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## Why the IRS Has Not Taxed Income from Virtual World Transactions . . . Yet

Virtual world transactions (VWT) involve the sale or exchange of goods and services that are used exclusively within a virtual world. As participation in virtual worlds increases, both in volume and in character, the boundary between VWT and real world transactions becomes unclear.<sup>1</sup> Consequently, many wonder whether the Internal Revenue Service (IRS) will tax participants in virtual worlds, even before they have converted their virtual items into real goods or services. Although IRS agents are not counting virtual earnings quite yet, they may begin to take notice of VWT on a broader scale if and when one of three events occur: (1) courts grant property rights to virtual world participants in the virtual items they amass; (2) vendors begin accepting virtual items (such as virtual currency) on a regular basis in exchange for real goods and services; or (3) Congress adopts legislation requiring owners of virtual worlds to report certain transactions to the IRS.

### CURRENT LAW

Until one of these events occurs, virtual world participants should have little to fear from the tax collector. Why VWT should be tax-free based on existing law may not be immediately clear, as Congress generally taxes “all income from whatever source derived.”<sup>2</sup> However, two main theories have been advanced against taxing VWT.<sup>3</sup>

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1. Real world transactions may be defined as anything involving the transfer of *real* goods or services.
  2. I.R.C. § 61 (West Supp. 2008).
  3. For a more detailed analysis of current tax law as it applies to VWT, see Brian T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 HASTINGS L.J. 1 (2007); and Leandra Lederman, “*Stranger than Fiction*”: *Taxing Virtual Worlds*, 82 N.Y.U. L. REV. 1620 (2007).

First, Congress typically does not tax income until it has been “realized,”<sup>4</sup> which occurs when property is sold or exchanged for “property differing materially either in kind or in extent.”<sup>5</sup> Therefore, because *property* must be received to trigger realization, VWT should not be realization events if virtual items are not “property.” To understand why virtual items might not be property, consider the terms of use for a typical virtual world in the context of a hypothetical VWT.

Assume that Jack, a participant in World of Warcraft, trades his virtual battle-axe to Jill for her virtual shield. Arguably, no “property” has changed hands in this transaction. An essential component of property is the *right to exclude*,<sup>6</sup> which is a right that neither Jack, nor any participant in World of Warcraft, possesses. Blizzard Entertainment, which owns World of Warcraft, retains all rights to the content of its virtual world, and reserves the right to “suspend, terminate, modify, or delete the accounts at any time with any reason or no reason, with or without notice.”<sup>7</sup> Accordingly, if Blizzard eliminated all shields from World of Warcraft, Jack apparently would have no recourse. Thus, Jack has what might best be described as a *non-exclusive license* to use his new shield rather than a *property right*. Without a property right, he has not realized any income from the transaction.

Professor Brian Camp proposes a second theory for not taxing VWT, suggesting that virtual earnings are equivalent to “imputed income.”<sup>8</sup> *Imputed income* is the “flow of satisfactions from . . . goods and services arising out of the personal exertions of the taxpayer on his own behalf.”<sup>9</sup> Examples of imputed income fall into one of two categories: wealth from self-provided services (such as growing one’s own food) and use of one’s property (such as living in one’s own home). The fundamental characteristic of imputed income is that it is *personal*; it does not take place in a market context. Accordingly, the IRS has historically ignored imputed income, largely because any attempt to tax it would prove to be unfair and impractical.

One example of imputed income, to which virtual earnings have been compared, is the value one gets from role-playing or participation in a game. Like other types of imputed income, “game” income is entirely personal in

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4. See, e.g., *Eisner v. Macomber*, 252 U.S. 189, 207-12 (1920).

5. Treas. Reg. § 1.1001-1(a) (as amended in 2008).

6. *Kaiser Aetna v. United States*, 444 U.S. 164, 179-180 (1979) (“[T]he ‘right to exclude’ [is] universally held to be a fundamental element of the property right . . .”).

7. World of Warcraft, Terms of Use (last visited Dec. 17, 2008), <http://www.worldofwarcraft.com/legal/termsofuse.shtml>.

8. Camp, *supra* note 3, at 56-61.

9. *Id.* at 37 (citing Donald B. Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514, 514 (1943)).

nature; it does not take place in the market. Arguably, virtual worlds are a type of game in which the virtual items one earns more closely resemble Monopoly money than real income. Under this theory, so long as virtual worlds are primarily used for personal enjoyment, and participants generally do not intend to cash out their virtual earnings when the game is over, then VWT should not be taxed.

