

## DO VIRTUAL WORLD ACTIVITIES GIVE RISE TO REAL CANADIAN TAX LIABILITIES?

Brendan Burns\*

---

In 2005, Jon “NEVERDIE” Jacobs made headlines when he mortgaged his Miami home to purchase an asteroid in *Entropia Universe* for \$100,000 US Dollars (USD).<sup>1</sup> *Entropia Universe* is not some far away galaxy and Jon did not purchase this asteroid from an online star naming registration service. Rather, *Entropia Universe* is one of countless virtual worlds. These online, computer-based simulated environments provide a forum for people to partake in countless activities “ranging from role playing in medieval fantasy worlds”, exploring untamed planets, or “setting up online branches of real world businesses.”<sup>2</sup> Popular examples of virtual worlds include *Second Life*, *World of Warcraft*, *Entropia Universe*, *Ultima Online*, and *the Sims Online*.<sup>3</sup> While Jon Jacobs’ purchase is a large transaction, it is by no means an anomaly. On any given day thousands of virtual items are exchanged in these worlds and on various online auction sites. Because of the profits being made and the inherent real-world economic value of virtual world commodities, various countries have begun to explore taxing virtual world activities.<sup>4</sup>

While few dispute that a sale of virtual goods for real currency should be a taxable event, a scholarly debate has arisen over whether exchanges of virtual goods for virtual currency or other virtual goods,

---

\* B.A. (UBC); LL.B. (UM)

<sup>1</sup> “Virtual Egg Sold for \$69,996 USD -- “NEVERDIE” Avatar Sets Virtual World Record”, *Marketwire* (3 February 2010), online: Marketwire <<http://www.marketwire.com/press-release/Virtual-Egg-Sold-for-69696-USD-NEVERDIE-Avatar-Sets-Virtual-World-Record-1111600.htm>> [*Marketwire*].

<sup>2</sup> Adam S. Chodorow, “Ability to Pay and the Taxation of Virtual Income” (2007-2008) 75 *Tenn. L. Rev.* 695 at 696; U.S., Internal Revenue Service, *National Taxpayer Advocate: 2008 Annual Report to Congress, volume 1* (31 December 2008) at 214, online: Internal Revenue Service <[http://www.irs.gov/pub/irs-utl/08\\_tas\\_arc\\_intro\\_toc\\_msp.pdf](http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf)> [*Taxpayer Advocate Report*].

<sup>3</sup> See *Second Life*, online: <<http://secondlife.com/>>; *World of Warcraft*, online: <<http://www.worldofwarcraft.com/index.xml>>; *Entropia Universe*, online: <<http://www.entropiauniverse.com/>>; *Ultima Online*, online: <<http://www.uoherald.com/news/index.php>>; *the Sims Online*, online: <<http://thesims2.ea.com/>>.

<sup>4</sup> Chodorow, *supra* note 2 at 696-698.

taking place entirely within a virtual world, should be taxed.<sup>5</sup> This paper examines whether, and to what extent, the Canada Revenue Agency can and should seek to tax income generated from virtual world activity, with a particular focus on activity that occurs entirely within virtual worlds.

## I. BRIEF DESCRIPTION OF VIRTUAL WORLDS

In order to understand the tax implications arising from virtual worlds, a basic understanding of what virtual worlds are is required. Virtual worlds are simulated online environments that allow users to interact with one another through fictional representations of themselves.<sup>6</sup> These representations, known as avatars, may “look like a person, animal, mythical creature, or any other representation that the software allows.”<sup>7</sup> These worlds are sophisticated three dimensional spaces that allow users to move and interact through their avatar’s eyes.<sup>8</sup> In order to gain access users generally pay a monthly subscription<sup>9</sup> and have to “sign End User License Agreements (EULAs) or Terms of Service (TOS) agreements, which purport to establish participant’s rights with respect to the virtual goods created and obtained in these worlds.”<sup>10</sup>

Although virtual worlds share many similarities with traditional video games, several fundamental differences exist. First, “these worlds do not pause or end when a user exits.”<sup>11</sup> Rather, they “operate continuously and retain the location of an avatar and other items, even if the person represented by the avatar has shut off his or her computer.”<sup>12</sup> Second, virtual worlds are malleable, meaning that participants have the ability to modify the world.<sup>13</sup> Thus, players can “create their own, unique experiences with the world, and much of what happens in a given world is as much a function of the participants’ initiative as it is the

---

<sup>5</sup>G. Martin Bingisser, “Federal Tax Consequences of Virtual World Transactions” (2008) 5 *Shidler J.L. Com. & Tech.* 7 at para. 7, online: (<<http://lctjournal.washington.edu/vol5/a07Bingisser.html>>).

<sup>6</sup> Chodorow, *supra* note 2 at 699; Steven Chung, “Real Taxation of Virtual Commerce” (2008-2009) 28 *Va. Tax Rev.* 733 at 736.

<sup>7</sup> Leandra Lederman, “Stranger Than Fiction: Taxing Virtual Worlds” (2007) 82 *N.Y.U.L. Rev.* 1620 at 1625.

<sup>8</sup> Ben K. Pollitzer, “Serious Business: When Virtual Items Gain Real World Value” (07 February 2008) at 1, online: Social Science Research Network (<[http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=904738](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=904738)>).

<sup>9</sup> *Taxpayer Advocate Report*, *supra* note 2 at 214.

<sup>10</sup> Chodorow, *supra* note 2 at 699-700.

<sup>11</sup> *Ibid.* at 699.

<sup>12</sup> *Taxpayer Advocate Report*, *supra* note 2 at 214.

<sup>13</sup> Pollitzer, *supra* note 8 at 7.

developer's."<sup>14</sup> Third, most of these worlds have virtual economies, where users can make, find, and win virtual goods, as well as buy, sell, and exchange them with other users.<sup>15</sup>

Although every virtual world is unique, these worlds are often classified as either "structured" or "unstructured". Structured worlds, also known as "Massively Multiplayer Online Role Playing Games", resemble traditional role-playing video games. These worlds provide "players with pre-set roles and challenges", varying from finding treasure, slaying monsters, or exploring new planets.<sup>16</sup> Although these worlds have no end goal, for each mission or quest accomplished the game developers reward players with greater skills, weapons, talents, or game treasure. In addition, completing a quest can lead a player to level up, thus enabling them to undertake more difficult quests.<sup>17</sup> Structured worlds are heavily controlled environments. World designers insert computer generated non-player characters (NPCs) that play a significant role in guiding game play. World designers also control the range of virtual items that can be obtained and periodically integrate new quests in order to maintain the subscriber base.<sup>18</sup> *World of Warcraft*, *EverQuest*, *Entropia Universe*, and *Ultima Online* are all examples of structured worlds.<sup>19</sup>

On the other hand, unstructured worlds tend to have "few rules, no objectives, and no pre-set roles."<sup>20</sup> Unlike structured worlds, these "are not considered games, and instead have been classified as socialization venues in which participants create their own experiences."<sup>21</sup> Activities in unstructured worlds range from chatting with friends, attending concerts or lectures, shopping, going to nightclubs, or simply moving around as a spectator.<sup>22</sup> Unstructured world developers are less active in managing what goes on in-world. Thus, unlike structured worlds, almost all of the goods within

---

<sup>14</sup> Chodorow, *supra* note 2 at 699.

