
China Taxes Real Profits from Virtual World Transactions

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China has declared that it will tax profits on transactions involving virtual currency. In response to an inquiry from the Beijing Tax Bureau, China's State Administration of Taxation issued a "Written Reply on Imposing Individual Income Tax on the Revenue Derived from Online Trade of Virtual Currency by Individuals" on September 28, 2008 (the "Written Reply"). The Written Reply imposes an individual income tax of 20% on income derived from online trade of virtual currency.

China's new policy has significant implications for those who participate in transactions involving virtual currency associated with games and virtual worlds having presences in China and, perhaps, elsewhere in the world. It may also have implications for those who facilitate such transactions. But this is just one of many emerging legal and regulatory issues that will impact this growing industry. As a courtesy to its clients, Pillsbury's Virtual Worlds and Video Games team stays abreast of these issues and provides client alerts on topics of interest.

Taxation of Virtual World Transactions in Other Countries

Tax experts have long cautioned that profits made through transactions involving virtual currency and goods may be taxable. But until recently, official guidance has been scant and collections efforts have been almost nonexistent. While the United States has yet to issue any guidelines, several other countries, including China, have begun to take steps to collect taxes on real profits realized in transactions involving virtual currency and/or goods.

China is not the first country to tax profits on the real world sale of virtual property, but it is the first to issue formal guidelines. In 2007, the United Kingdom's HM Revenue and Customs department said that it was investigating people who were earning profits in social virtual worlds like Second Life and not paying taxes on the profits. Earlier this year, Sweden also declared that it would tax profitable activities in online worlds. Neither Sweden nor the U.K., however, issued new regulations or formal guidelines. China, leapfrogging these initial steps, has issued a specific declaration regarding the taxation of profits derived from such

sales—sales which China says fall under its provision for the taxation of “transfer of property.” In the U.S., the Congress has held various hearings relating to virtual transactions.

Virtual Worlds, Real Profits

The rapid development of virtual worlds has made “virtual currency” and “virtual property” big business. Virtual currency from almost every game and social virtual world can be exchanged for real world currency. In some games and virtual worlds the exchange of virtual currency takes place via provider-approved channels. For those games and worlds where the provider does not authorize “real money trade,” Internet-based third-party markets abound and are thriving. In other cases, virtual currency can be redeemed for real-world goods or services. For example, pizza.net provides a service in Second Life that enables a user to enter a virtual pizza store and order real pizza for real-world delivery using the virtual currency of Second Life (Linden Dollars). Worldwide, the market for transactions involving an exchange of real-world currency and/or goods for virtual currency and/or goods is estimated at more than US \$2 billion per year and growing.

Profits from these transactions are realized in a variety of ways. For example, profits can result from running in-world businesses that provide virtual goods or services to customers, “gold farming,” speculation in virtual land, and sales of advanced game characters. Many online game players buy virtual currency and other virtual world assets such as weapons, virtual buildings, and game resources from professional “gold farmers.” “Gold farmers” are individuals (often in third world countries) who spend significant time playing online games to develop more powerful avatars and accumulate virtual currency and other assets and offer them for sale. Other players buy entire user accounts that come with game characters that have already been “leveled up” (i.e., characters that have advanced skills and/or powers) through time-consuming game play by gold farmers. In this way, the purchasing player can gain immediate access to content and a playing experience that is only available via a character that has reached a certain level of power and/or achievement, which requires a significant investment of time. Other users, particularly users of social virtual worlds, create and sell virtual goods like clothing, cars, and houses, provide services to other users, and speculate in or lease virtual real estate, among other things.

Virtual Currency in China

The online trade of virtual currency for real world currency, goods, or services has become very common in China. In 2005, the *New York Times* reported that more than 100,000 people were employed as professional “gold farmers” in China, and that number has certainly increased since then. A recent search of the Chinese words for “trade of game currency” yielded more than 500,000 Google hits. The iResearch Consulting Group reports that more than ten billion yuan (approximately US \$1.5 billion) worth of virtual currency is traded for real world value on the Internet in China each year, and that amount is growing at an annual rate of 15% to 20%.

If this was pure profit, there could be as much as two billion yuan (approximately US \$300 million) in tax income generated each year in China through the imposition of a 20% income tax on such profits.

Taxing Profits on Virtual Transactions in China

Until now, China’s Individual Income Tax Law was silent on whether profits derived from transactions involving virtual currency were subject to income tax. Recently, the Beijing Tax Bureau asked the State

Administration of Taxation to determine whether such profits are taxable. The State Administration of Taxation confirmed that they are.

According to the State Administration of Taxation's Written Reply, any real world profits realized from the purchase or sale of virtual currency between game players fall within the scope of individual taxable income, which is taxable as an item of income from the transfer of property. Under the PRC Individual Income Tax Law, the tax rate on income from the transfer of property is 20%. The calculation of taxable income from the transfer of property is the difference between the revenue derived from transferring the property and the original purchase price of the property, including deductions for the reasonable costs and expenses incurred from the transfer of the property. If an individual fails to provide proof of an original real world price for the exchanged virtual currency, then taxation officials have discretion to determine the original price. Costs associated with transactions in which real world value is obtained for virtual currency, such as online access charges and purchases of in-game assets, could presumably be deducted from the taxable income.

