

SOUTH AFRICAN INCOME TAX IMPLICATIONS OF INCOME EARNED IN VIRTUAL WORLDS

Mini dissertation by

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ENGLISH SUMMARY

SOUTH AFRICAN INCOME TAX IMPLICATIONS OF INCOME EARNED IN VIRTUAL WORLDS

by

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There has been a significant increase in the number of internet business and e-commerce transactions being entered into over the last couple of years. More recently, the development of virtual worlds on the internet has become a more important feature of the environment businesses operate in.

Although the tax consequences of income earned in virtual worlds have been researched in the United States of America before, no research of this kind exists within South Africa. This study extends prior research by performing a critical analysis of the tax treatment from a South African tax perspective.

The study's specific aim was to determine whether income earned by South African residents from structured and unstructured virtual worlds respectively, would qualify as gross income according to the South African Income Tax Act 58 of 1962.

The study builds on previous international research performed, but provides a new perspective from a South African point of view. From a theoretical perspective, the study will make a valuable contribution to the application of basic principles of gross income but on a brand new concept which did not exist when the principles were laid down.

The study was limited to determine whether the income earned in virtual worlds by South African residents who are taxed on their world wide income, will be included in gross

income as defined by the South African Income Tax Act. Capital gains tax consequences were not considered for any transaction where the income was classified to be of a capital nature. The study did not consider which deductions might be available to taxpayers in terms of the income being included in gross income and no detailed discussion were included to determine when a taxpayer would only be considered to engage in virtual worlds as a hobby versus when the taxpayer's action would constitute a business. Future research can be extended to this very area.

This research concluded that most transactions in virtual worlds resulting in income will qualify as gross income under the South African Income Tax Act. At this stage the only possible disqualification in terms of the South African gross income definition appears to be the qualification of income received as, "of a capital nature".

Keywords:

Virtual worlds

Unstructured virtual worlds

Gross income

Structured virtual worlds

South African resident

AFRIKAANSE OPSOMMING

SUID AFRIKAANSE INKOMSTEBELASTING IMPLIKASIES VAN INKOMSTE VERDIEN UIT VIRTUELE WÊRELDE

deur

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In die laaste aantal jare was daar 'n beduidende toename in die aantal internet besigheid en e-handel transaksies wat aangegaan is. Meer onlangs het die ontwikkeling van virtuele wêrelde op die internet 'n groter rol begin speel in die omgewing waarin besigheid bedryf word.

Alhoewel die belastinggevolge van inkomste verdien in virtuele wêrelde reeds voorheen in die Verenigde State van Amerika nagevors is, bestaan geen navorsing van hierdie aard in Suid-Afrika nie. Die studie is 'n uitbreiding van voltooide navorsing deur die uitvoering van 'n kritiese analise van die belastinggevolge vanuit 'n Suid-Afrikaanse belastingperspektief.

Die studie het spesifiek ten doel om vas te stel of inkomste verdien deur Suid-Afrikaanse inwoners vanuit gestruktureerde en ongestruktureerde virtuele wêrelde, sal kwalifiseer as bruto inkomste ingevolge die Suid-Afrikaanse Inkomstebelastingwet 58 van 1962.

Die studie bou op voltooide internasionale navorsing, maar gee 'n nuwe perspektief vanuit 'n Suid-Afrikaanse oogpunt. Vanuit 'n teoretiese perspektief, sal die studie 'n waardevolle bydrae maak ten opsigte van die toepassing van die basiese beginsels van bruto inkomste op 'n splinternuwe konsep wat nie bestaan het toe die beginsels neergelê is nie.

Die studie is beperk tot die bepaling of inkomste, verdien uit virtuele wêrelde deur Suid-Afrikaanse inwoners, wat op hul wêreldwye inkomste belas word, ingesluit sal word by

bruto inkomste soos gedefinieer in die Suid-Afrikaanse Inkomstebelastingwet. Kapitaalwinstbelastinggevolge is nie in ag geneem vir enige van die transaksies waar die inkomste geklassifiseer is as kapitaal van aard nie. Die studie het nie enige moontlike toelaatbare aftrekkings oorweeg as gevolg van die insluiting van die inkomste by bruto inkomste nie en geen detail bespreking is ingesluit ten opsigte van wanneer 'n belastingbetaler slegs 'n stokperdjie beoefen teenoor wanneer 'n belastingbetaler se aksies die bedryf van 'n besigheid sal uitmaak nie. Toekomstige navorsing kan uitgebrei word na hierdie areas.

Die slotsom van die navorsing is dat meeste transaksies in virtuele wêreld wat inkomste tot gevolg het, sal kwalifiseer as bruto inkomste volgens die Suid-Afrikaanse Inkomstebelastingwet. Op hierdie stadium blyk die enigste moontlike diskwalifiserende faktor in terme van die Suid-Afrikaanse bruto inkomste definisie, inkomste ontvang van 'n "kapitale aard" te wees.

Sleutelwoorde:

Virtuele wêreld

Gestruktureerde virtuele wêreld

Ongestruktureerde virtuele wêreld

Suid-Afrikaanse inwoner

Bruto inkomste

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LIST OF ABBREVIATIONS

EULA	End User License Agreement
MMOG	Massively Multiplayer Online Games
MMORPG	Massively Multiplayer Online Role-Playing Games
NPCs	Non-player characters
SARS:	South African Revenue Services
TOS	Terms of Service
US	United States
WoW	World of Warcraft

1 CHAPTER 1: INTRODUCTION TO THE STUDY

1.1 BACKGROUND TO THE STUDY

A Nobel Prize Winner for economics Milton Friedman (2008) once said that the most important way in which the internet will affect the big issue, is that it will make it more difficult for government to collect taxes. This is a valid statement with regards to income earned through formal business activities taking place on the internet, but even more so with the recent development of virtual worlds on the internet.

Lymer (2003:249) referred to the significant effect the internet had on businesses and rightly noted that this was but the beginning of a revolution. The taxation of so-called e-commerce transactions is suggested as a field of tax research as it becomes a more important feature of the environment businesses now operate in. Current tax systems are designed to operate in physical environments and research supporting the development of systems addressing e-commerce transactions is still very limited. As presumed, initial e-commerce transactions was only the tip of the iceberg and the latest internet developments are beginning to draw the attention of real-world authorities (Pasick:2006). Deloitte (2007) confirmed the reason for the real-world tax authority's interest in virtual economies, as real people are spending real money on entirely virtual goods and services.

Users of virtual worlds such as Second Life and World of Warcraft (WoW) transact millions of dollars worth of virtual goods and services every day (Pasick:2006). According to Au (2008:9), Second Life has its own currency: the Linden dollar (L\$). Linden dollars are exchangeable for real-life dollars. Table 1 provides a summary of the value of user to user transactions from January 2005 to August 2008.

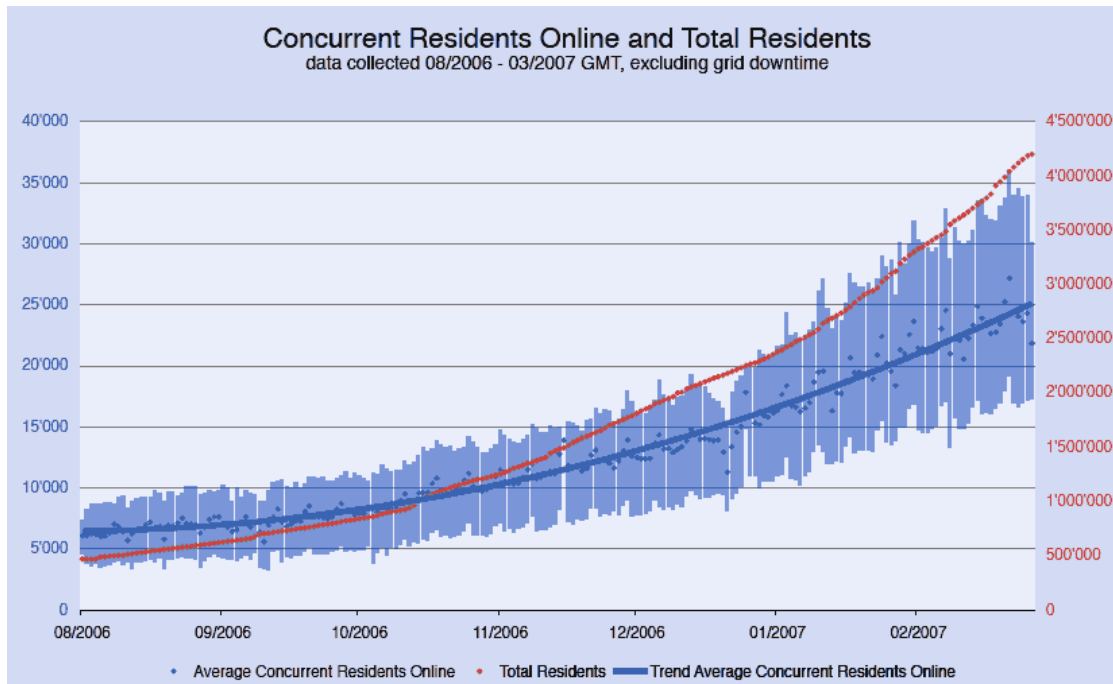
Table 1: Value of user to user transactions in Second Life