<sup>15</sup> *Ibid.*

<sup>16</sup> Chung, *supra* note 6 at 736-737; Bryan T. Camp, "The Play's The Thing: A Theory of Taxing Virtual Worlds" (2007-2008) 59:1 *Hastings L.J.* 1 at 4, online: Social Science Research Network<[http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=364489](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=364489)>.

<sup>17</sup> Camp, *ibid.* at 5; Chung, *ibid.* at 737.

<sup>18</sup> Chung, *supra* note 6 at 737; Camp, *supra* note 16 at 4-5.

<sup>19</sup> Chodorow, *supra* note 2 at 700.

<sup>20</sup> Camp, *supra* note 16 at 4.

<sup>21</sup> Chung, *supra* note 6 at 738; see also Chodorow, *supra* note 2 at 702.

<sup>22</sup> Lederman, *supra* note 7 at 1630; David Assalone, "Law in the Virtual World: Should the Surreal World of Online Communities Be Brought Back to Earth by Real World Laws?" (2009) 16 *Vill. Sports & Ent. L.J.* 163 at 164.

unstructured worlds are created by users.<sup>23</sup> In *Second Life*, for instance, which is one of the most popular unstructured virtual worlds, players use building blocks called “primatives” to create almost any item imaginable.<sup>24</sup> These range from “real estate (homes, shops, discos, movie theatres, gardens, arenas), to personal items (clothing, body parts, furniture, pictures, vehicles, airplanes, fireworks, art), to recreation items (thunderstorms, pets, magic fountains, toys), to animation routines that make avatars do things like dance, skip, makes faces, or simulate sex.”<sup>25</sup> *Second Life*, *There, Kaneva*, and *Habbo Hotel* are all examples of unstructured virtual worlds.<sup>26</sup>

## II. WHY SHOULD CANADA TAX VIRTUAL WORLDS?

### a. Real Income Generating Activities

The primary reason why the issue of taxing virtual worlds has arisen is that, unlike games such as *Monopoly* or *Call of Duty*, virtual worlds have activities generating real world income. At the heart of these activities in both structured and unstructured worlds is the fact that virtual world developers implemented in-world economies, complete with virtual currencies, in order to facilitate exchanges between users.<sup>27</sup> Creating a system of exchange has allowed participants in virtual worlds to create wealth through two types of activity: in-world transactions and real money trades.<sup>28</sup> In-world transactions are exchanges of virtual goods either for other virtual goods, currency, or services. Real money trades (RMT) refer to virtual world participants selling virtual currency, goods, or services for real world currency or consideration, often on sites like eBay or other third party vending sites.<sup>29</sup> Purchases which involve real world currency generally involve a “two step process because the deal almost always has to be closed within the game environment.”<sup>30</sup> In RMT, “the buyer essentially buys the seller’s agreement to meet the buyer’s character in-world and give the purchased item.”<sup>31</sup>

---

<sup>23</sup> Chodorow, *supra* note 2 at 702. Players created content by using “building blocks made available in world.”

<sup>24</sup> Camp, *supra* note 16 at 7.

<sup>25</sup> Camp, *supra* note 16 at 7.

<sup>26</sup> Chung, *supra* note 5 at 738.

<sup>27</sup> Camp, *supra* note 16 at 9.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.* at 13.

<sup>31</sup> *Ibid.*

These forms of transaction play an important part in both structured and unstructured worlds. As economist Edward Castronova found in his study of the online role-playing game *Everquest*, “virtual economies are an integral part of game play [in structured worlds] as game developers create conditions of scarcity.”<sup>32</sup> For instance, in *World of Warcraft* all characters need virtual items, such as swords and potions, to advance their avatar to the next level. These items are crafted by characters in production professions (blacksmiths, alchemists, engineers, etc.), but they require ingredients gained by players in gathering professions (such as miners).<sup>33</sup> By limiting each player to only two professions, the game environment makes it necessary for players to trade with other players or NPCs in order to advance within the game.<sup>34</sup> Furthermore, because of the large time cost involved in collecting ingredients and acquiring the powerful items or experience necessary to advance in the game, many players are willing to use real-world money to purchase virtual world currency, higher characters, powerful items, or even entire player accounts from other players.<sup>35</sup>

Trading plays an equally important role in unstructured worlds. Worlds such as *Second Life* rely on player-to-player transactions in order to attract and retain users. While the acquisition of virtual cars, cell phones, or new clothes for one’s avatar will not help a user advance along any storyline, these items make the world enjoyable and attractive for users. Moreover, much like in the real world, items like these can “increase [a] participant’s status within the virtual world.”<sup>36</sup> Since the basic building blocks in *Second Life* are free for users, the only production cost associated with creating in-world commodities is time. Thus, users with less time are willing to substitute Linden Dollars (*Second Life*’s virtual currency) for commodities or services created by other users.<sup>37</sup>

Different online economies have taken different positions on RMT. Some virtual worlds, such as *Second Life* and *Entropia*, have embraced

---

<sup>32</sup> *Ibid.* at 9.

<sup>33</sup> Pollitzer, *supra* note 8 at 12-13; See also Camp, *ibid.* at 10.

<sup>34</sup> Camp, *ibid.* at 10-11. . NPC traders are designed to “buy low and sell high,” thus discouraging players from using them unless absolutely necessary.

<sup>35</sup> Lederman, *supra* note 7 at 1628-29. Acquiring the necessary items and experience to advance can require months of game play and the completion of some tedious virtual tasks.

<sup>36</sup> *Ibid.* at 1630.

<sup>37</sup> See Camp, *supra* note 16 at 9-11. “Players with paid subscription[s]” to *Second Life* get a “periodic allowance” of Linden Dollars. To supplement this they can generate income by creating and selling goods or services, or by purchasing additional Linden Dollars with real world money.

RMT and even implemented real cash economies.<sup>38</sup> Both of these virtual worlds “allow participants to convert real money into a virtual currency and to redeem it back through an internal currency conversion mechanism.”<sup>39</sup> *Second Life*’s internal currency exchange system, known as LindeX, operates like a real world currency exchange. It provides a fluctuating exchange rate for Linden Dollars (L\$) relative to the USD, usually ranging around L\$270 to L\$280 per \$1 USD.<sup>40</sup> *Entropia* has gone so far as to allow users to get real-life cash cards that can be used at ATMs to convert their stored Project Entropia Dollars (PED) into real world money.<sup>41</sup> Likewise, *Everquest II* has created an in-world auction site where players can trade or buy items using either in-world currency or USD.<sup>42</sup>

On the other hand, many administrators and purist players in other worlds (primarily structured worlds) are adamantly opposed to the practice of RMT on the grounds that it is a form of cheating that undermines the efforts of legitimate players.<sup>43</sup> As a result, the administrators in some virtual worlds have taken steps to prevent RMT. For instance, most structured worlds operate as closed economies and their TOS and EULA terms specifically prohibit the sale of virtual items for real money, with violations resulting in the termination of a user’s account.<sup>44</sup> Another common method of combating RMT, used by *World of Warcraft*, is to “limit the trade of several rare or unique items by “binding” them to the avatars who initially acquire them.”<sup>45</sup> Some virtual world administrators have even lobbied for real-world laws making RMT illegal.<sup>46</sup> Despite these efforts, due to the high “demand for virtual items and the relatively low risk” of getting caught, it “appears... RMT operations will continue”.<sup>47</sup>

#### **b. Significant Real Value in Virtual World Commodities**

Due to the sheer amount of wealth that is changing hands, both in-world and real-world transactions of virtual goods are attracting the attention of tax scholars around the world. As mentioned in the

---

<sup>38</sup> Chung, *supra* note 6 at 735.