The State Administration of Taxation's Written Reply does not expressly impose an obligation on operators of virtual worlds or exchanges for virtual currency to deduct and withhold any tax due from affected individuals, or to remit to the taxing authority any tax due on behalf of individuals who realize real world profits from the trade of virtual currency for real world value. Instead, such individuals who realize real profits from transactions involving virtual currency are expected to "self-regulate" by paying taxes on their own accord. Also, the State Administration of Taxation's Written Reply seems to address only individuals, leaving open the question of whether an entity whose business relies in whole or in part on transactions involving exchanges of virtual currency for real world value would be subject to taxes other than the Enterprise Income Tax.

Legal Status of Virtual Currency and Property

A few scattered court decisions from the Netherlands, China, and South Korea have held that "virtual property" is valuable and deserves protection, but outside of these isolated cases, no country's legal system has squarely addressed the legal status of virtual property.

In China, property law protects real tangible property and intangible intellectual property. However, virtual currency arguably is neither real tangible property nor intellectual property, and its legal status has not previously been addressed by Chinese law. While the taxation of revenues derived from the sale of virtual currency, goods, and avatars does not necessarily recognize the exchanged currency, goods, and avatars as real property, it will likely provide fodder for legal scholars, many of whom have advocated for recognition of this new category of property in the U.S. and elsewhere.

One could argue that a precondition for the transfer of property is that the transferor have ownership over the property to be transferred. If this argument is valid, the Written Reply has arguably affirmed that virtual currency is the private property of the game players. However, the Written Reply does not necessarily take a position on whether or when the exchange of virtual currency for real world currency or goods is legal. It merely imposes a tax if a profit is made from such a transaction. In many jurisdictions, including the U.S., tax is owed on income however that income is derived. This includes income that results from illegal activity (sale of drugs, gambling, etc.). Therefore, while some will undoubtedly argue that the imposition of a tax on profits from virtual currency transactions evidences a property right in virtual currency, this fact alone may not be dispositive of the issue.

In fact, the situation is hardly settled. The Written Reply appears to conflict with another formal proclamation, China's "Circular on Further Strengthening the Administration on Internet Bar and Online Games" (the "Circular"). This Circular was jointly issued by fourteen Chinese ministries and commissions, with the notable exception of the State Administration of Taxation. The Circular expressly prohibits the exchange of virtual currency for real world currency or the purchase of real commodities using virtual currency. Thus, even though such transactions may be illegal in China, if you nevertheless engage in and generate a profit from such transactions, you will be obligated to pay tax on those profits.

In the U.S., there has been no formal guidance from the Internal Revenue Service. However, many tax experts agree that profits made on the real world trade of virtual goods and currency are taxable. This is so even though many virtual worlds have Terms of Service agreements that prohibit the sale of virtual currency and impose restrictions on the sale of avatars, and in spite of virtual property's lack of formal recognition under U.S. law. Past U.S. Supreme Court precedent has held that the U.S. Internal Revenue Code is for taxing net income, and is not a mechanism for enforcing other laws (e.g., codes covering breach of contract, copyright infringement, or other potential claims against users acting outside the bounds of a Terms of Service or End-User License Agreement). As such, tax may be due on such real profits even if the transaction violates the relevant Terms of Service. Accordingly, the taxation of such profits may not adversely impact the enforceability of terms of service provisions restricting the real world sale of virtual currency and/or avatars, or be dispositive of the issue of the property rights in virtual currency, at least in the United States.

Enforcement

Although the Written Reply imposes a tax on the profits realized from the trade of virtual currency for real world value, in practice, it may be difficult to enforce. Unlike the traditional trade of real property and currency, the virtual market currently is largely unregulated, highly fragmented, and notoriously unstable, particularly for exchanges of virtual currencies or goods that are not sanctioned by the appropriate virtual world provider. At any given time, there are hundreds of small-scale third-party websites offering virtual currency and property for sale. The sites quickly open and close in an ever-shifting landscape of new names and Internet domains, and there is no central clearinghouse where a government agency could easily impose reporting requirements.

One solution that taxing authorities may consider is to require virtual world providers and/or virtual currency exchange operators to keep records of transfers of virtual currency between users and report transfers above a certain threshold to the taxing authority. However, even this may prove ineffective because many transactions are "microtransactions" that could fall below even a modest threshold. The problem is exacerbated by the fact that the transactions typically occur through avatars, which may be associated with user accounts opened by individuals using fictional identifications. Some reports indicate that the Beijing Tax Bureau is working on relevant operational measures, including mechanisms for verifying the original real world price of the virtual currency traded by individuals. We will monitor these developments.

No specific requirements have yet been imposed on game and virtual world companies operating in China or accepting real world payments from Chinese users, but China has a long history of tight regulation of the gaming and Internet industries. Companies with a stake in the Chinese gaming and virtual world market may wish to consult an attorney to discuss the implications of this law.

Conclusion

China's move to tax profits from transactions involving virtual assets is likely a harbinger of regulation to come to virtual worlds, both in tax law and other areas. Other governments, including the U.S. government, are already eyeing the booming virtual transaction industry as a source of possible tax revenue and as an industry in need of tighter regulation. In early 2008, the U.S. Congress held hearings on virtual worlds and lawmakers focused on the potential for virtual currencies to be used as vehicles for money laundering. Congress' Joint Economic Committee has also indicated that it plans to issue a formal report on taxation of virtual transactions. Other efforts are also underway.

As governments move to regulate virtual worlds and online games, operators, service providers and users of virtual worlds will need to pay close attention to emerging regulatory schemes. Should you have questions about the new China tax law or other issues regarding virtual worlds and games, feel free to contact us.

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