Year	Month	User to User Transactions (L\$ Millions)	Average Exchange Rate (L\$ to one U.S.\$)	User to User Transactions (\$ Millions)
2005	January	L\$ 288.3		
2005	February	L\$ 279.5		
2005	March	L\$ 334.8		
2005	April	L\$ 286.8		
2005	May	L\$ 417.7		
2005	June	L\$ 392.1		
2005	July	L\$ 440.3		
2005	August	L\$ 471.5		
2005	September	L\$ 600.4		
2005	October	L\$ 694.1	L\$ 260.3	\$2.67
2005	November	L\$ 731.2	L\$ 255.3	\$2.86
2005	December	L\$ 1,052.1	L\$ 265.3	\$3.97
2006	January	L\$ 1,384.8	L\$ 272.9	\$5.07
2006	February	L\$ 1,231.4	L\$ 278.2	\$4.43
2006	March	L\$ 1,559.1	L\$ 285.1	\$5.47
2006	April	L\$ 1,371.9	L\$ 298.6	\$4.59
2006	May	L\$ 1,761.3	L\$ 316.5	\$5.56
2006	June	L\$ 1,736.9	L\$ 330.4	\$5.26
2006	July	L\$ 1,934.8	L\$ 304.6	\$6.35
2006	August	L\$ 1,785.0	L\$ 296.3	\$6.02
2006	September	L\$ 1,994.0	L\$ 278.7	\$7.16
2006	October	L\$ 2,448.1	L\$ 274.2	\$8.93
2006	November	L\$ 3,427.8	L\$ 273.2	\$12.55
2006	December	L\$ 4,597.3	L\$ 270.4	\$17.00
2007	January	L\$ 6,418.2	L\$ 268.9	\$23.86
2007	February	L\$ 7,051.8	L\$ 268.9	\$26.22
2007	March	L\$ 9,810.9	L\$ 268.7	\$36.51
2007	April	L\$ 9,115.9	L\$ 268.8	\$33.92
2007	May	L\$ 8,901.7	L\$ 268.9	\$33.11
2007	June	L\$ 9,371.3	L\$ 268.8	\$34.87
2007	July	L\$ 9,664.8	L\$ 268.5	\$35.99
2007	August	L\$ 5,939.1	L\$ 268.7	\$22.10
2007	September	L\$ 5,352.0	L\$ 268.5	\$19.93
2007	October	L\$ 5,614.2	L\$ 268.5	\$20.91
2007	November	L\$ 5,869.0	L\$ 268.4	\$21.86
2007	December	L\$ 6,060.1	L\$ 268.4	\$22.58
2008	January	L\$ 6,424.5	L\$ 268.5	\$23.93
2008	February	L\$ 6,254.3	L\$ 268.4	\$23.30
2008	March	L\$ 7,130.4	L\$ 267.6	\$26.64
2008	April	L\$ 7,036.0	L\$ 267.4	\$26.31
2008	May	L\$ 7,675.8	L\$ 267.3	\$28.72
2008	June	L\$ 7,875.5	L\$ 267.4	\$29.46
2008	July	L\$ 8,448.0	L\$ 267.4	\$31.59
2008	August	L\$ 8,941.8	L\$ 266.8	\$33.52

Linden Lab (2008)

The increase in value of user to user transactions corresponds with the growing number of active Second Life residents online as well as the total number of residents as shown in Figure 1.

Figure 1: Concurrent residents online and total residents

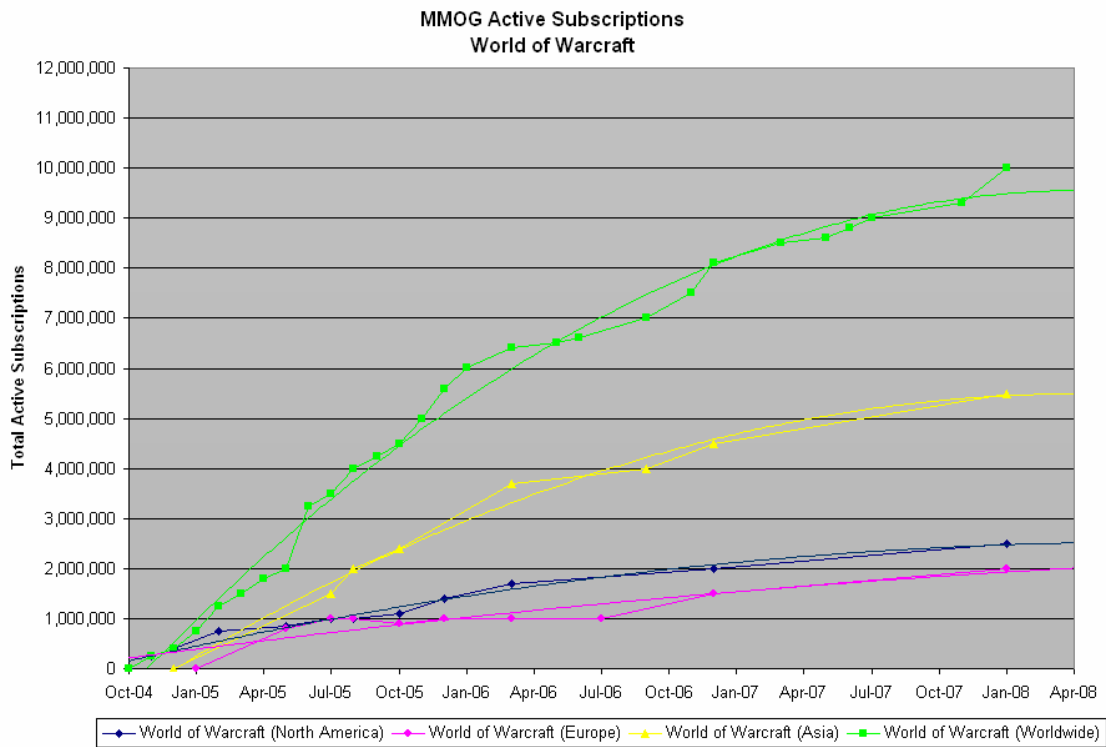


Lang (2007)

From August 2006 the total number of residents in Second Life increased from an average of 500 000 to over 4 000 000 residents in mid-2007. For the same period the average concurrent users online increased from just below 5 000 to 25 000 users “living” concurrently in this environment.

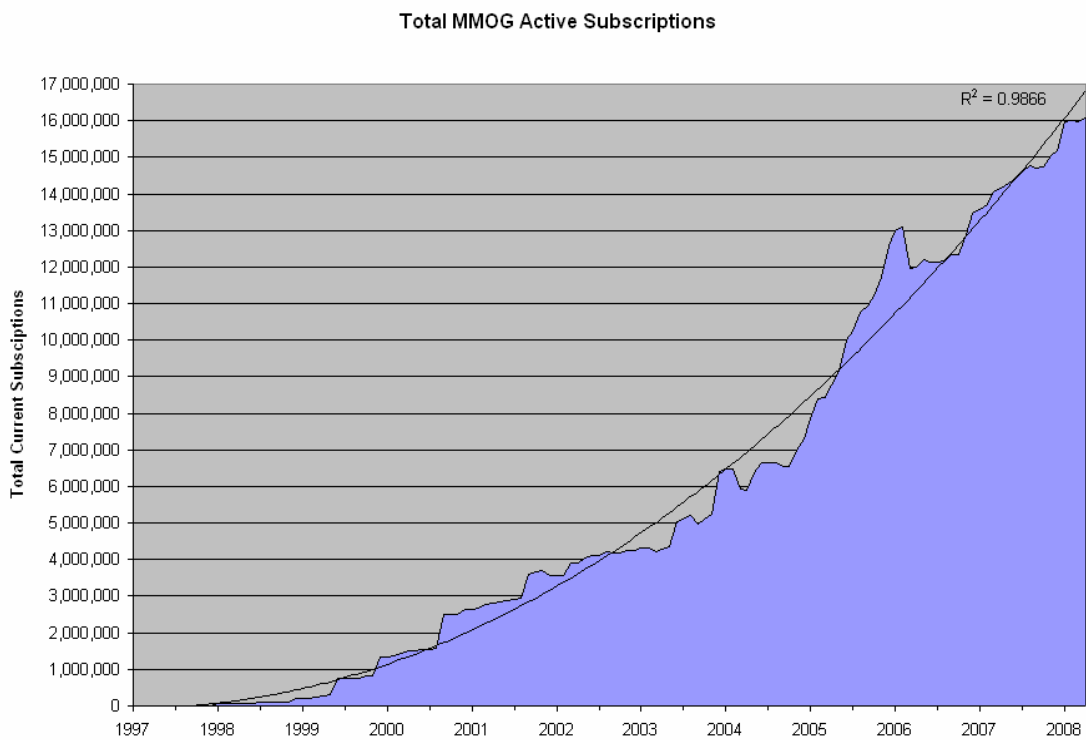
The active subscriptions in WoW as indicated in Figure 2 as well as the total estimated subscriptions to all Massively Multiplayer Online Games (MMOG) as indicated in Figure 3 corresponds with the steady incline as displayed by the Second Life graphs. The total active subscriptions to WoW which launched in October 2004 increased to approximately 5 000 000 subscribers at the beginning of 2006 and hit the 10 000 000 mark in January 2008. Total MMOG active subscriptions statistics started around 1998, inclined to around 6 000 000 subscribers in 2006 and is showing around 16 000 000 active subscribers at the beginning of 2008.

Figure 2: MMOG Active Subscriptions: World of Warcraft



Woodcock (2008)

Figure 3: Total MMOG Active subscriptions



Woodcock (2008)

Considering the fact that an estimated 16 million registered accounts were activated in all MMOGs by March 2008 (Woodcock, 2008), this might be an important development to be investigated by tax authorities in the near future. These statistics and the fact that users are willing to pay real money to obtain assets in these virtual worlds, meaning someone is earning a real income out of these virtual transactions.

An extensive search of leading electronic journal databases, including EBSCOHost, Emerald, Google Scholar, Proquest, ScienceDirect and SA ePublications suggests that no academic research has examined whether income earned in virtual worlds will qualify under the gross income definition as defined in the South African Income Tax Act 58 of 1962 (the South African Income Tax Act). Bray (2007:22) emphasises the new multi-disciplinary research opportunities created by virtual worlds. However, very little research has been performed in this regard. “The Play’s The Thing: A Theory of Taxing Virtual Worlds” (Camp, 2007) and “Stranger than Fiction’: Taxing Virtual Worlds” (Lederman, 2007) is international research performed considering the taxation of income earned in virtual worlds.