<sup>39</sup> *Ibid.* at 744.

<sup>40</sup> *Ibid.* at 744-745; “[N]o banking institutions currently accept the Linden Dollar as legitimate currency”: Assalone, *supra* note 22 at 186.

<sup>41</sup> Chung, *ibid.* at 744-745.

<sup>42</sup> Camp, *supra* note 16 at 46.

<sup>43</sup> Chung, *supra* note 6 at 741.

<sup>44</sup> *Ibid.* at 742.

<sup>45</sup> *Ibid.* at 743; Camp, *supra* note 16 at 46.

<sup>46</sup> Chung, *ibid.* at 743.

<sup>47</sup> *Ibid.* at 743-744.

introduction, Jon “NEVERDIE” Jacobs’ purchase of a virtual asteroid is just one of countless transactions involving virtual world goods. Players of structured games regularly sell their player accounts for thousands of dollars.<sup>48</sup> Items available on third party auction sites, for use in *Ultima Online*, range from sandals for \$5, a battle axe for \$150, or a castle for \$750 USD.<sup>49</sup> The sale and purchase of virtual world commodities, such as cars, planes, jewellery, clothes, shoes and furniture are all common place in *Second Life*.<sup>50</sup>

Some users are even using the sale of virtual world commodities to generate their real world incomes. For instance, by purchasing land in *Second Life*, subdividing or developing it, and reselling or renting it to other users, Ailin Graef, a Chinese-born citizen of Germany, was able to turn an initial investment of \$9.95 USD into a virtual world empire with a real-world fair market value, in the aggregate, of more than one million USD in just over two and half years.<sup>51</sup> Graef is not alone. Bob Kiblinger from Beckley, West Virginia “trades Ultima items for a living, scanning eBay listings on his laptop in search of assets undervalued and overlooked”, and is apparently making substantially more than he did as a Chemist for Proctor and Gamble.<sup>52</sup> Some University students are even opting to use virtual worlds to make money rather than getting summer jobs.<sup>53</sup>

In recognition of the profit that can be made, many virtual worlds market themselves as places where users can make real income. For instance, *Second Life*’s promotional materials inform users about how they can make a profit by taking on a virtual world job, designing and selling new items, becoming a land baron, or creating a virtual business.<sup>54</sup> The potential for profits has even resulted in a recent book, “written about how to become an entrepreneur in” *Second Life*.<sup>55</sup> Possibly as a result of the success in-world entrepreneurs have enjoyed, many real-world corporations are also taking an interest in virtual worlds.<sup>56</sup> For example, Reebok, Adidas, Telus, Toyota, Nissan, Sony

---

<sup>48</sup> Lederman, *supra* note 7 at 1629; Camp, *supra* note 16 at 13.

<sup>49</sup> Julian Dibbell, “The Unreal Estate Boom”, *Wired* (January 2003) at 1, online: [Wired <http://www.wired.com/wired/archive/11.01/gaming.html>](http://www.wired.com/wired/archive/11.01/gaming.html).

<sup>50</sup> Assalone *supra* note 22 at 167.

<sup>51</sup> See *ibid.* at 172, 52; Theodore P. Seto, “When Is A Game Only a Game?” (2008-2009) 77 U. Cin. L. Rev. 1027 at 1027.

<sup>52</sup> Dibbell, *supra* note 49 at 3.

<sup>53</sup> Chodorow, *supra* note 2 at 703-704.

<sup>54</sup> Second Life, “What is Second Life” (22 March 2010), online: Second Life <[http://secondlife.com/whatis/?lang=en-US#Make\\_Money](http://secondlife.com/whatis/?lang=en-US#Make_Money)>.

<sup>55</sup> Pollitzer, *supra* note 8 at 17.

<sup>56</sup> Assalone, *supra* note 22 at 168.

BMG Music, and Starwood Hotels have all purchased properties in *Second Life* and created businesses where they sell in-world and/or real world goods.<sup>57</sup> Other real world businesses such as Major League Baseball, Harvard University, H&R Block, and Reuters have all established a presence in *Second Life* as well.<sup>58</sup>

While virtual world millionaires and \$100,000 USD single item transactions are rare, the extent and real world value of some of these virtual economies is surprisingly large. For instance, a 2001 study by Castronova found that the Norrathian currency, which is used in the fictional world of Norrath in *Everquest*, had a better exchange rate than the Japanese yen. Furthermore, this study found that the theoretical GNP of Norrath (\$135 million) was actually greater than that of Bulgaria, and the theoretical per capita GNP of \$2,226 was roughly equivalent to that of Russia.<sup>59</sup> In 2008 *Second Life*'s website claimed residents spend the Linden equivalent of over \$1 million USD per day and that their "in-world currency exchange facility, converts almost \$100 million worth of Lindens to [USD] annually."<sup>60</sup> The value of RMT occurring outside virtual world economies is also surprisingly large. The president of one third-party auction site, IGE.com, reported "that over \$880 million dollars had passed through that site during its 2004 operating year."<sup>61</sup> Seeing as these statistics are only taken from two virtual worlds and one third-party auction site, it is apparent that the annual economic activity arising out of virtual worlds is likely in the billions.

Furthermore, the rate of annual economic activity generated by virtual worlds is expected to continue rising as the number of online users steadily increases.<sup>62</sup> During 2007 the number of "residents" in *Second Life* was growing by one million per month and as of July 2009 had reached over 19 million.<sup>63</sup> *World of Warcraft* has "boast[ed] a total of more than 8.5 million paid subscribers."<sup>64</sup> Based on current growth

---

<sup>57</sup> *Ibid.* at 168-169; KZero Worldwide, "Technology sector companies in Virtual Worlds", at 4, online: <<http://www.slideshare.net/nicmitham/technology-and-virtual-worlds>> [KZero Worldwide]

<sup>58</sup> *Taxpayer Advocate Report*, *supra* note 2 at 217.

<sup>59</sup> *Taxpayer Advocate Report*, *ibid.* at 213; Camp, *supra* note 16 at 8. . Note: The average wage of an avatar was "measured by regressing the total value of an avatar's equipment and cash by the number of hours that avatar had been active".

<sup>60</sup> Seto, *supra* note 51 at 1028.

