & Lee Legal Stud. Paper No. 2007-20, 2007), available at <http://ssrn.com/abstract=1002997> (criticizing the magic circle argument in tort and other contexts).
 15. See I.R.C. § 61 (2000); *Clark v. Comm’r*, 95 T.C.M. (CCH) 1265, 1268 (2008) (citing *Cook v. Tait*, 265 U.S. 47, 56 (1924)).
 16. See I.R.C. § 61 (2000).
 17. Craigslist, <http://www.craigslist.org> (last visited Dec. 15, 2008).
 18. See I.R.C. § 165(a), (c) (2000).

Many eBay sellers accept PayPal. Sellers may let PayPal balances accumulate, rather than immediately transferring the funds to a bank account. This may be for convenience, particularly if the seller also purchases items online. The casual seller, for example, may be a collector who purchases online and occasionally resells duplicates. A business seller may use PayPal to purchase packing materials or wholesale lots.

While many people might not have felt comfortable accumulating PayPal balances in its early days, PayPal is now ubiquitous, in part because of the success of eBay, which has owned it since 2002.¹⁹ Federal income tax law makes no distinction between the seller who leaves funds in PayPal format (or spends them directly) and the seller who transfers the funds to a bank account so they can be used offline. There is no sense in which reinvesting defers tax, any more than there would be for a brick-and-mortar retailer.

Many eBay sellers likely underreport their income for tax purposes, whether because of ignorance of the law or simply because, absent information reporting, noncompliance is not obvious. Accordingly, the IRS has proposed that Congress consider enacting legislation providing that Internet auction sites fall within the definition of “broker” for information reporting purposes.²⁰

As with PayPal at its inception, while many people might not yet be inclined to accumulate substantial amounts of Lindens, as more retailers accept them as payment, that reticence may well change.²¹ PayPal and Lindens differ in that PayPal provides a means of sending and receiving various currencies electronically, while Lindens are their own currency—they must be exchanged in order to become U.S. dollars.²² However, they both serve as electronic means of conducting commerce online.

Bartering is less convenient than using money, because bartering requires a match-up of the goods and services to be exchanged—whether through a direct

19. eBay, The eBay Company, <http://pages.ebay.com/aboutebay/thecompany/companyoverview.html> (last visited Dec. 15, 2008).

20. See Dustin Stamper, *IRS Wants Legislation To Require Auction Web Sites To Collect TINs*, 113 TAX NOTES 725, 725 (2006).

21. For a list of retailers who accept or have accepted Lindens, see Lederman, *supra* note 7, at 1667 n.235. At least two webhosting sites also do. See Save-Host, <http://save-host.com> (last visited Dec. 15, 2008); 3rdRockGrid.com, http://www.3drockgrid.com/main/index.php?view=article&catid=7%3Afaq&id=49%3Alindendollars&option=com_content&Itemid=25 (last visited Dec. 15, 2008).

22. Cf. William D. Terando et al., *Taxation Policy in Virtual Worlds: Issues Raised by Second Life and Other Unstructured Games*, 6 J. LEGAL TAX RES. 94 (2008) (arguing that Second Life residents lack constructive receipt of profits in Lindens).

swap, or indirectly, using barter credits. Nonetheless, history demonstrates that barter clubs can mushroom where they provide an opportunity for tax avoidance on sales by businesses.²³ Similarly, if exchanges in Second Life using Lindens are not taxed, Second Life may become the e-commerce platform of choice for tax evaders.

One argument against taxing the receipt of Lindens is that it will burden those primarily using Second Life for entertainment and only incidentally selling items. Existing law already protects those in that situation, however. The hobby loss provision of the Internal Revenue Code allows the deduction of expenses up to income from an activity that is not engaged in for profit.²⁴ Thus, even someone whose Second Life activities do not constitute a business can eliminate taxable income from in-world sales with in-world expenditures that equal or exceed the profits. Moreover, eBay and other sales platforms have no special exception for casual sellers. The occasional seller and big business alike are liable for tax on net profits from eBay sales.

RECOMMENDATION

To prevent Second Life from becoming the equivalent of an online barter club, sales for Lindens should be subject to tax. One could argue that only when Lindens are used to purchase some non-Second Life good or service, such as real world clothing, website services, or music downloads, should they be taxed. That approach, however, would create the odd result of imposing income tax on *purchases*, not sales. The better approach is to recognize Lindens as a cash equivalent and tax transactions in them accordingly, much the way the receipt of barter credits is taxed.²⁵ Information reporting at an appropriate threshold could be used to foster compliance.

Leandra Lederman is the William W. Oliver Professor of Tax Law at the Indiana University Maurer School of Law-Bloomington. She thanks Adam Chodorow and Jody Madeira for helpful comments, and Michala Irons for research assistance.

23. See Camp, *supra* note 11, at 33 (“By 1982, the value of goods and services exchanged through barter clubs had been growing by approximately 20% per year for about six years and was estimated to involve some sixty thousand barter club members exchanging some \$300 million annually. . . . [T]he high level of non-compliance by barter club members made suckers out of honest taxpayers.”) (footnote omitted).

24. I.R.C. § 183(b) (2000).

25. See Rev. Rul. 80-52, 1980-1 C.B. 100 (stating that value of credit units must be included by cash method barter club member in year in which units are credited to member’s account).

Preferred Citation: Leandra Lederman, *EBay's Second Life: When Should Virtual Earnings Bear Real Taxes?*, 118 YALE L.J. POCKET PART 136 (2009), <http://thepocketpart.org/2008/01/26/lederman.html>.