Camp’s (2007) research mainly focuses defining what a virtual world is. Camp explains that virtual worlds developed from a growth in Massively Multiplayer Online Role-Playing Games (MMORPGs) on the internet. In a MMORPG, a player uses an online persona called an avatar. The avatar takes on a role within the context of the game environment and the player plays the game within that role. These MMORPGs or virtual worlds are divided into two distinct groups, structured worlds (also referred to as game worlds) and unstructured worlds (also referred to as unscripted worlds). The study investigate what the resulting income generating activities from different virtual worlds will be and if and when it will qualify as income for tax purposes. The result of the study was that while transactions occurred within the different virtual worlds, no real money is flowing and these transactions will not have any tax consequences. However, if players cash out by selling virtual items for real money, the transactions will possibly qualify as income for tax purposes.

Lederman’s (2007) research on taxing virtual worlds also focuses on the main definitions but she also considers why the players would be taking part in one of the two groups of virtual worlds. The study focuses on the difference in the nature of transactions between structured and unstructured worlds and if a transaction needs to be cashed out to qualify

as income for tax purposes. The study concludes with a strong case for not taxing income from transactions in a structured world, including sales within these worlds for virtual currency. Lederman bases this conclusion mainly on the fact that structured worlds, or game worlds focus on conquering challenges and not on trading. On the other hand, unscripted worlds are designed to support trade and commerce. Players of an unscripted world, like Second Life, are encouraged to create virtual items or services to be traded with other players. Players retain the intellectual property rights of their creations and Second Life's currency, Linden dollars can be converted to U.S. dollars. The study use these arguments to motivate why income earned from transactions in unscripted worlds should qualify as income for tax purposes.

There is currently no reliable way to determine to what extent qualifying gross income is earned by South African residents from virtual worlds, however, Mr Pravin Gordhan, Commissioner of the South African Revenue Service (SARS), in 2000 said that the detection of tax evasion through Internet transactions would be one of SARS's prime tasks. He further noted that SARS is fortunate that many evasion schemes will start in the developed part of the world and will only filter to South Africa in about six months to a year, by which time SARS will be adequately prepared to deal with it. The Joint Economic Committee in the United States of America indicated that they are in the preliminary stages of looking at the issues and what kind of public policy questions virtual economies raise amongst other with regards to taxes (Arrison: 2007). Considering Mr Gordhan's statement it should therefore not be a long time before SARS will show an increased interest with regards to these transactions to determine which transactions will form part of a resident's taxable income. This research would therefore be helpful to both the taxpayer and SARS to identify possible gaps in South African legislation in respect of virtual income qualifying as gross income.

The significance of the study is emphasised as it attempts to look at very basic principles in South African tax legislation in a new way.

The country of focus for this study is South Africa. Previous research addressing the taxability of income earned in virtual worlds by B.T. Camp (2007) and L. Lederman (2007) will be replicated in a South African context to determine whether income from virtual worlds will qualify as gross income as defined in the South African Income Tax Act. South

African case law with regards to determining whether a transaction is of an income or capital nature will be analysed and the study will attempt to apply the principles in case law to determine whether income from virtual worlds will qualify to be gross income as defined in the South African Income Tax Act.

In terms of section 5(1) of the South African Income Tax Act, income tax is paid on the taxable income received by a person or accrued to a person during the year of assessment. Taxable income is defined in section 1 of the South African Income Tax Act as the amount remaining after the deduction of any allowable expenditure and/ or any set-offs against the income of the taxpayer. Section (1) of the South African Income Tax Act furthermore defines the term as:

“...the amount remaining of the gross income of any person for any year or period of assessment after deducting there from any amounts exempt from normal tax under Part I of Chapter II.”

From the above definition of income it is evident that the definition of gross income is vital in terms of the calculation of taxable income of a taxpayer. Section 1 of the South African Income Tax Act defines gross income as follows:

“...in relation to any year of assessment, means –

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or*
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,*

during such year or period of assessment, excluding receipts or accruals of a capital nature...”

According to the above mentioned definition of gross income, the important element that will be investigated in this study is whether the income will be of a capital or income nature. If the income is of an income nature it will be included in the taxpayer's gross income. Several cases in South Africa deal with revenue nature versus capital nature of receipt and accruals. This is as a result of the term capital not being defined in the South African Income Tax Act (Clegg & Stretch, 2008:§5.1). It follows therefore that if an income is of a capital nature, the amount will not be included in a taxpayer's gross income. Even though

capital gains are specifically excluded from the gross income definition as defined in the South African Income Tax Act, a portion of the capital gain, subject to certain exceptions, is included in the taxable income of a taxpayer in terms of section 26A of the South African Income Tax Act.

1.2 RESEARCH QUESTION

The main purpose of this study is to determine the income tax consequences of income earned in virtual worlds and more specifically whether the income earned in virtual worlds will qualify as gross income in terms of definition in section 1 of the South African Income Tax Act.

1.3 RESEARCH OBJECTIVES

The study will be guided by the following specific research objectives:

- To determine if the income earned by South African residents from structured virtual worlds will qualify as gross income as defined in the South African Income Tax Act.
- To determine if income earned by South African residents from unstructured virtual worlds will qualify as gross income as defined in the South African Income Tax Act.

As the South African income tax system is one of residence, it means that world-wide receipts derived by a resident (as defined in section 1 of the South African Income Tax Act) are included in the resident's gross income (Jordaan, Koekemoer, Stiglingh, Van Schalkwyk, Wasserman and Wilcocks, 2008:41). Non-residents (persons who are not residents as defined by the South African Income Tax Act) only pay income tax on receipts derived or deemed to be derived from a source within South Africa (with certain exceptions). Therefore, non-residents are taxed on a source-based system of tax. This study will only focus on income earned from virtual worlds by residents as defined by the South African Income Tax Act.

1.4 IMPORTANCE AND BENEFITS OF THE STUDY

From a theoretical perspective, the proposed study will make a valuable contribution as to the application of basic principles but by looking at a brand new concept which did not exist when the principles were initially laid down and will possibly force revenue authorities and taxpayers to look at virtual transactions more carefully. The significance of this research is further emphasised by the fact that, as far as could be determined, this will be the first study to determine whether income earned from virtual worlds will qualify as gross income as defined in the South African Income Tax Act.

From a practical perspective, the findings may assist the South African Revenue Services to identify gaps in the South African income tax legislation and assist South African taxpayers to identify gaps in income tax legislation to plan their income tax responsibility.

1.5 DEFINING THE KEY TERMS

This study revolved around a number of key concepts, namely, *virtual worlds*, *structured worlds*, *unstructured worlds*, *South African resident* as well as *gross income*. The manner in which these key terms have been defined for the purpose of this study is considered below:

Virtual worlds:

Virtual worlds for the purpose of this study are defined as: "...role-playing games taking advantage of the internet's ability to create graphic representations of reality also known as Massively Multiplayer Online Role-Playing Games (MMORPGs). Role-playing games fall along a continuum from highly structured games to highly unstructured games" (Camp: 2007).

Structured virtual worlds:

Structured worlds for the purposes of this study are defined as: "...environments where users are provided with structured adventures involving quests, raids and fights against opposing forces. Examples of such structured worlds are City of Heroes, Everquest and World of Warcraft (WoW)" (Lederman: 2007).

Unstructured virtual worlds:

Unstructured worlds for the purpose of this study are defined as: "...environments where the owners of the worlds provide a basic environment and users create most of the in-world content. Examples of such unstructured worlds are Second Life, The Sims Online and There" (Lederman: 2007).

South African resident:

South African resident for the purpose of this study is defined as: "...in relation to a natural person as either a person ordinarily resident in South Africa or a person who meets the requirements of the physical presence test" (paragraph (a) of the definition of "resident" in section 1 of the South African Income Tax Act).

Gross income:

Gross income for the purpose of this study is defined as: "...in relation to any year or period of assessment, in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such period of assessment, excluding receipts or accruals of a capital nature..." (section 1 of the South African Income Tax Act).

1.6 RESEARCH DESIGN AND METHODOLOGY

An extensive literature study will be conducted in order to establish the theoretical platform for the research as well as understanding the basic concepts of virtual worlds as it is quite a new technological development. Searches will be performed for both local and international studies with regards to the topic.

A theoretical case study will be used to determine whether income earned in structured and unstructured virtual worlds will qualify as gross income per the definition in section 1 of the South African Income Tax Act. The research performed by Lederman (2007) and

Camp (2007) will be replicated in a South African context and South African legislation and case law will be used to determine the outcome of the study.

1.7 LIMITATIONS TO THE STUDY

This study will only consider if virtual income earned in both structured and unstructured worlds will qualify as gross income as defined in section 1 of the South African Income Tax Act.

It must be noted that the study is done within the following limitations:

- (1) The study will only consider income earned from virtual worlds by South African residents who are taxed on their worldwide income.
- (2) The study will only consider if income earned from virtual worlds will qualify as gross income.
- (3) The study will not consider the capital gains tax consequences of income earned from virtual worlds.
- (4) The study will not consider the detailed circumstances that will cause a taxpayer's actions within a virtual world to be considered a business rather than a hobby.
- (5) The study will not consider what exclusion or deductions might be available to taxpayers, either those who constitute a trade or business or those engaging in the activity as a hobby or leisurely activity.
- (6) The study will not consider the effect of any double taxation agreements or any other international tax rules.

1.8 SUMMARY

This chapter introduced the focus of the study. It provided a background to the study and presented the research question and objectives. The importance and benefits of the study were highlighted for both the revenue services and the taxpayer. The key terms being used in the study were defined. The research design and methodology were explained to provide an outline for the rest of the study. Finally the limitations with regards to the study were set.