<sup>61</sup> Camp, *supra* note 16 at 12; Chung, *supra* note 2 at 740.

<sup>62</sup> Chung, *ibid.* at 738.

<sup>63</sup> Kzero Worldwide, *supra* note 57 at 2.

<sup>64</sup> Chung, *supra* note 6 at 738.



trends, “[t]he virtual world population is predicted to reach fifty million by 2011.”<sup>65</sup>

### c. International Interest in Taxing Virtual Worlds

As a result of the growing popularity of these worlds and the amount of wealth changing hands through virtual worlds, many countries have begun examining whether virtual economies should be subject to real world taxation. For instance, in 2008 the Joint Economic Committee (JEC) submitted a White Paper to the United States Congress, claiming that the Internal Revenue Agency should proactively address taxation issues arising from virtual worlds.<sup>66</sup> The Australian tax office has already issued a formal warning to virtual world users that if they convert their virtual fortunes to real money then it must be declared on their tax returns.<sup>67</sup> The European Union (EU) has gone further, requiring Linden Labs (the company which operates *Second Life*) to charge “Value Added Tax” (VAT) on anything players resident in the EU purchase directly from them.<sup>68</sup> Recently China, Sweden, and Korea have even indicated that they intend to tax virtual world income that is left in-world.<sup>69</sup>

## III. CAN CANADA TAX VIRTUAL WORLD PROFITS?

To date Canada has been relatively silent on the topic of taxing virtual world income. While no legislation dealing with virtual worlds has been passed, the recent decision in *eBay Canada Ltd. v. Canada (Minister of National Revenue)* shows that the Canada Revenue Agency (CRA) is taking a closer look at online revenue.<sup>70</sup> In this case, the Federal Court ordered eBay Canada to provide the CRA with the names, contact information, and sales records of eBay sellers, so the CRA could audit and tax them (with a focus on power sellers). In response to the case, Jean-Pierre Blackburn, the Minister of National Revenue, stated that “[t]axpayers should know that the tax laws that apply to traditional

---

<sup>65</sup> *Ibid.*

<sup>66</sup> *Taxpayer Advocate Report*, *supra* note 2 at 225-226; Camp, *supra* note 16 at 70; See Chung, *ibid.* at 747. “Although the JEC is not a Committee with jurisdiction over tax statutes, it has an important voice in the process.”

<sup>67</sup> Assalone, *supra* note 22 at 184, n. 128.

<sup>68</sup> Second Life, “Policies & Guidelines – Value Added Tax”, online: Second Life <<http://secondlife.com/corporate/vat.php>>. “Transactions... between individual residents” in Linden Dollars “are not subject to VAT.”

<sup>69</sup> Chodorow, *supra* note 2 at 698.

<sup>70</sup> See *eBay Canada Ltd. v. Canada (Minister of National Revenue)*, [2008] F.C.J. No. 1527 [*eBay Canada Ltd.*].

commerce apply in the same way to electronic commerce, like eBay selling.”<sup>71</sup>

While this case made no mention of virtual worlds, in 2007 Brad Alvarez, a CRA spokesman in Vancouver, confirmed that once income in these worlds is pulled out and becomes tangible and real, users must report it on their tax return.<sup>72</sup> However, Mr. Alvarez’s statement failed to specify how this income should be classified for taxation purposes. Furthermore, no guidance has been provided by the CRA on whether in-world transactions could be subject to tax.

Based on the following brief examination of Canadian income tax provisions, profits generated from virtual worlds (both in-world and real world transactions) could potentially be classified as either business, property, or capital gains income for tax purposes.

#### **a. Business Income**

Canada’s income tax system is based on the source concept of income.<sup>73</sup> Section 3(a) of the *Income Tax Act* (the *Act*) sets out four different sources of income: office, employment, business, or property income.<sup>74</sup> If a taxpayer generates income from one of these sources or from a source recognized by case law, then they must declare it as taxable income.<sup>75</sup> Income generated through virtual world transactions could potentially be classified as either business or property income, depending on how the income is principally obtained.

Section 248(1) of the *Act* states:

“Business” includes a profession, calling, trade, manufacture, or undertaking of any kind whatever and... an adventure or concern in the nature of trade...<sup>76</sup>

---

<sup>71</sup> Canada Revenue Agency, News Release, “eBay Sellers Must Declare All Income For Tax Purposes,” says Minister Blackburn” (30 July 2009), online: CRA < <http://www.cra-arc.gc.ca/nwsrm/rlss/2009/m07/nr090730-eng.html> >.

<sup>72</sup> Curt Cherewayko, “Taxing Events In Your Business Second Life” *Business in Vancouver* 941 (6-12 November 2007), reprinted in David Spratley Quoted in *Business in Vancouver Regarding Second Life* (13 November 2007), online: Davis LLP < <http://www.davis.ca/en/news/David-Spratley-Quoted-in-Business-In-Vancouver-Regarding-Second-Life> >.

<sup>73</sup> Tim Edgar and Daniel Sandler, eds., *Materials on Canadian Income Tax*, 13th ed. (Toronto: Thompson Carswell, 2005) at 79.

<sup>74</sup> *Income Tax Act*, R.S.C. 1985, (5<sup>th</sup> Supp.), c.1, s. 3(a) [ITA]

<sup>75</sup> Edgar and Sandler, *supra* note 73 at 79-80.

<sup>76</sup> ITA, *supra* note 74, s. 248(1).

The court has consistently held “that a business is an organized activity... carried on for the purpose of profit.”<sup>77</sup> Generally, if the earning of income involves significant amounts of activity, the income is likely from a business and therefore taxable.<sup>78</sup> The means by which virtual world entrepreneurs and casual users make a profit from virtual world activities could be categorized as business income. For instance, someone who develops a high level *World of Warcraft* character and then sells it for several thousand dollars would meet the above test for business income because this is an organized activity and it is likely done for the purpose of profit. Likewise, users of *Second Life* who develop virtual commodities and sell them at a profit, either in Linden Dollars or for real money, have partaken in an organized activity for the purpose of profit.

#### **b. Property Income**

The definition of property as set out in section 248(1) of the *Act* includes the following:

(a) a right of any kind, a share or a chose in action; (b) unless a contrary intention is evident, money... and (d) the work in progress of a business that is a profession.<sup>79</sup>

“This broad definition of property means that something of value is generally considered to be property for the purposes of the *Act*.”<sup>80</sup> Income from property is generally derived from ownership of the property, such as earning interest, rent, royalties or dividends.<sup>81</sup>

Two types of transactions within virtual worlds could be classified as property income. First, the profits made by land barons in *Second Life* who develop virtual land and then rent it out could be considered property income. Second, the interest that virtual world users earn through in-world banks<sup>82</sup> could also qualify as property income.

---

<sup>77</sup> Edgar and Sandler, *supra* note 73 at 315; *Étoile Immobilière S.A. v. Canada (Minister of National Revenue –M.N.R.)*, [1992] 2 C.T.C. 2367 at 2375, 92 D.T.C. 1978 (T.C.C.) [*Étoile Immobilière*]; *Canadian Marconi Co. v. R.*, [1986] 2 S.C.R. 522 at 528-530, 86 D.T.C. 6526 ; *Chapman v. Minister of National Revenue*, [1971] Tax A.B.C. 81, 25 D.T.C. 88, at 91 (Tax Appeal Board)..