Regardless of whether we accept the realization or imputed income arguments, the likelihood that our system will tax VWT seems minimal.<sup>10</sup> The Joint Economic Committee has recently stated that “if [a] transaction takes place entirely within a virtual economy, then it seems there is no taxable event.”<sup>11</sup> Nevertheless, certain events might make Congress and the IRS reconsider this position.

### PROPERTY RIGHTS

First, VWT may be taxed if courts grant participants more property rights than are indicated in the terms of use for a typical virtual world. The argument that VWT are not realization events would fail if virtual items were considered property. Such a legal status may also undermine the imputed income argument, which relies on the belief that virtual items are for personal enjoyment and not intended for use in a real market context.

Already, one court has overturned portions of a virtual world’s terms of use. In *Bragg v. Linden Research, Inc.*, the court invalidated the arbitration clause in Second Life’s terms of use, finding it substantively and procedurally unconscionable.<sup>12</sup> Similarly, a court determining property rights for virtual world participants may ignore the terms of use and grant more extensive property rights in virtual items. If that happens, the realization and imputed income arguments would falter and the IRS might conclude that VWT should be taxed.

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10. As discussed below, the appropriate taxation of a given VWT depends upon certain qualities of the particular virtual world, including the extent of property rights granted by the user agreement and the fungibility of virtual items for *real* goods and services. Although taxation may therefore be more justified for some virtual worlds than others, such a nuanced discussion is beyond the scope of this article.

11. Press Release, Joint Econ. Comm., Virtual Economies Need Clarification, Not More Taxes (Oct. 17, 2006).

12. 487 F. Supp. 2d 593, 611 (E.D. Pa. 2007).

**REAL PURCHASING POWER**

The second issue concerns the purchasing power of virtual currencies. The more “virtual” currency is used to purchase real goods and services, the more it begins to look like “real” currency. This would effectively foreclose the imputed income argument, which relies on virtual items being personal, not market driven.

For example, one can earn Microsoft Points on Xbox Live and use them to purchase real world items from Microsoft, including video games and movies.<sup>13</sup> Accordingly, any Microsoft Points that a participant earns should be taxable, even prior to being cashed out. On the other hand, a virtual currency like gold on World of Warcraft, which may not be used to purchase real goods or services, should not be taxable until converted into cash. Notably, some vendors have already accepted virtual currency in exchange for real goods and services.<sup>14</sup> If this trend continues, these otherwise nonmarket virtual currencies may become taxable.

**INFORMATION REPORTING TO THE IRS**

Finally, the IRS may tax VWT if Congress passes legislation requiring virtual world owners to report VWT to the IRS. Although the IRS generally will not tax unrealized or imputed income, this is due to the impracticality of taxing such income as opposed to limitations on Congress’s taxing power. Simply put, the IRS cannot track unrealized and imputed income on its own. Accordingly, a law that required virtual world owners to report transactions directly to the IRS would make taxation of virtual earnings possible for the first time.

Although no such law exists today, the Treasury would like to strengthen information reporting to the IRS.<sup>15</sup> For instance, the President’s Fiscal Year 2008 Budget Proposal sought to broaden the scope of I.R.C. § 6045, which requires any person doing business as a broker to report certain transactions to

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13. See Xbox, Xbox 360: Get the Points, <http://www.xbox.com/en-US/live/features/microsoftpoints.htm> (last visited Dec. 17, 2008).

14. For companies that have accepted virtual currency for real world items, see, for example, Pizza.Net, Press Release, Dynamedia Mktg., Pizza Enters the Virtual World of Second Life (Apr. 21, 2007), available at <http://www.fastpitchnetworking.com/pressrelease.cfm?PRID=8734> (pizza delivery service); and Virtual to Reality, <http://www.vtoreality.com/advertising> (last visited Dec. 17, 2008) (advertising agency).

15. See DEP’T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP (2006).

the IRS.<sup>16</sup> Under the proposal, I.R.C. § 6045 would be expanded to cover auction sites such as eBay, and would require those companies to report transactions between website users.<sup>17</sup> It is unclear whether such legislation, if passed, would also require reporting from virtual world owners. If so, the IRS would have the means to track, and to assess tax on, the income from VWT, regardless of whether such earnings are unrealized or imputed.

## CONCLUSION

Although the tax system currently appears not to reach virtual earnings, certain events may cause Congress and the IRS to reevaluate the need for taxation. Virtual world participants should be aware that the principles of realization and imputed income can only do so much to fend off the Taxman. Continued reliance on the realization and imputed income arguments depends on certain conditions that may change, including property rights in virtual items, the purchasing power of virtual currencies, and the relative capabilities of the IRS to track VWT.

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16. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2008 REVENUE PROPOSALS 65 (2007).

17. See *id.*