The following chapter discusses the working of structured virtual worlds and the different types of transactions generating income. A critical analysis of the US tax treatment will then be performed from a South African tax perspective.

2 CHAPTER 2: THE DETERMINATION OF GROSS INCOME IN RESPECT OF INCOME EARNED FROM STRUCTURED VIRTUAL WORLDS

2.1 INTRODUCTION

The literature review provides an understanding of structured virtual worlds and how they work. It also includes a discussion on what the different types of transactions are which occur within structured virtual worlds. This is followed by a discussion on the reason for in-world trade and the consequent real money trade which arise due to the market created by in-world trade. Previous research performed with regards to whether virtual income from structured virtual worlds should be taxed in the United States of America is discussed. Conclusions on both in-world and real-money transactions will be compared. Finally a critical analysis of previous research will be performed in terms of South African income tax legislation and case law to determine whether income earned from structured virtual worlds will qualify as gross income in South Africa.

This study is performed with US tax legislation as the basis for completed research in comparison to South African tax legislation. The US tax legislation works on the principle that all income will qualify as gross income unless the income qualifies for one of three exceptions available. On the other hand the South African Income Tax Act defines gross income with the main difference that even if income qualifies as gross income per the required definition and this income is of a capital nature, then the income will not qualify as gross income. According to South African income tax legislation, two taxpayers can therefore earn the same income and the one could be taxed on it and the other, not based on the income versus capital nature rules.

The South African Income Tax Act does not define “receipts and accruals of a capital nature”. There are several tests being used and acknowledged in South African case law to determine whether a certain income is of a capital or revenue nature. The most important test being used by the courts is the test of intention (Jordaan *et al.*, 2008: 21). The taxpayer’s intention needs to be determined when the asset was acquired. Generally

the income would be of a revenue nature if the intention was to sell the asset for a profit. On the other hand it will be considered to be capital in nature if the asset was acquired not for the purpose of making a profit but to use it to produce income, for example if a house which was bought to earn rental income is sold, the income would be of a capital nature. Whether South African capital gains tax will be payable on such a transaction is outside the scope of this study. It is also possible for the owner of a certain asset to change their intention during the period of ownership or to change their intention at the time of disposal (Lace Proprietary Mines Ltd v CIR (AD 1938) (9 SATC 349)).

It is important to remember that even though a transaction might appear to be taxable according to all the South African tax legislation as discussed below, it is possible not to qualify as taxable income if the income is of a capital nature. The revenue versus capital debate about the type of transactions which are investigated in this study will revolve around the question when a hobby turns into a business, where income from a hobby will be capital in nature and income from a business will be revenue in nature (Williams, 1996:50).

2.2 UNDERSTANDING STRUCTURED VIRTUAL WORLDS

Dan Miller, a senior economist on the Joint Economic Committee in the United States once said:

“To me it seems unbelievable that somebody could incur some tax liability just from playing a game. The more the virtual world is purely just a gaming or entertainment function, the harder it will be to introduce taxes to it, the more it seems to be parallel to the real world, the easier it will be to introduce taxes to it” (Datastream, 2007:11).

Miller’s words probably reflect most people’s intuition with regards to the accumulation of assets within a virtual world which is merely a “game”, as long as the assets are not cashed out for real funds (Lederman, 2007:1624). But is this feeling necessarily fact? First we have to understand more about the working of structured virtual worlds.

According to Camp (2007:3), a player uses an online persona called an avatar to assume a role within the context of the game environment of a MMORPG. According to

Bartle (2004:30), people participate in virtual worlds for entertainment, social value and the experience of a “hero’s journey”. With regards to structured worlds specifically, the games define pre-set roles, challenges and objectives. When playing the game, a player agrees to “live” according to a set of rules and regulations in return for the benefits of playing the game (Bartle, 2004:23). These rules regulate interaction between both the player generated avatars and the non-player characters (NPCs), characters provided with the game environment by the game owner (Camp, 2007:3).

One of the biggest MMORPGs WoW describes itself as follows:

“World of Warcraft is an online experience. Players assume the roles of Warcraft heroes as they explore, adventure, and quest across a vast world. Whether adventuring together or fighting against each other in epic battles, players will form friendships, forge alliances, and compete with enemies for power and glory.”

(World of Warcraft: 2008)

According to Camp (2007:3-4), structured games typically have three prominent characteristics.

Firstly, each avatar fits into a strong pre-defined role which fit into the overall context of the storyline. This means that each role has strengths and weaknesses which cannot be changed as the game is pre-programmed in such a way. The different roles support each other in different quests, treasure hunts, rescuing NPCs or any other experiences as provided by game owner. Players are awarded for each successful experience as determined by the game owner. In structured worlds, game owners use NPCs to a large extent to guide game play.

Secondly, players are allowed to craft but not create. In a structured game, players acquire assets by way of treasure hunt or by completing a quest. Alternatively players can gather or buy ingredients from other players and assemble a particular asset as defined by a recipe provided by the game owner. For example, a sword can be made if you click on a number of ingredients as prescribed by the recipe. This process is called “crafting”.

Thirdly, the game consists of a number of levels. The more you kill, the better you get at it and your avatar will automatically be assigned a higher level which will provide better odds

of success to the player in a battle. The higher the level of play, the more skill is required to perform activities within the game.

According to Lederman (2007:1643), one distinctive problem, especially in scripted worlds, is the taxation of “loot drops” or prizes. Loot is what is obtained after the defeat of a monster, the completion of a quest or a successful treasure hunt. There are possibly two ways of conceptualising loot drops: either they are property or they are not. The property rights of participants in virtual worlds are outside the scope of this study and therefore the provisions in agreements between game owners and players which deny players any rights in virtual property will be accepted and not challenged in this study. Even though loot drops are not actual trade within a structured virtual world, it gives rise to the items players do trade with and it will influence a player’s level within the game as well as the market for a certain skill in the performing of quests.

Co-operation between players is a very important part of game play. To perform some of the game world’s experiences, “guilds” of as many as 25 members have to be formed. Players use the pre-defined strengths of the different players to enhance the power of the overall guild. To enable this, players of the different professions sell or trade items with each other to craft the necessary items as defined above (Camp, 2007:5).

It is these exchanges which result in the game world’s economy and give rise to possible tax issues.

2.3 REASON FOR TRADE IN STRUCTURED VIRTUAL WORLD ITEMS

Even though virtual world designers ban the trade of game world items (Bartle, 2004:41) and the sale of virtual game goods have been banned by certain internet auction sites (Guardian.co.uk Games Blog, 2007), this does not prevent players to trade assets from structured virtual worlds.

Players with little time and a lot of money buy items in structured virtual worlds and players with more time and less money sell their items to players with money (Lederman, 2007: 1628-1629). In this way a low-level avatar can advance to a much

higher level very quickly to for instance, participate in quests with player-friends of a higher level. According to Bartle 2004: 39-40), people also buy complete online characters or assets as an investment and also do this to inflate their status, so that they can act like they are a higher ability player.

The game owners themselves also create an economy within the game world as their recipes require a certain number of ingredients to craft an item which is necessary for a certain quest (Camp, 2007:8-9). Apart from player-to-player trade, it might also be required from a player to trade with NPCs for certain scarce items in the game. Game owners create this market and programme NPCs to automatically sell high and buy low.

In WoW, trade can either take place by means of exchanging two in-world items or by using in-world currency to buy a certain in-world item from another player. The in-world currency used in WoW is called Gold. This currency can be broken down into subunits called Silver and Copper. The most common virtual item to be purchased in-world is currency. WoW Gold appears to trade around a surprising four to ten units per one US dollar. Where there is a real world value, real world trade starts.

2.4 REAL MONEY TRADE

According to Lederman (2007:1622), people pay to participate in virtual worlds. Part of the “return” for the monthly fee which is paid by players, is periodic “allowances” in in-world currency by the game owner to the player. However this allowance is not for a player to participate at a high level of the game (Camp, 2007:11). Camp explains that real money trade speeds up the game process as it is sometimes a lot faster to buy a certain in-world item, like a sword, on an auction website compared to an in-world transaction as the in-world transaction costs are a lot higher than in real money trade. Even though a transaction takes place in real money trade, the transaction is almost always a two step process, because the transaction needs to be finalised in the game environment. Because the item has been paid for with real money, the in-world transaction will take place at no charge.

Apart from virtual currency and item sales, certain players will sell their complete player account. A player account can consist of single or multiple avatars (Camp, 2007:12). Such accounts will be valued based on the level of characters being sold and the accompanying items owned by the characters.

According to Lederman (2007:1623) it seems to be obvious that that a person selling their virtual property to make a living should be taxed on their earnings, even players who only sell a valuable item occasionally, but the big debate seems to be around whether a person should be taxed if they accumulate their items or currency in the virtual world and whether in-world trade transactions will attract tax consequences. Camp's (2007:2) opinion is "where the play ceases, taxation begins."

The outcome on research performed by both Lederman and Camp with regards to the tax consequences of structured virtual world transactions will be discussed in the following section.

2.5 A CRITICAL ANALYSIS FROM A SOUTH AFRICAN PERSPECTIVE

2.5.1 Introduction

This section considers the completed research of Leandra Lederman (2007) and Brian Camp (2007) with regards to the taxation of income earned in structured virtual worlds. Both studies were performed based on gross income as defined in §61 of the Federal Income Tax Code of the United States (US) of America. Section 1 of the Federal Income Tax Code of the US imposes income tax on taxable income which equates to gross income minus deductions as per § 63. Gross income is defined by § 61 as "all income from whatever source derived." According to US case law income means "any undeniable accessions to wealth, clearly realised, and over which the taxpayer has complete dominion." Clearly the form of income is not important, but rather the access to it which is important.

It is in terms of this background that the outcomes of the completed studies are compared and a critical analysis from a South African perspective is discussed.