<sup>78</sup> *Étoile Immobilière*, *ibid.* at 2374-75; *Canadian Marconi*, *ibid.*; *Chapman*, *ibid.*.

<sup>79</sup> *ITA*, *supra* note 74, s. 248(1).

<sup>80</sup> Edgar and Sandler, *supra* note 73 at 332.

<sup>81</sup> *Ibid.* at 332-33; *Solmon v. R.*, 2000 DTC 2093 at para. 10, [2000] 3 C.T.C. 2473 (T.C.C.).

<sup>82</sup> See Hannah Yee Fen Lim, “Who Monitors the Monitor? Virtual World Governance and the Failure of Contract Law Remedies in Virtual Worlds” (2008-

### c. Capital Gains

Capital gains are the amount of profit someone realizes on the sale of any capital property, capital asset, or personal property.<sup>83</sup> These can include profits gained from the sale of things such as shares or land held for investment purposes, or the sale of a valuable painting held for personal use. These gains are taxable because the taxpayer is receiving something of economic value.<sup>84</sup> Under the provisions set out in section 40 of the *Act*, 50 percent of the amount by which a taxpayer's proceeds realized on a disposition of property exceeds the adjusted cost base of the property and any associated expense of disposition, is taxable income.<sup>85</sup>

Due to this preferential tax treatment, taxpayers generally prefer to characterize transactions as capital gains as opposed to claiming them as business income.<sup>86</sup> Most instances where there is uncertainty about whether a transaction amounts to business or capital gains income “turn on whether the transaction can be characterized as an ‘adventure or concern in the nature of trade’ within the definition of ‘business’ in section 248(1)” of the *Act*.<sup>87</sup> As a general rule, if property was purchased to be held and used as an investment it will be a capital gain, but if it

---

2009) 11 Vand. J. Ent. & Tech L. 1053) at 1057; *Chung*, *supra* note 6 at 746; Kend Linden, “New Policy Regarding In-World Banks” *Second Life Blogs* (8 January 2008), online: Second Life

<<https://blogs.secondlife.com/community/features/blog/2008/01/08/new-policy-regarding-in-world-banks>>

Banks which provide loans and allow users to make interest on savings exist within many virtual worlds. While virtual world banking used to be risky, as many banks offering high rates of returns were ponzi schemes and others defaulted on promised rates of return, many virtual worlds have implemented methods to make virtual world banking secure. For instance, *Entropia Universe* regulates who it will issue virtual banking licenses to. *Second Life*, on the other hand, limits who can offer interest or a direct return on investment to virtual world banks which have “proof of an applicable government registration statement or financial institution charter.”

<sup>83</sup> Edgar and Sandler, *supra* note at 541; *ITA*, *supra* note 74, s. 39(1); Canada Revenue Agency, T4037(E) Rev. 09, “Capital Gains 2009” at 5, 9, 19, online: CRA <<http://www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-09e.pdf>> [CRA, “Capital Gains”].

<sup>84</sup> Edgar and Sandler, *ibid.* at 541; CRA, “Capital Gains”, *ibid.* at 5, 9.

<sup>85</sup> *ITA*, *supra* note 74, s. 40(1)(a); CRA, “Capital Gains”, *ibid.* at 16. Adjusted cost base usually includes costs (purchase price or fair market value of deemed disposition) of the property plus acquisition and disposal fees (i.e. legal and engineering fees, minor renovations, etc.).

<sup>86</sup> Edgar and Sandler, *supra* note 73 at 330. .

<sup>87</sup> Edgar and Sandler, *ibid.* at 547.

was purchased for immediate sale then it will be business income.<sup>88</sup> Thus, purchases and sales made by someone like Bob Kiblinger, who buys undervalued virtual world items on eBay and immediately sells them, would be business income. But when Jon “NEVERDIE” Jacobs was able to sell a virtual egg he bought four years earlier at \$10,000 USD for \$69,696.00 USD, he should claim the profit as a capital gain.<sup>89</sup>

#### IV. SHOULD CANADA TAX IN-WORLD TRANSACTIONS?

The above analysis in conjunction with the statement made by Mr. Alvarez demonstrates that the CRA can tax virtual world profits. However the bigger question is *when* virtual transactions should be liable to Canadian taxes. Based on Mr. Alvarez’s statement it is clear that whenever a taxpayer sells a virtual account, avatar, good, or service for real-world consideration, the profit is taxable.<sup>90</sup> However, there remains uncertainty over whether exchanges that occur entirely within virtual worlds will be subject to tax.

Although intuitively it seems virtual world transactions should only be taxable if real-world money has changed hands, real money need not be received for a taxable event to exist.<sup>91</sup> For instance, tax is due on transactions where goods or services are exchanged instead of money (“barter transactions”).<sup>92</sup> This is because the “payment or benefit in kind is an accretion to wealth and enhances the taxpayer’s ability to pay.”<sup>93</sup> The CRA takes the view that through a barter transaction the recipient’s income is increased by the amount “the taxpayer would normally have charged a stranger for his services or would normally have sold his goods or property to a stranger.”<sup>94</sup> “Where the goods or services given up cannot readily be valued but the goods or services received can, the [CRA] will normally accept the value of the latter as being the price at

---

<sup>88</sup>Canada Revenue Agency, Interpretation Bulletin IT-218R, “Profit, Capital Gains and Losses from the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate from Capital Property to Inventory and Vice Versa” (16 September 1986) at paras. 3-6, online: CRA <<http://www.cra-arc.gc.ca/E/pub/tp/it218r/it218r-e.html>>.

<sup>89</sup> *Marketwire*, *supra* note 1.

<sup>90</sup> Seto, *supra* note 51 at 1031.

<sup>91</sup> Bingisser, *supra* note 5 at para. 7.

<sup>92</sup> Canada Revenue Agency, Interpretation Bulletin IT-490, “Barter Transactions” (5 July 1982) at paras. 4-7, online: CRA <<http://www.cra-arc.gc.ca/E/pub/tp/it490/it490-e.html>> [CRA, “Barter Transactions”].

<sup>93</sup> *Halsbury’s Laws of Canada*, 1st Ed., Income Tax (General) (Markham: Lexis Nexis Canada Inc., 2008) at 172 [*Halsbury’s Tax*].

<sup>94</sup> CRA, “Barter Transactions”, *supra* note 92 at para. 7.

which the transaction took place if the parties were dealing at arm's length."<sup>95</sup>

Much like barter transactions, although no real money trades hands during in-world virtual transactions, a market transaction with a corresponding accretion to wealth has occurred. Furthermore, as a result of RMT many virtual world items have ascertainable market values and are susceptible to valuation.<sup>96</sup> For instance, an in-world transfer of a level 60 *Everquest* character could be given a real world value because characters at this level routinely sell for as much as \$5,000 USD on third-party auction sites.<sup>97</sup> This valuation method would also work well for transactions involving virtual currency, since most virtual currencies have relatively stable and traceable conversion rates.

