

Should real profits in virtual worlds be taxed? ISU professors say there's a way to do it

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Gut Noel, the avatar of ISU profesor Brian Mennecke, strolls through a marketplace area in Second Life.

Ben Franklin's astute observation -- "In this world, nothing can be said to be certain, except death and taxes" -- has stood the test of time fairly well over the past 219 years. Until now.

In online virtual worlds like Second Life and World of Warcraft, some game players are making real money -- in some cases thousands, even millions, of dollars. But neither the Internal Revenue Service nor game administrators have a process in place for players to report their profits

upon cashing out, making these virtual worlds a tax haven for some.

Four professors from Iowa State University's College of Business have been studying how to change that. They have recommended some tax methods for Second Life income in a pair of recent research papers.

The team includes Brian Mennecke, an associate professor in management information systems; Bill Terando, assistant professor of accounting; Bill Dilla, associate professor of accounting; and Diane Janvrin, assistant professor of accounting. Their first paper, titled "It's Just a Game, or Is It? Real Money, Real Income, and Real Taxes in Virtual Worlds," was published in a 2007 edition of the *Communications of the Association for Information Systems*, a professional journal. A second paper, "Taxation Policy in Virtual Worlds: Issues Raised by Second Life and Other Unstructured Games," is currently under review for publication in another journal.

"The primary audience for these papers is the occasional player who makes in the range of \$1,000 to \$10,000 (through virtual worlds)," said Dilla. "The analogy would be the occasional gambler who goes out and gets very lucky and has a big enough winning to be issued a 1099 at the casino. There's probably a good group of people out there who are unaware that if they cash in their Linden dollars (Second Life currency) and get a couple of thousand in U.S. currency, they're liable for tax."

There are currently more than 13 million residents (accounts) in Second Life, according to its economic statistics Web site (secondlife.com/whatis/economy_stats.php). Of that group, 328,122 conducted 16.5 million transactions in February alone.

Virtual income currently self-reported

The ISU researchers say that most people who make their livings from

these virtual worlds probably already report it to the IRS. But some of the less serious or occasional players who also make sizable profits may choose not to report.

"To date, this income has largely escaped taxation due to the lack of a well-developed body of tax law in this area," the researchers wrote in their latest paper. They propose that Second Life participants be required to recognize virtual world income when they convert their profits into real world currency.

"We're kind of going down two tracks here," Dilla said. "One is that there are various things that can happen to make your virtual income worthless before you cash it out. And secondly, there's a lot of difficulty measuring income while it's within the game. So we're proposing that the income should not be taxable until it's taken out of the game -- or more precisely, until virtual dollars are converted into real dollars."

The ISU researchers note that much can happen to virtual profits within the game. The Second Life terms of service agreement provides Linden Lab the right to cancel participants' accounts without notice at any time, without refunds. The ability of participants to use LINDEX to convert Linden dollars to U.S. currency (250 Linden dollars equal one U.S. dollar) is also dependent upon market forces in Second Life. Runs on Second Life banks in August 2007 and January 2008 resulted in losses to participants who were unable to convert their Linden dollars back to real currency.

Creating a report upon cashing out

So, waiting to report taxable income until that conversion takes place just makes good sense, according to the ISU team.

"From a tax policy perspective, recognition of virtual income at the time

of conversion into real- world currency may prove beneficial because it reduces Linden Lab's tax reporting compliance costs," they wrote. "It would only be necessary for the game administrator to report cash through distributions made through the LINDEX to participants and the IRS. In addition, this recognition method allows more Second Life participants to use the virtual world without fear of triggering income tax consequences, until the point at which they convert virtual profits into real currency."

And since all transactions in virtual worlds are conducted electronically online, the researchers agree that an easy tax reporting mechanism could be put in place at the time players decide to cash out.

"It's an electronic environment, so they can set up anything that they want as far as reporting (for tax purposes)," said Mennecke, who teaches an e-commerce course through Second Life.

But until that's created, the virtual reality will be that profits from those "games" will continue to be self-reported to the IRS.

Source: Iowa State University of Science and Technology

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