2.5.2 Loot (prize) drops

Many virtual world participants never sell any of their in-world items. But even for these players a tax problem might arise as all the swords and gold pieces they own in a structured virtual world still holds economic value from the moment their online avatar takes ownership of these items (Lederman, 2007:1641). If these loot drops or prizes qualify as gross income, these receipts will be taxable even if their owners never physically trade with these virtual items inside the virtual world or with real money.

According to Camp (2007:14) the Supreme Court aimed to extend the reach of the gross income definition per § 61 to extent as far as constitutionally possible. With regards to loot drops, Revenue Services in the US look at income earned in structured virtual worlds and sees taxpayers playing for prizes and awards (Camp, 2007:46). Due to the far reaching definition of gross income, prizes and awards are included in a US resident's gross income and ultimately, their taxable income. However, there are three exceptions as expressed in statutes, cases and interpreted in administrative guidance as to what taxpayers must include in gross income. These limits are "priceless" or income for which there is no ascertainable fair market value; "unrealised" income derived from the appreciation of property and "imputed" income, which arises from self-benefiting activity or property ownership (Camp, 2007:25).

For income to qualify as "priceless", means that the income should not have a readily ascertainable fair market value. If an objective market value cannot be determined to a value in US currency, there is no reportable income. The US Treasury Regulation 1.74-1(a)(2) further states that prizes and rewards be reported as income at its fair market value.

A taxpayer will not qualify for the priceless exception as it is easy convert virtual items into US currency by selling it on an internet auction site or to sell the item in-world for the in-world currency (for instance Gold in WoW) and then convert the in-world currency to US dollar. The virtual items therefore do have a readily ascertainable fair market value and will not qualify under the priceless exception (Camp, 2007:47).

South African taxpayers have a smaller risk with regards to the classification of loot drops as awards and prizes. Where a prize or lottery depends on good fortune and the transaction is not of a business nature, the transaction will be of a capital nature for South African income tax purposes and will not qualify as gross income (Hamel, Stiglingh & Venter: 2008:43).

Part of the South African gross income definition determines that the amount to be included in gross income should be “the total amount in cash or otherwise” (section 1(i)). This principle agrees with the US “priceless” exception.

According to South African tax legislation, there need to be an amount received or accrued for gross income to be recognised (Hamel *et al.*: 2008:29). In *WH Lategan v Commissioner for Inland Revenue* (1926 CPD 203), (SATC 16), it was stated that even without the words “whether in cash or otherwise”, by virtue of the word “amount” in the gross income definition, not only money but every form of property, whether corporeal or incorporeal, which has a monetary value, will be included in the gross income definition. This was confirmed in *CIR v Delfos* (1933 AD 242) (6 SATC 92), when judge Wessels said:

“The tax is to be assessed on all receipts or accruals having a monetary value. If it is something which is not money’s worth or cannot be turned into money, it is not to be regarded as income.”

South African legislation therefore determines that if an asset or service is received instead of cash, the value of the asset or service should be included in gross income (Hamel *et al.*, 2008:29). Clegg & Stretch, 2008:§4.11 confirm that the courts have giving a very wide meaning to the word “otherwise”. As long as whatever is received can be converted to money, it can be of any nature. The fact that it may be difficult to determine the monetary value of the thing or right of action is immaterial. As long as it has an ascertainable value, the thing or right of action will be included in gross income.

The value to be placed on an asset received instead of cash received or accruing as income is the fair market value of the asset if it was sold under fair and reasonable circumstances (Clegg & Stretch, 2008:§2.13).

In *CIR v Butcher Bros (Pty) Ltd* (1945 AD 301) (13 SATC 21) the principle was laid down that the onus for proving an ascertainable money value was the Commissioner's (Hamel *et al.*, 2008:30). Once the Commissioner has determined the amount, onus is back on the taxpayer to prove another.

Both *ITC 932* (1965 24 SATC 341) and *Lace Proprietary Mines Ltd v CIR* (AD 1938) (9 SATC 349) confirmed that the value of the income needs to be determined by valuing the asset and that this value normally is the market value at which the asset was initially obtained (Hamel *et al.*, 2008:29).

The only further requirement with regards to the determination of amount of income when it is otherwise than cash is that the value should be an objective one (*Ochberg v CIR* (1931 AD 215) (5 SATC 93)) and *CIR v Butcher Bros (Pty) Ltd* (1945 AD 301) (13 SATC 21)). The value of the determined income to the taxpayer is irrelevant. The value taken into account for gross income purposes should be one determined objectively.

The market value of a loot drop can easily be determined in a number of ways. Loot can be sold to a NPC or another player in-world for in-world currency and the in-world currency can be converted to US dollar and then to South African rand. The South African Income Tax Act even specify a method of translation from foreign currency amounts making it even easier to convert the item value to South African currency (section 25D of the South African Income Tax Act). Another indirect way to value the loot is to determine the average price for a similar item as displayed on the many internet auction sites. As loot has a readily ascertainable fair market value, it will qualify as gross income as per the definition in the South African Income Tax Act.

According to US legislation (Camp, 2007:28-38), income from a service realise when a taxpayer receives cash, property or services in exchange for past, present or future services by the taxpayer. On the other hand, income from property can be generated by one of two ways. Simply owning a piece of property might generate income, for example shares might generate dividends and a house might create rental income. It may also produce income if the property is sold, exchanged or otherwise disposed of. For all of the above transactions, the income needs to be realised before it can be included in gross

income. For income to qualify as “unrealised” income, means that access to income should not have been realised.

Camp (2007:47) proposes that there is a strong argument that no wealth is realised from a loot drop as no actual cash, property or service has been received as a taxpayer’s ability to convert the loot to usable wealth is remote and dependant on factors beyond his control. With this exception, the less rights a taxpayer has in a virtual item, the better the chances are that the income will qualify for the exception. But Camp concludes that he has doubts whether this argument will be strong enough to save a taxpayer from paying taxes on the loot.

A requirement of the South African gross income definition is that the income should be received by or accrued to the taxpayer (section 1 of the South African Income Tax Act). This agrees to an extent with the realisation exception in US legislation. Income needs to be either a receipt or an accrual for it to qualify as gross income. In *SARS v Cape Consumers (Pty) Ltd* (1999 (4) SA 1213) (61 SATC 91) it was said that there would be no receipt or accrual if a person has not received an amount or it has not accrued to him for his own benefit. As the terms “received by” or “accrued to” has not been defined in the Act, it is important to determine the exact meaning of these words referring to relevant prior case law.

In *Geldenhuis v CIR* (1947 3 SA 256) (C) (14 SATC 419) the court determined that “received by” means that a taxpayer must have received by for his own benefit and on his own behalf. It is therefore clear that a person cannot be liable for income tax on an amount received on behalf of another person. However, it is irrelevant whether the taxpayer has already benefited from the transaction (*Ochberg v CIR* 5 (1931 AD 215) (5 SATC 93)) before an amount can be included in gross income.

With regards to accrued to, the courts have tested the principle but finally decided that the most appropriate interpretation would be that income has accrued to a taxpayer when they become entitled to claim payment (*Jordaan et al.*: 2008:14). This opinion was originally held in *WH Lategan v Commissioner for Inland Revenue* (1926 CPD 203), (SATC 16) and was confirmed in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* (1990 (2) SA 353 A) (52 SATC 9).

It is important to note that a taxpayer can only be taxed either on receipt or accrual of the transaction (Jordaan *et al.*:2008:15). If the taxpayer is therefore taxed when the loot drop is received it cannot be taxed again when the loot is sold.

Considering South African tax legislation, it does not appear as if there is any reason why loot drops will not be considered as a non-monetary accrual to the South African taxpayer. A taxpayer's game account will be credited with the loot as soon as quest or raid has been completed. The virtual item can be used for their own benefit until they decide to transfer the item and whatever powers are attached to another player or sell it to an NPC. The loot cannot be received on behalf of another player. The player is entitled to "payment" in the form of the loot drop the moment the quest or raid is completed.

In Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others (2007) (69 SATC 205), the Supreme Court of appeal held that the "benefit" derived from using an interest-free loan, represents an "amount" and has to be included in gross income. If the taxpayer therefore wants to argue that the loot drops are not taxable, it might be an argument from the Commissioner that the loot drop provide the player with a benefit, that is to advance to another level or whatever the advantages caused by the loot received might be. This will result in the benefit being seen as an amount which should be included in the taxpayer's gross income.

The last resort for exception is "imputed" income (Camp, 2007: 38-42). Income qualifies as imputed income when a taxpayer receives a benefit which arises from personal exertions of the taxpayer on his own behalf. There are two types of imputed income, income from services and income from property. Imputed income from services means that every person performs services for their own benefit. These services have an economic value but will not be included in a taxpayer's gross income. Imputed income from property means that a value can be assigned to the use of assets for a taxpayer's own asset for their own benefit. The same rule applies as with imputed income from services. The imputed income from property has a value but this value will not be included in a taxpayer's gross income.

According to Camp (2007:56), a taxpayer's best chance of exception of the loot drop from gross income, is the concept of imputed income. The game activities bring a taxpayer in-kind services, playing the game and the enjoyment of self-owned property, the right to play. Playing a game is compared with gambling, where a player want to get as much "play" as possible for the original cash used to buy casino chips. Only the final amount cashed out by the taxpayer qualifies as gross income.

However, Lederman's research does not agree with the basis of Camp's research. Lederman (2007:1644-1646) is of the opinion that loot drops are not purely due to the actions of the taxpayer only, a third party, the game owner is also necessary to receive the virtual items. The fact that loot drop might be seen as their property increases the chances of it being seen as an award or prize. Lottery winnings and game show prizes all qualify as gross income and are therefore taxable in the US. If the loot is not considered property (as for the purpose of this study), loot should be considered as part of the game service in return for the monthly game fee.