Despite the fact that the transfer of real world money is not prerequisite for the existence of a taxable event, some scholars, such as Bryan T. Camp, argue that in-world exchanges should not be taxed. Rather, Camp believes that the "cash out" rule should be the only method used for determining whether income generated from virtual transactions in both structured and unstructured worlds is applicable for taxes.<sup>98</sup> Under this rule, users would only have to pay tax once they convert virtual assets into real money.<sup>99</sup> While this method is beneficial because it is easy to implement and only taxes those who are making real world profit, using it exclusively would allow for numerous abuses of the tax system.<sup>100</sup> Most notably, exclusive reliance on the cash out rule could lead to the use of virtual worlds for tax deferral and evasion. In his article, "Real Taxation of Virtual Commerce", Steven Chung provides the following example:

"[I]f a taxpayer, through his avatar's activities, earns \$60,000 worth of virtual currency in the taxable year, the cash out rule holds that he will be taxed only on the amount that he converts into real money. The taxpayer will be motivated to reduce his cash out transactions to minimize taxes on his virtual world income. The taxpayer can deposit the virtual currency into a bank operating in the virtual world and collect non-taxable interest."<sup>101</sup>

---

<sup>95</sup> *Ibid.* at para. 8.

<sup>96</sup> Lederman, *supra* note 7 at 1622.

<sup>97</sup> *Ibid.* at 1623.

<sup>98</sup> Camp, *supra* note 16 at 2.

<sup>99</sup> Chung, *supra* note 2 at 747.

<sup>100</sup> *Ibid.* at 748.

<sup>101</sup> *Ibid.*

More sinister uses of virtual worlds could also arise if the CRA relies exclusively on the “cash out” rule. There are already rumours in *Second Life* about “a real-world drug dealer who accepts payment only in Linden [Dollars].”<sup>102</sup> Essentially, a “drug dealer could demand that his real-world drug customers establish accounts in the same virtual world, convert their real money into virtual currency, and then give it to the dealer’s avatar as payment for the drugs.”<sup>103</sup> While this may be nothing more than an urban legend, criminals may soon utilize virtual transactions for real world exchanges because they are nearly impossible for the government to trace, virtual currency can be easily converted into real money, and interest can be earned on virtual world savings held in virtual world banks.

## V. CAN CANADA TAX IN-WORLD TRANSACTIONS?

Not only would exclusive use of the cash out rule be inappropriate for taxing virtual world activities, it is not the only option available in Canada. Canada’s tax system uses two methods of accounting: the cash method and the accrual method. Under the cash method taxpayers only need to declare revenues that have actually been received in a tax year.<sup>104</sup> This method, which is generally used for income from office or employment, if applied to virtual world profits would be analogous to the “cash out” rule discussed previously.<sup>105</sup> Using the accrual method means “income is recognized in the year in which it is earned, regardless of when payment is actually received.”<sup>106</sup> Sections 9(1) and 12(1)(b) of the Act provide that profits earned by a business during a taxation year are included in computing income taxes based on the accrual method.<sup>107</sup> If the accrual method were applied to virtual worlds, once a taxpayer received virtual currency, service, or a gain from trading virtual items in-world, that taxpayer would be subject to taxation on the transaction’s profits.

---

<sup>102</sup> Seto, *supra* note 51 at 1031.

<sup>103</sup> Chung, *supra* note 2 at 748.

<sup>104</sup> Canada Revenue Agency, Interpretation Bulletin IT-433R, “Farming or Fishing - Use of Cash Method” (4 June 1993) at summary. To calculate income or loss using the cash method, one must take “the difference between the cash revenue received in the year and the cash revenue expenditures paid in the year with appropriate adjustments for non-cash items such as capital cost allowance and the recapture of capital cost allowance.”

<sup>105</sup> Edgar and Sandler, *supra* note 73 at 444.

<sup>106</sup> *Ibid.* at 445; *Ikea Ltd. v. Canada*, [1998] 1 S.C.R. 196 at para. 37.

<sup>107</sup> *ITA*, *supra* note 73, ss. 9(1), 12(1)(b).

However, in order to apply the accrual method to in-world transactions, the CRA would have to be able to determine a real world value for these virtual transactions. In the case of *Imperial Oil v. R.* the Supreme Court of Canada noted that Canadian income tax law only recognizes Canadian currency.<sup>108</sup> Thus, “the assessment of a taxpayer’s income and resultant tax liability must be determined in Canadian dollars.”<sup>109</sup> This could be done for in-world transactions by one of two methods.

First, as previously mentioned, as a result of RMT many virtual world items have ascertainable market values and are susceptible to valuation. However, this valuation method has limited application. For one, many virtual items are very unique in nature, making an accurate valuation difficult. Furthermore, many items have too small a sample size of sales on third party auction sites to obtain an accurate estimate of the item’s fair market value.<sup>110</sup>

Second, the CRA could choose to treat virtual currencies in the same way they treat foreign currencies. The use of foreign currency is important in three circumstances under Canadian tax law.<sup>111</sup> First, with the purchase or sale of goods using foreign currency the value of the transaction must be converted into Canadian dollars at the rate of conversion at the time of the transaction.<sup>112</sup> Second, as noted in *Tip Top Tailors Ltd. v. Canada (Minister of National Revenue – M.N.R.)*, gain realized by exchanging foreign currencies at a more favourable rate than at the time of purchase is taxable as income.<sup>113</sup> Third, in *Gaynor v. R.* the Federal Court of Appeal held that when capital gains or losses are realized from the disposition of foreign currency denominated capital property, the foreign currency must be converted into Canadian dollars “at the spot exchange rate prevailing at the relevant times – that is at acquisition and disposition.”<sup>114</sup> The two Canadian dollar amounts would then be used to determine the total gain on the disposition. Because the cost of the sale or purchase of goods must be converted into Canadian

---

<sup>108</sup> *Imperial Oil v. R.*, 2006 SCC 46, [2006] 2 S.C.R. 447 at para. 76[*Imperial Oil*].

<sup>109</sup> Sina Akbari, “Foreign Currency Considerations in Tax Law and Policy” (2006) 66 U.T. Fac. L. Rev. 1 at 12.

<sup>110</sup> Bingisser, *supra* note 5 at para. 23.

<sup>111</sup> Akbari, *supra* note 109 at para. 25.

<sup>112</sup> Canada Revenue Agency, GST Memoranda, G300-7-10, “Foreign Currency” (15 March 1994), online: CRA < <http://www.cra-arc.gc.ca/E/pub/gm/g300-7-10/g300-7-10-e.html> >.

<sup>113</sup> *Tip Top Tailors Ltd. v. Canada (Minister of National Revenue)*, [1957] S.C.R. 703 at 705-06, 11 D.L.R. (2d) 289.

