

# 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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