Lederman (2007:1644-1648) uses principles laid down by Professor Joseph Dodge to explain the tax effect of loot drops. Loot drops require substantial investment in time and effort by players. According to Dodge there is no difference between "self-created" objects and "taken" objects. The only difference is the person who has invested the time to create the object. Virtual property resembles "taken" property, as it requires substantial effort by the taxpayer, but were not self-created by the taxpayer as the taxpayer depends on the effort of the game's designers to create the items. It is purely investment by the taxpayer which resulted in the loot drop; however it will only become taxable once the taxpayer sells the loot. A loot drop will therefore not be taxed until the player enters into a transaction to cash out the value of the loot drop.

Hamel *et al.* (2008:30) explains the concept of "imputed" income in a South African context as hypothetical income, income that could have been earned if an amount were invested. This kind of hypothetical interest will not be included in gross income. No other South African publication could be found explaining exactly when income will not qualify as hypothetical interest. But Lederman's disagreement argument makes sense. Normally, hypothetical income does not involve any third party involvement. The fact that a taxpayer uses an asset and therefore cannot earn income from it does not involve a third party.

When a taxpayer delivers a service to themselves in instead of using the time and skill to earn income, no third party is involved. With a loot drop, the player uses his own skills to follow a “hero’s journey” by completing quests, taking part in raids and defeating monsters and ultimately a third party rewards the player for the use of those skills. Even though the player might be involved in a structured world for the entertainment value, the loot has a fairly ascertainable value from the moment it is in the player’s hands and should the player ever decide that he needs to the income, it will be readily available.

Camp’s comparison of loot drops with gambling winnings might be a player’s only saving grace. Not only would it save certain players from paying taxes on the loot drops, but it might go as far as saving players from paying any taxes at all on income earned in structured virtual worlds. But each case will have to be decided by its own set of facts (De Koker, 2008:§3.26). When a taxpayer uses gambling as a form of entertainment, it is seen as income from a capital nature and it is not included in his taxable income. However, as soon as the gambling activities are systematic and it can be seen as a business of a scheme of profit making, the income will be of a revenue nature and will be included in a taxpayer’s gross income (Jordaan *et al.*, 2008:27)

In *Morrison v CIR* (1950 2 SA 449) (A) (16 SATC 377), the following differences between a systematic or professional punter and the occasional better were identified:

“But where an ordinary punter simply lays a bet, or bets habitually, this conducts is so irrational from a business point of view that its gains cannot ordinarily be subject to payment of income tax. The reason for this difference is apparently that where persons associated with racing take to betting on the results of races, they have specialised knowledge and sources of particular information which make their occupation less irrational by reducing substantially the purely arbitrary results of their efforts. Where the element of risk and arbitrary gain or loss is reduced substantially the betting on horse races becomes, not irrational, but an undoubted means of making income. If it remains entirely irrational there is a good deal to be said for the view that its gains can hardly be made the subject of income tax any more than its losses can be deducted from normal income.”

Even though it depends on each individual case's facts, it is all about how regular a taxpayer takes part in gaming activities. According to SARS practice, gambling winnings are taxed when transactions take place on a systematic basis. Not even ordinary punters will get taxed on gambling winnings if they take part for entertainment purposes (De Koker, 2008:§3.26).

Lederman's counter argument against Camp's 'imputed income' is the 'self-created' object by Dodge. If the actions around a loot drop are investigated, there is doubt whether Lederman's argument will be able to prevent income from qualifying as gross income under South African income tax legislation. The player needs to invest a significant amount of time to form a guild and complete a quest or raid. If the quest or raid is successful, the game owner decides what the prize is that will be awarded to the player. Lederman's argument against the 'imputed income' argument was that a third party is involved in the transaction, the same if however true about the 'self-created' argument. In return for the effort and time put in by the player, a loot drop, with a fairly ascertainable value, is awarded. Even though this does not resemble a straight forward service delivered for a fee, the principle agrees to the benefit received in *Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and others* (2007 69 SATC 205).

On the other hand a taxpayer can argue that the monthly service charged was paid to receive the benefit and that the loot are received are received in the same way inventory are bought and received. In such instance inventory will not be included in the taxpayer's gross income until the inventory are sold by the taxpayer.

The taxpayer's only certain relief seems to be if they can prove that the transactions are of a capital nature and that participation is purely for entertainment and that there is no scheme of profit making.

2.5.3 In-world transactions

According to Lederman (2007:1653), there is a strong argument that in-world exchanges will not qualify as gross income if a player only has a license to use items in the game world. If two taxpayers both exchange the use of an item, no physical disposal has taken place as the items are not owned by the taxpayers. If two players exchange items in-world, it can be argued that the only transaction that happened was a relocation of the items within the domain controlled by the game-owner. If the exchange is accompanied by a real world payment, the payment will constitute gross income, but the exchange of the right to use a certain item will not be treated as a realisation and will therefore not qualify as gross income.

Even though Lederman tries to argue the possibility that a player only has a license to use items in the game world, by now we know that players trade with their in-world items in real money even though they are not allowed to do so as per several of the structured world EULA's and TOS agreements. This confirms the real money value of the virtual items "owned" by players and therefore the same rules will apply for in-world exchanges as for real world exchanges. As explained under loot drops, the gross income definition includes the total amount received in cash or otherwise. This means that a taxpayer needs to include the value of any assets received, otherwise than in cash, in their gross income. Where one asset is exchanged for another, the value of the asset received by the taxpayer and not value of the old asset will be included in gross income (Jordaan *et al.*:2008:13). Where a player therefore exchanges a magic cloak for a powerful sword in a structured world, the value to be included in the taxpayer's gross income is the fair market value of the sword.

Where a real money exchange accompanies the in-world exchange, the true intention of the parties needs to be considered (Clegg & Stretch, 2008:§4.10). In *Lace Proprietary Mines Ltd v CIR (AD 1938) (9 SATC 349)*, it was stated that the true intention of the two parties was to exchange mining rights for shares, but the sale included a cash amount. The court held that the intention was the exchange of the assets and the money paid was not intended to be the real purchase price of the transaction. Every in-world transaction will therefore need to be judged on its own merit to determine what the player's true intention was. However, the transaction will not be treated as two separate sales

transactions. Both the in-world and the real world exchanges will be taken into account to determine the nett gross income from the transaction.

Camp (2007:46-56, 65) follows the same arguments with regards to in-world transactions as with the loot-drops. His ultimate conclusion is that no money is flowing within a virtual world when these transactions are taking place, both the prizes and the in-world exchanges are merely play. With play means that no real money flows, only representations of real money, “units of play”.

The same South African tax principles applied to Lederman’s opinion will apply for Camp’s argument. Again each individual transaction will determine whether the exchange is of a revenue or capital nature which will indicate whether any amount will be included in gross income. If the transactions taking place are merely “play”, the exchanges will be classified to be of a capital nature and therefore not included in gross income. If the player is however busy with a scheme of profit making and “systematic” and regular trade is taking place, the chances are very good that the amounts will be included in gross income.

2.5.4 Real money transactions

All completed research agrees that real money trade or real money transactions give real economic value to virtual worlds and are the reason why income from virtual worlds would attract the attention of tax authorities. It is reported that one of the third-party auction sites estimated that \$880 million of virtual item trade were recorded on the site (Salyer: 2005). Even though certain EULAs and TOS agreements ban the sale of virtual items, it can only be limited in-world to a certain context as the trading of goods is an essential part of game play.

According to Camp (2007:44), if a player of a structured virtual world sells any virtual item or their player account for real money, the income from the sale will qualify as gross income, regardless of all the differences in opinion with regards to virtual property and where ownership lies. If players have no property rights in virtual items, transactions will be classified as the sale of services as one player assists another player to either enhance play or to “level up” a character. If players have property rights in virtual items,

transactions will be classified as a sale of property and will be subject to §1001 of the Federal Income Tax Code which ultimately constitutes gross income with the basis of the virtual item being allowed as a deduction from the sale amount.

Players might want to defend the taxability of income due to a EULA or TOS not allowing trade of in-world items. According to §61 income received does not have to be “moral, immoral, legal or illegal” to qualify as gross income (Camp, 2007:45). Another argument by players is that real money trade only results in a smaller game cost, but §61 does not depend on the intent of the taxpayer. Whatever the income was, it will be included in gross income.

Even though the EULA’s and TOS agreements of a lot of structured worlds ban the trade of virtual items, players still trade the items on a number of well publicised auction sites. The EULA’s and TOS agreements initially giving players limited property rights in their virtual items is not enforced and the contractual restrictions can therefore not be seen as a true reflection of players’ actual ability to trade and realise virtual items to real world value (Camp, 2007:54).

The fact that players are illegally trading with their virtual items has however no effect on whether an amount will qualify as gross income or not. *CIR v Delagoa Bay Cigarette Company Ltd* (1918 TPD 391) (32 SATC 47) decided that even though a business which produces income might not be into a legal trade, the income will still be included in gross income. The fact that a transaction is illegal or immoral does not determine whether it is gross income or not, the underlying transaction determines whether income will qualify under the gross income definition (ITC 1789 (2005 67 SATC 205)).

The fact that a player is therefore trading in real money with his virtual items, even though it is banned by a EULA or TOS will not mean that the transaction cannot qualify as gross income. If the underlying transactions result in income producing activities, the gross income definition might be applicable and the income can be included in a taxpayer’s taxable income.

2.6 SUMMARY

This chapter presented a literature review performed for the purposes of this study. Previous research performed in connection with income earned from structured virtual worlds was the main focus of this chapter. The working of structured virtual worlds and the different types of transactions generating income was explained. The tax implications for income earned by US residents from these different types of transactions were examined and analysed. A critical analysis of the US tax treatment was then performed from a South African tax perspective.

The study found that even though people's general perception and intuition tends to assume that income received from a structured or game world will not be taxable because it is merely a game, the research indicated that it might not necessarily be the case if South African tax legislation is applied.