<sup>114</sup> *Gaynor (H.R.) v. M.N.R.* [1991] 1 C.C.T. 470, 131 N.R. 65, 91 D.T.C.5288 (F.C.A.); Akbari, *supra* note 109 at 16.



dollars at the prevailing spot rate at the time of purchase, the CRA uses the Bank of Canada's exchange rates page to determine what exchange rate should apply.<sup>115</sup>

Section 248(1) of the *Act* defines "foreign currency" as a "currency of a country other than Canada".<sup>116</sup> Despite the fact that virtual world currencies do not fit within this definition, the possibility of the CRA treating virtual currencies as foreign currency for tax purposes is not as far-fetched as it sounds. Chung argues that currencies from virtual worlds that allow real cash to be integrated into their economies should be taxed the same as foreign currency. He believes that virtual world currencies can be treated the same as foreign currencies for tax purposes because they function the same way as real-world money. According to Chung, money has three functions and all three are performed by virtual currencies. First, money is a means of exchange. Virtual currency performs this role because it "acts as a medium of exchange for all virtual goods and services".<sup>117</sup> Second, money is "store of value."<sup>118</sup> Again, virtual currency serves this purpose as the currency itself does not depreciate over time. Finally, money acts as a "measure of value".<sup>119</sup> Virtual currencies perform this function, since goods and services in virtual worlds are assigned a value based on their virtual currency purchase price.<sup>120</sup>

Although the Bank of Canada does not currently keep track of virtual world exchange rates, which would be required for Canadian tax purposes, this information is available for some virtual world currencies. For instance, *Second Life's* website has a page that provides detailed market data for the LindeX. Statistics provided include the daily opening, closing, and average rate of exchange for the Linden Dollar over the previous 30 days. In much the same manner as real-world currency exchanges, the value of the Linden Dollar fluctuates on the LindeX throughout the day based on user supply and demand.<sup>121</sup> The statistics

---

<sup>115</sup> See Canada Revenue Agency, "What Are the Average Exchange Rates" (10 March 2010), online: CRA <[http://www.cra-arc.gc.ca/tx/ndvdl/fq/xchgng\\_rt-eng.html](http://www.cra-arc.gc.ca/tx/ndvdl/fq/xchgng_rt-eng.html)>. The Bank of Canada provides exchange rates for various periods (e.g. daily, monthly, and annually). See Bank of Canada, "Rates and statistics", online: Bank of Canada

<<http://www.bankofcanada.ca/en/rates/exchange.html>>; Akbari, *ibid.* at 12.

<sup>116</sup> *ITA*, *supra* note 74, s. 248(1).

<sup>117</sup> Chung, *supra* note 2 at 739.

<sup>118</sup> *Ibid.*

<sup>119</sup> *Ibid.*

<sup>120</sup> See Chung, *supra* note 2 at 736-739.

<sup>121</sup> Second Life, "Currency Exchange", online: Second Life <<http://secondlife.com/whatis/currency.php>>.

provided on the LindeX Market Data page provide sufficient detail to accurately determine the fair market value of the Linden Dollar. Therefore, the CRA could confidently rely on this information for taxation purposes.

Despite the relative ease in determining exchange rates for *Second Life*, the CRA may encounter problems when attempting to determine rates for virtual worlds that do not operate their own exchange services. For example, the server a player chooses to use affects the price of *World of Warcraft* gold, which at any given time can vary widely from G\$4-10 per USD.<sup>122</sup> As a result, it may only be practical for the CRA to treat the currency of virtual worlds that operate their own exchange systems as foreign currency under the *Act*.

## VI. ANALYSIS OF POTENTIAL EXCLUSION OR EXEMPTION OF TAXATION ON IN-WORLD TRANSACTIONS

Although it appears that the CRA could tax in-world transactions, and it seems intuitive that a person who earns profit from these transactions should be taxed, several arguments against taxing in-world transactions exist.

### a. Windfalls

Some scholars argue that if a taxpayer's avatar discovers or wins an item of value that item should be classified as a windfall.<sup>123</sup> Found items are usually associated with structured worlds and are often referred to as "drops" because they generally only appear after a foe is defeated.<sup>124</sup>

In Canada, while windfalls are recognized as being exempt from taxation, it is often difficult to determine what constitutes a windfall. Generally the term implies a gain that is of an unexpected and unplanned nature and is not from a customary source of income for the taxpayer.<sup>125</sup> In light of difficulties in classifying windfalls, the Federal Court of Appeal in the case of *R. v. Cranswick* adopted a non-exhaustive list of seven indicia of windfall gains:

---

<sup>122</sup> Camp, *supra* note 16 at 13.

<sup>123</sup> See Lederman, *supra* note 7 at 1644, 1646.

<sup>124</sup> Chodorow, *supra* note 2 at 706.

<sup>125</sup> Canada Revenue Agency, Interpretation Bulletin IT-334 R2, "Miscellaneous Receipts" (21 February 1992), online: CRA <<http://www.cra-arc.gc.ca/E/pub/tp/it334r2/it334r2-e.html>> at para. 3.

(a) the [taxpayer] had no enforceable claim to the payment; (b) there was no organized effort on the part of the [taxpayer] to receive the payment; (c) the payment was not sought after or solicited by the [taxpayer] in any manner; (d) the payment was not expected by the [taxpayer]...; (e) the payment had no foreseeable element of recurrence; (f) the payment was not a customary source of income to the [taxpayer]; (and) (g) the payment was not in consideration for or in recognition of property, services or anything else provided or to be provided by the [taxpayer], it was not earned by the [taxpayer], either as a result of any activity or pursuit of gain carried on by the [taxpayer] or otherwise.<sup>126</sup>

Since tasks that result in ‘drops’ require substantial investments of time and effort on the part of the player, and players often expect a reward after defeating a foe, drops cannot be classified as windfalls.<sup>127</sup>

### **b. Imputed Income**

Another possible basis for excluding in-world transactions from tax is that they might be “imputed income”, which is not taxable within Canada.<sup>128</sup> Imputed income is income “derived from the personal use of one’s own assets and from the performance of services for one’s own benefit.”<sup>129</sup> The two main characteristics of imputed income are that “(1) it is non-cash income or income in kind and (2) [that] it arises outside the market place.”<sup>130</sup> Examples of imputed income include the rental value of an owner-occupied house and the value of self-grown crops.<sup>131</sup>

Part of Camp’s claim that the cash out rule should be the sole means by which virtual world profits are taxed is his argument that in-world income from both structured and unstructured worlds is best classified as imputed income. Camp argues that in-world activities are not normal market transactions, but rather self-provided services, done for personal enjoyment.<sup>132</sup> According to Camp, “(t)he service provided is play and the property is a right to play, a chose-in-action, a thing.”<sup>133</sup> Camp even claims that the acquisition of virtual world currencies, such

---

<sup>126</sup> *R. v. Cranswick*, [1982] 1 F.C. 813 at 818-819, (1982) C.T.C. 69, 40 N.R. 296.

<sup>127</sup> Lederman, *supra* note 7 at 1646.

<sup>128</sup> *Symes v. Canada*, [1993] 4 S.C.R. 695, at 765 [emphasis in original].

<sup>129</sup> *Halsbury’s Tax*, *supra* note 93 at 163.

