

Gamer Technology Law Conference

Tax Considerations for "Virtual Currency" Transactions

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Overview

1. "Virtual Currencies"
2. Bitcoins
3. Game Currencies: Linden Dollars
4. Are Virtual Currency Transactions Taxable?
5. General Tax Rules
6. Application of General Tax Rules
7. Tax Rules for Foreign Currencies
8. Practical Considerations
9. Final Thoughts

Please ask questions any time.

"Virtual Currencies"

- * GAO definition: "generally, a digital unit of exchange that is not backed by a government-issued legal tender."
- * Examples
 - Bitcoins (BTC)
 - Game Currencies
 - Linden Dollar (L\$) – Second Life
 - "Gold"/"Silver"/"Copper" – World of Warcraft

Bitcoins

- * Bitcoin (BTC) is a digital currency not backed by a government, institution, or tangible (or intangible) asset
- * Accepted as payment by real-world persons in exchange for goods and services
- * May be exchanged for real-world currencies
- * New Bitcoins (up to BTC 21 MM, in 2160) created ("mined") when transactions are "confirmed"

Bitcoins

(Continued)

- * BTC Statistics (as of September 3, 2013)
 - Market Cap: US\$1.68B (\$2.6B in April, 2013)
 - US\$600K new BTC "mined" per day
 - US\$44.4MM BTC transactions per day
 - Exchange rate: BTC1/US\$144
- * E.D. Tex. District Court ruled on Aug 8, 2013 that "**Bitcoin is a currency or form of money**" for securities law purposes (emphasis added)

Game Currencies: Linden Dollars

- * A transferrable license (per Second Life Terms of Service)
- * L\$ Statistics (as of September 3, 2013)
 - * Exchange rate of ~ L\$250/1US\$
 - * Daily US\$ Transactions of US\$300-400K
 - * Aggregate Transactions of US\$3.2B since inception (2003)
 - * Market Cap of US\$200MM in June 2012

Are Virtual Currency Transactions Taxable?

Internal Revenue Service:

"If you receive more income from the virtual world than you spend, you may be required to report the gain as taxable income."

Translation:

"Maybe. You figure it out."

General Rules

- * Code § 61: "... gross income means all income from whatever source derived"
- * Income includes barter exchange gains and losses:
 - Pig for chickens
 - Services for stock
 - iTunes gift card for building website
- * Generally taxable at the time of the exchange, not when property converted to US\$

General Tax Rules: Bitcoins

- * One merchant's approach for calculating tax: "We plan to convert them [to US\$] in one fell swoop and calculate the income that way."
 - Is this consistent with current tax law?
 - Probably not
- * As Bitcoins are readily priced and readily exchangeable for real-world currencies, why should they be any different than any other property?

General Tax Rules: Bitcoins

(Continued)

* Examples

1. Sell a coffee for BTC
2. Sell BTC for US\$
3. Use BTC to purchase coffee beans

* Probably should be subject to tax at the time BTC is received for goods or services and when BTC is used to purchase goods, services, or real-world currencies

General Tax Rules: Game Currencies

- * As L\$ are readily priced and readily exchangeable for real-world currencies, why should they be any different than any other property?
 1. Sell goods created in-game for L\$
 - Compare exchange of iTunes gift cards for building website
 2. Buy in-game goods for L\$
 - Compare purchase of coffee with gold

General Tax Rules: Game Currencies

(Continued)

- * An exchange involving IP licenses are taxable, so why not exchanges involving L\$ licenses?
- * Should the fact that they are part of a game matter?
 - Gambling income
 - Racing for pink slips

General Tax Rules: Game Currencies

(Continued)

- * A possible distinction: game currencies are intangible items that would have no value but for the game
 - But, is that any different than gift cards, stock or promissory notes?
 - Presumably if game currencies stop being readily convertible into real-world currencies and thereby become essentially valueless, game transactions would not be taxable

General Tax Rules: Game Currencies

(Continued)

- * Like-kind exchange?
 - Would require the game currency and the property exchanged to be held for productive use in a trade or business or for investment
 - Probably not satisfied for most gamers
 - Do the game currency and the game property have the same "nature and character"?
 - Does the game currency constitute "money"?

Tax Rules for Foreign Currencies

- * Special tax rules apply to currencies
- * Code § 985 provides rules for determining a taxpayer's "functional currency"
 - Currencies other than a taxpayer's functional currency are "property" rather than money/cash
- * Code § 988 generally treats foreign currency gains and losses as ordinary income and losses
 - Exceptions for "personal" transactions (*e.g.*, \$200 rule)

Tax Rules for Foreign Currencies

(Continued)

- * Current Regulations do not define "currency," but tend to refer to currencies of countries
 - Bitcoins are probably more likely to constitute "currency" than game currencies
- * If virtual currency is "currency" for tax purposes
 - Individuals may be able to qualify for § 988 exceptions
 - Businesses may qualify to treat virtual currency as a functional currency

Practical Considerations

Game Currencies

- * Will players really track in-game transactions?
 - Presumably the game companies could do this
 - Are games "barter exchanges"?
 - New reporting obligations?
- * Is enforcement worth the costs?
 - Probably < US\$1B of tax revenue over 10 years for L\$
 - Most users probably at lower tax rates
 - Amounts for each user probably relatively low

Practical Considerations

(Continued)

Bitcoins

- * People are using Bitcoins for real-world transactions
 - Transactions probably would be readily apparent in audits of businesses
- * Enforcement is probably more economically justified
 - Annual transactions of ~ US\$8.5B
 - If 50% were taxable in the US, that is US\$1 - US\$1.5B tax revenue per year
 - Returns more likely prepared by accountants

Practical Considerations

(Continued)

Generally

- * IRS needs to issue real guidance
 - GAO has officially recommended this
 - FinCEN has issued Bitcoin guidance
 - SEC is pursuing Bitcoin securities law violations
- * The general tax rules are not intuitive for general public
- * Application of foreign currency rules is unclear

Practical Considerations

(Continued)

Generally

- * Probably easiest to classify as "currency"
 - Could result in unexpected income for people who purchase goods or services with Bitcoins
 - § 988 exceptions probably limit taxable gain for personal transactions in Bitcoin and game transactions
- * Is there an alternative?
 - Possibly impose tax only upon conversion to real-world currency (open transaction)

Final Thoughts

- * Bitcoins are a small market, but they are growing
 - Ordinary taxpayers probably have no idea how they are supposed to pay tax on these
 - Many probably don't realize (or don't want to realize) that their transactions could be taxable
 - Unsophisticated taxpayers will likely feel blindsided by their tax liabilities if the IRS does not start releasing guidance

Final Thoughts

(Continued)

- * Discussion about game currencies is mostly academic
 - For the most part, the stakes are low
 - Results, however, would surprise most gamers
 - Game companies with in-game currencies suggestions
 - Include disclaimers to users to consult with their own tax advisors
 - Consider whether barter exchange or broker reporting rules apply

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