With regards to loot drops, previous research did not agree on the basis why loot drops should not be taxable, but both studies agreed that loot drops should not be taxed unless a cash out transaction takes place. According to South African income tax legislation, loot drops appear to qualify as gross income as it qualifies as an "amount received or accrued in cash or otherwise" as required by the definition.

Previous research concluded that in-world transactions should not be taxable until a cash out transaction takes place. Again, South African income tax principles appear to disagree with the US principles. As with loot drops, in-world transactions qualifies as gross income per the definition in the South African Income Tax Act. Real money transactions are the only type of transaction where both US and South African income tax perspective includes any form of transaction which involves real money trade in gross income.

The next chapter discusses the working of unstructured virtual worlds and the different types of transactions generating income. A critical analysis of the US tax treatment will then be performed from a South African tax perspective

3 CHAPTER 3: THE DETERMINATION OF GROSS INCOME IN RESPECT OF INCOME EARNED FROM UNSTRUCTURED VIRTUAL WORLD

3.1 INTRODUCTION

The literature review provides an understanding of unstructured virtual worlds and how they work. It also includes a discussion on what the different types of transactions are which occur within unstructured virtual worlds. This is followed by a discussion on the reason for in-world trade and the consequent real money trade which arise due to the market created by in-world trade. Previous research performed with regards to whether virtual income from unstructured virtual worlds should be taxed in the United States of America is discussed. Conclusions on both in-world and real-money transactions will be compared. Finally a critical analysis of previous research will be performed in terms of South African income tax legislation and case law to determine whether income earned from unstructured virtual worlds will qualify as gross income in South Africa.

The difference between the basis for determining gross income from a US tax legislation perspective and a South African tax legislation perspective has already been explained in chapter 2. These same principles will form the background to the research performed in chapter 3.

The biggest overall difference between the South African tax treatment of income from structured versus unstructured virtual world would probably be the fact that unstructured worlds like Second Life are not considered to be a game (as discussed under section 3.2 in this chapter). The impact of this fact could be substantial when the “receipts and accruals of a capital nature” principles are considered. As explained in chapter 2, the most important test to determine whether income is of a capital or revenue nature, is the test of intention (Jordaan *et al.*, 2008:21).

Case law exists with regards to the racing of horses and whether it would constitute a hobby or a business (ITC 712 (1950 17 SATC 335(N))). It has also been the subject of

several articles through out the years (Williams, 1996:50). The general conclusion is that benefit of treating an activity as a hobby would be that the taxpayer will not be taxed on any income from the activity. It should however be borne in mind that where a taxpayer's hobby is of such a large scale that it takes on the form of a business, it will be argued that the hobby is not a hobby but a business. The tax treatment of a hobby seen as a business and a normal business would be the same; income would be considered as a revenue nature and will therefore be included in the taxpayer's gross income.

Should unstructured virtual worlds not be seen as games, the question arises why someone would become a resident of these virtual worlds if it is not to play a game especially if it is considered that the owners of an unstructured virtual world like Second Life encourage their residents to trade? If the hobby versus business argument is considered, income from virtual unstructured worlds might be considered to be income from a business and would therefore be included in the gross income of the taxpayer.

With the possible argument that all transactions in unstructured worlds could be considered to be a business, the following section explains more about the working of unstructured virtual worlds and why it is drawing the attention of tax authorities.

3.2 UNDERSTANDING UNSTRUCTURED VIRTUAL WORLDS

“Real economies are emerging within digital online fantasy worlds. The largest virtual worlds such as Second Life, collectively hosts millions of citizens, some spending many hours every day living their virtual lives. Virtual fantasy worlds have become a serious business in their own right. There is a steady blurring of the line between fantasy and reality, which is leading real people to spend real money on entirely virtual goods and services” (Deloitte: 2007).

Is this all just play? Or is this what Dan Miller referred to when he said, *“the more it seems to be parallel to the real world, the easier it will be to introduce taxes to it”* (Datastream, 2007:11).

Linden Lab, the creator of Second Life does not consider it to be a game at all and rather describes it as an unstructured online universe (Stamper, 2007). This opinion is also supported by the auction site eBay, which specifically distinguish between virtual games and Second Life (Terdiman: 2007). It is possible to build games within the Second Life environment however; this still does not make Second Life a game (Svarog: 2006). Players rather use it to socialise and take part in every day activities. As with structured worlds, players also use an avatar to assume a role within the context of the unstructured virtual world (Camp, 2007: 5).

A big difference between a structured and an unstructured worlds is the fact that the world's creator simply provide a virtual environment, basic avatars and tools to create any kind of item to the players. Even though the basic avatar is very limited, the players have endless possibilities to modify their avatars appearance and skills. No levelling exists as with structured worlds and players do not get better at performing a task (for example flying) over and over. There are no structured roles, quests, raids or missions. The game developers basically provide an environment where players can create and do anything "virtually" possible (Camp, 2007:6). Players can design real estate, personal items, recreation items and even routines which will assist their avatars to perform certain actions.

Where co-operation is an important part of game play in structured virtual worlds, player interaction is a crucial factor for a successful life in an unstructured virtual world like Second Life. The interaction can be social, co-operative or competitive. Ultimately, most interaction requires players to trade to increase the player's overall fun-experience from the living in this virtual world (Camp, 2007:6).

As with structured virtual worlds, trade is the driver of the in-world economy and the reason for an increased interest from tax authorities.

3.3 REASON FOR TRADE IN UNSTRUCTURED VIRTUAL WORLD ASSETS

Where the trade of virtual items from structured virtual worlds are banned by some virtual world designers and auction sites, items from Second Life are specifically exempt from this ban (Terdiman: 2007).

Second Life is described as follows:

“...an online, 3D virtual world imagined and created by its residents. ...Because residents retain intellectual property rights in their digital creations, they can buy, sell and trade with other residents.”

It therefore appears that apart from being entertainment to their owners, the main purpose of this unstructured world appears to be the promotion of trade amongst its residents when its creators explain the interaction of ‘the World’, ‘the Creations’ and ‘the Marketplace’ (Second Life: 2008). Second Life is not the only unstructured world where trade is encouraged. The virtual items used in Entropia Universe deteriorate on a regular basis and players have to pay real world currency to replace them. This encourages continuous trade within this unstructured world (Mindark: 2008).

As with structured virtual worlds, there will always be players in unstructured virtual worlds with little time and more money and players with less money and more time (Lederman, 2007:1628). Residents of unstructured virtual worlds do not need virtual items to become stronger or to move to higher levels like the players of structured virtual worlds. They trade to improve their experience and increase the resident’s status within the virtual world. Residents will chat with friends, attend a concert and buy virtual items like real estate, cars and cloths. Ultimately all these transactions contribute to an economy supporting millions of US dollars in monthly transactions (Second Life: 2008).

Second Life’s TOS agreements with residents’ further support trade by specifically stating that residents retain any intellectual property in their own creations (Second Life; 2008). According to Lederman (2007:1630), awarding intellectual property rights to residents encourage creativity and “entrepreneurial activity”.

In-world trade therefore plays a very important role within unstructured worlds. Second Life has even been described as a 3D world devoted to capitalism (Konrad: 2006). Camp (2007:10) emphasises that unstructured worlds have to promote player-to-player transactions to keep residents interested as there are no “hero’s journey” as in structured worlds. This trade can be in the form of an in-world item exchanged for another in-world item, but more often residents sell their in-world creations for an amount in Linden dollars, Second Life’s currency.

3.4 REAL MONEY TRADE

As with structured worlds, residents of an unstructured world like Second Life have to pay a monthly subscription fee (Lederman, 2007:1622). There is a free basic membership, but to be an active trading resident and in order to own land within Second Life, you have to pay a monthly subscription fee (Second Life: 2008). These membership plans entitles the resident to an allowance from time to time but as with structured virtual worlds, a resident can put more real money into the virtual world to give your avatar more skills and in-world possessions (Camp, 2007:11). The real money input can mean that more in-world currency is bought to trade in-world or alternatively real-money can be used to buy virtual items from internet auction sites. As with structured virtual worlds, the hand over of the virtual item will have to take place in-world even if the transaction took place with real world currency.

There seems to be a lot of similarities between structured and unstructured virtual worlds, but from a US perspective the differences in tax treatment were quite different. The debate on unstructured virtual worlds is as with structured virtual worlds around whether tax will be payable on both in-world and real-world transactions.

The following section will discuss and analyse the outcome of the research performed by Lederman and Camp and the tax implications of unstructured virtual world transactions will be discussed from a South African point of view.

3.5 A CRITICAL ANALYSIS FROM A SOUTH AFRICAN PERSPECTIVE

3.5.1 Introduction

This section considers the completed research of Leandra Lederman (2007) and Brian Camp (2007) with regards to the taxation of income earned in unstructured virtual worlds. Both studies were performed based on gross income as defined in §61 of the Federal Income Tax Code of the US of America. Section 1 of the Federal Income Tax Code of the US imposes income tax on taxable income which equates to gross income minus deductions as per §63. Gross income is defined by §61 as “all income from whatever source derived.” According to US case law, income means (any undeniable accessions to wealth clearly realised and over which the taxpayer has complete dominion.” Clearly the form of income is not important, but rather the access to it which is important.

The outcomes of the completed studies are compared in terms of this background and a critical analysis from a South African perspective is discussed.

3.5.2 In-world transactions

Unlike structured worlds, an unstructured world like Second Life does not involve loot drops (Lederman, 2007:1669). The in-world transactions are therefore limited to trade amongst residents, being virtual item for virtual item (including virtual services) or virtual item for in-world currency.