<sup>130</sup> Edgar and Sandler, *supra* note 73 at 334.

<sup>131</sup> *Ibid.*

<sup>132</sup> Camp, *supra* note 16 at 60.

<sup>133</sup> *Ibid.*

as Linden Dollars, should be classified as imputed income because he believes it is a play-thing “used to enhance the value of play” in a play-market.<sup>134</sup>

However, in-world transactions do not fit well with the concept of imputed income. For one, “unlike typical imputed income, [most virtual world profits] require the efforts of a third party (the game publisher) in order for the taxpayer to receive them.”<sup>135</sup> Moreover, while taxes usually are not imposed on imputed income because the taxpayer has not entered into any market transaction, profits earned in virtual worlds are obtained by entering a virtual market and transacting with other users. Finally, while imputed income is not taxed because the income is derived from one’s personal use of one’s own asset, the majority of income generated through virtual worlds arise from users entering into transactions with other users. Therefore, in-world transactions should not be considered imputed income.

### c. Closed Economies

A further claim is that in-world transactions from virtual worlds with closed economies should be tax exempt. Most EULA and TOS agreements for closed world’s state that users caught dealing in RMT will have either a temporary or permanent suspension of their account.<sup>136</sup> For instance, *World of Warcraft’s* Terms of Use provide that they may “suspend, modify, terminate, or delete the account at any time with any reason or no reason, with or without notice.”<sup>137</sup> This creates a scenario where users could potentially be forfeiting thousands of dollars worth of goods stored in-world if they are caught partaking in RMT.<sup>138</sup> Demanding that taxpayers take this risk and breach the terms of a contract in order to obtain the funds necessary to pay their taxes would undermine the integrity and credibility of the Canadian tax system.

To avoid this inequity, while transactions in worlds with intentionally commodified economies should be taxed, users of worlds with closed economies should only be taxed when they cash out.<sup>139</sup> Worlds that prohibit cashing out should be considered “closed” and virtual income acquired in such worlds should be excluded from the tax base. However, if users voluntarily circumvent closed worlds’

---

<sup>134</sup> *Ibid.* at 62.

<sup>135</sup> Lederman, *supra* note 7 at 1644.

<sup>136</sup> Pollitzer, *supra* note 8 at 15-16.

<sup>137</sup> *Ibid.* at 16.

<sup>138</sup> *Ibid.*

<sup>139</sup> Lederman, *supra* note 7 at 1625.

prohibitions and do cash out, that profit must be included in income. Essentially, by participating in RMT users of closed worlds would be accepting the inherent risks and the tax consequences. Worlds where taxpayers are allowed by the administrators to cash out should be considered “open” and their in-world transactions should be taxable.<sup>140</sup> In this way, any virtual world developers who do not want users to be liable for taxation on in-world transactions can take steps to ban RMT, including making RMT a breach of user agreements, making all in-world items available for sale directly by the virtual world developers, and making rare items “bound” to an avatar. Furthermore, any users in closed worlds who truly are partaking purely for the enjoyment of the game environment can avoid taxation by avoiding RMT.

#### **d. Enforcement Difficulties**

Some scholars claim that in-world transactions should be exempt from taxation because of the difficulties in enforcing and administering taxation of in-world transactions. According to Lederman, virtual world users will view taxation of in-world transactions as inequitable and their resentment will discourage them from voluntarily declaring virtual world income.<sup>141</sup> In order to enforce taxation of in-world transactions the government would have to require virtual worlds to track all transactions.<sup>142</sup> This would involve coding beyond that needed for current virtual world purposes, and would likely be resisted by virtual world developers.<sup>143</sup> However, in Canada this enforcement issue is a relatively moot point. As evident from *eBay Canada Ltd.*, Canadian courts are willing to impose reporting requirements on electronic service providers. While compliance might be costly for virtual world providers they have the option of switching to a closed economy, thus avoiding the implications of in-world tax.

#### **e. Potential For A Fixed Exemption**

The principle of equity, which is arguably the most important criteria for evaluating tax measures, holds that “people who are ‘similarly situated’ should pay the same amount of tax.”<sup>144</sup> Since many people are making money and increasing their income through both in-world and real-world transactions arising from virtual worlds, equity would suggest

---

<sup>140</sup> Chodorow, *supra* note 2 at 698.

<sup>141</sup> Lederman, *supra* note 7 at 1660.

<sup>142</sup> *Ibid.* at 1661..

<sup>143</sup> See *ibid.* at 1661.

<sup>144</sup> Edgar and Sandler, *supra* note 73 at 66; “Tax Treatment of the Family: The Canadian Royal Commission on Taxation and the Internal Revenue Code” (1968) 117 U. Pa. L. Rev. 98 at 102.

that they should have to pay tax on this income, thus making it inequitable to totally exempt virtual world income from taxation. However, a fixed exemption may be an equitable solution. Under the Act the CRA provides several fixed exemptions. For instance, Canada has a lifetime capital gains exemption of \$750,000 on gains from the disposition of shares in farm properties and qualified small business corporations.<sup>145</sup> Similarly, section 46(1) of the Act provides a \$1,000 capital gains exemption on dispositions of personal-use property.<sup>146</sup> In light of the fact that the majority of users do not participate in virtual worlds to make real-world profits, a potential exemption of a set amount might be warranted for both in-world and real-world transactions.<sup>147</sup>

## VII. CONCLUSION

Because of the real income generating activities and the significant monetary value in virtual worlds, along with the fact that virtual world income can be classified as either business, property, or capital gains, income generated from virtual worlds should be taxed in Canada. While it appears settled that the CRA will tax any income generated from the sale of virtual goods for real-world consideration, the CRA must turn its attention to the tax implications arising from in-world transactions and create a comprehensive approach for all virtual world taxation.

Based on the above analysis the most equitable and efficient means for the CRA to tax virtual world transactions would be to:

1. Issue interpretation bulletin's announcing the implementation of the following CRA policies:
  - a. All virtual world transactions involving real-world consideration will be subject to tax, regardless of whether they arise from worlds with open or closed economies;
  - b. All in-world transactions arising from virtual worlds with intentionally commodified economies will be subjected to tax, while those from worlds with closed economies will be exempt;
  - c. All virtual currency from commodified virtual world economies will be treated like foreign currency for tax

---

<sup>145</sup> *ITA*, *supra* note 74, ss. 110.6(2)-(2.1); Canada Revenue Agency, Guide T4037-09(e), "Capital Gains 2009", online: CRA <<http://www.cra-arc.gc.ca/E/pub/tg/t4037/README.html>> at 12.

<sup>146</sup> *Ibid.*, s. 46(1).

<sup>147</sup> See Chodorow, *supra* note 2 at 698.

purposes, thus making valuation of in-world transactions simpler; and

2. Recommend that Parliament create a fixed exemption on income generated through virtual world transactions.

Regardless of whether these suggestions are adopted the CRA must address the tax issues arising from virtual worlds. If they remain silent on the topic, many taxpayers may be lost in the uncertainty surrounding taxation of virtual world transactions.