With structured worlds, previous studies concluded with a strong case not to tax in-world transactions unless it involves a cash-out transaction (Lederman, 2007:1624). But the complexity of transactions grows if the rights of residents of Second Life are taken into account. Because residents retain the intellectual property rights in their creations (Second Life, 2008), they are not only allowed to sell their original creations, but they are also allowed to make and sell copies of the original creation (Lederman, 2007: 1655). This right enables resident to involve themselves in trade in a far greater way that the players in a structured world would ever be able to trade.

Where income were earned by players in structured virtual worlds and possibly seen as a prize or award by revenue services, trade within Second Life might resemble barter clubs.

According to Camp (2007:32) bartering is as much a realisation event as a cash transaction would be and therefore a taxpayer has a duty to report such transactions.

As the US gross income definition has such a broad reach, the only possible exclusions from the definition is to test the income under the “priceless”, “unrealised” and “imputed” income exceptions. Income earned from an in-world sale where a virtual item is exchanged for the in-world currency, Linden dollars, has a very small claim to qualify for the “priceless” exception. Exchange between US dollars and Linden dollars are freely available in-world and Linden Labs also runs an in-world auction site to enable residents to freely trade with any virtual items. As an in-world transaction will therefore easily be converted to a readily ascertainable fair market value, income from unstructured virtual worlds will not qualify under the priceless exception.

According to South African income tax legislation income from any barter or exchange transaction should be included in a taxpayer’s gross income. Per definition South African gross income includes any form of property received or accrued to the taxpayer (De Koker, 2007: §2.16).

As explained in chapter 2, income needs to be “an amount received or accrued” for gross income to be recognised (Hamel *et al.*, 2008: 29). When a virtual item is sold to another resident in-world for in-world currency, the in-world currency can be converted to US dollars and then to South African rands. As income from unstructured virtual worlds has a readily ascertainable fair market value, it will qualify as income per the gross income definition in the South African Income Tax Act.

When it was stated that loot drops is not a realisation of wealth as no actual cash, property or service has been received by the taxpayer (Camp, 2007:47), the argument was that the less rights a taxpayer has in a virtual item, the better the chances are that the income will qualify for the exception. Therefore, as the Second Life EULA and TOS agreement awards all the intellectual property rights to their residents, a resident has the right to sell the design of a certain virtual item and separately sell the right to copy the specific virtual item. (Camp, 2007:56) According to Camp (2007:56), a taxpayer’s argument that their “ability to convert the loot to usable wealth is remote and dependant on factors beyond is remote” will not stand as the fact that the game owner might flood the market with Linden

dollars causing rampant inflation is much the same as the real world factors beyond a taxpayer's control. Income from unstructured virtual worlds will therefore not qualify for the realisation exception either.

The "realisation" exception is similar to the "received by or accrued to" element of the South African gross income definition (section 1 of the South African Income Tax Act). A resident's in-world account will be credited with the sales amount in in-world currency as soon as the sale has taken place. The in-world currency can then be used for the resident's own benefit. As with a real-world sale, a resident is entitled to in-world currency the moment the sales transaction was concluded and the in-world item was transferred to another resident.

Similar to the argument with loot drops, Camp's (2007:61-64) research includes a long discussion on why income from unstructured virtual worlds, and specifically Second Life, should be considered "imputed" income and should therefore not be taxable. He explains that residents have far less rights in their creations than they think. It is claimed that an in-world item needs to be very unique for a resident to be entitled to property copyrights, but Camp then tries to claim that the copyright will be worthless if Second Life ceases to exist.

This statement is supported by an argument that residents have even less rights in Linden dollars. Camp explains that it merely looks and acts like currency. It is even claimed that a resident might have less rights in Linden dollars than in casino chips. Ultimately the limited license right to use Linden dollars are classified the same as units of play. This implies that the income is "imputed" income and therefore confirms Camp's statement that in-world transactions should not be taxed unless a cash-out transaction takes place. Until real world businesses are accepting Linden dollars as payment for real world items, in-world transactions will be safe with regards to tax (Camp, 2007:64).

It is considered highly unlikely that the income from an unstructured world like Second Life would be considered imputed income under South African income tax legislation. The fact that a taxpayer is a resident of Second Life and entered into some kind of a transaction is the reason for any income earned from these unstructured virtual worlds. It does not seem to resemble any resemblance to what Hamel *et al.* (2008:30) describes as imputed income in the South African income tax context. Imputed income is what a tax payer would have

earned, should they have entered into a certain transaction. With income from unstructured virtual worlds, the taxpayer already entered into a transaction which has monetary value, so the exemption will definitely not be available to a South African taxpayer.

By contrast, Lederman's (2007: 1620) research states that income earned in co-modified virtual worlds like Second Life should be taxed regardless if a resident ever cashes out their in-world profits.

The same South African tax consequences appear to be applicable for a resident earning income from trade in Second Life. As the South African gross income definition includes all amounts "in cash or otherwise" (section 1 of the South African Income Tax Act), it means that whenever a taxpayer earns income in another form than cash, it will still be included in their gross income. When a virtual item is exchanged for Linden dollars, the exchange rate to dollars will be used to convert the value of the income to real money and the US dollar amount will then be converted to South African rand.

The issue with regards to property rights in Second Life is emphasised by Lederman's (2007:1656) research as with the research performed by Camp. If the courts find that residents do not own the property rights in in-world creations, the transaction will be no more than a trade of one limited licence item in a game world for another. On the other hand, if a court grants Second Life residents ownership rights in copies of their in-world items, these transactions will fall within the US gross income definition (Lederman, 2007: 1656).

Lederman (2007: 1656-1657) also addresses the limited rights residents have in Linden dollars. According to US legislation, a license to use property may not constitute property for income tax purposes. It seems however, that if residents obtain rights in property and it is exchanged for Linden dollars, which does not constitute property, the transaction will still qualify as a realisation event for tax purposes. If a resident holds limited rights in their virtual items and they exchange it for Linden dollars, it might therefore not be taxable as the right in the virtual item might not constitute property.

As explained in chapter 2, the fact that a taxpayer has traded with a virtual item without owning the full property rights will not affect the inclusion of the income earned from the transaction in gross income (CIR v Delagoa Bay Cigarette Company Ltd (1918 TPD 291) (32 SATC 47)). In terms of South African income tax legislation the transaction will therefore be taxed regardless if the resident was not the owner of all the property and copyrights.

The exchange of in-world items without the involvement of Linden dollars or cash is also discussed. Lederman (2007: 1665) is of the opinion that these exchanges should not be taxed, as individual exchanges in Second Life would typically only take place for entertainment purposes.

Where Linden dollars are however used to settle a transaction it is more difficult to determine whether the transaction was only entertainment or whether it was trade as a business. Lederman suggests that trade for in-world currency in Second Life should be taxable. In the case of entertainment, deductions are allowed up to the income included for any hobby. Should the taxpayer be carrying on a business within Second Life, this income will still be included in the individual's taxable income.

Under South African income tax legislation, transactions entered into by a resident purely for entertainment purposes, might qualify as "income of a capital nature" (section 1 of the South African Income Tax Act) and will therefore not be included in a taxpayer's gross income. All transactions will however need to be judged on its own merit and a general exclusion from gross income cannot be guaranteed for these types of transactions.

3.5.3 Real money transactions

According to US legislation, sales of any real world property or services within Second Life would be taxable exactly as it would be taxable if the sale happened on an auction site like eBay (Lederman, 2007:1655). Camp's (2007: 44) research confirms this opinion, regardless of what the courts may decide on the property rights within Second Life. A real money sale would be included in gross income as any other sales transaction would be included in real world.

The income will be included in gross income even if a taxpayer's intention was not to make money from the transaction (Camp, 2007: 45). According to Treasury Regulation 1.16-14 a taxpayer's intention does not determine whether income from a certain transaction will be included in gross income or not. When a taxpayer enters into a transaction without the intention to make income and the result is in fact income in the taxpayer's hand, the income must be reported even though it was not the intention of the taxpayer.

Residents do not have the option to defend the taxability of income from unstructured virtual worlds because trade of their virtual items are not allowed (Camp, 2007:45). Linden Lab, the owner of Second Life, encourages trade, whether in-world or in real money terms. Even if residents could defend themselves that their trade with virtual items were illegal, the income would still be included in gross income according to South African income tax case law (ITC 1789 (2005 67 SATC 205)).

As with the real money transactions with structured virtual worlds, all income earned from real money trade in virtual items from unstructured virtual worlds will be included in the gross income. This type of sale will not differ in any way from a normal real world transaction generating income that will be included in gross income per the South African Income Tax Act.

3.6 SUMMARY

This chapter presented a literature review performed for the purpose of this study. Previous research performed in connection with income earned from unstructured virtual worlds was the main focus of this chapter. The working of unstructured virtual worlds and the different types of transactions generating income was explained. The tax implications for the income earned by US residents from these different types of transactions were examined and analysed. A critical analysis of the US tax treatment was then performed from a South African tax perspective.

The study found that the single biggest difference between structured and unstructured virtual worlds is the fact that unstructured virtual worlds are not considered to be a game.

Residents of one of the largest unstructured virtual worlds, Second Life, are encouraged by its creator, Linden Lab, to trade, whether it is to enhance their in-world experience or whether the trade will be in the form of a business transaction. The focus is therefore not only the entertainment of a resident but also to provide a trade opportunity and ultimately a business opportunity to residents.

The South African tax consequences for income earned in unstructured virtual worlds agree to a large extent with the findings of the research based on US legislation, performed by Lederman. Whether a transaction took place in-world and the in-world income were never cashed out, or whether the virtual item was sold for real money, both transactions would result in the income generated being included in gross income as defined in section 1 of the South African Income Tax Act.

However, should a taxpayer become a resident of one of these unstructured virtual worlds and the only reason for trade is the entertainment of the taxpayer, income might be of a capital nature and per the South African gross income definition in section 1, not included in gross income. Every transaction will be evaluated on its own merit, especially because the nature of unstructured worlds tends to favour trade rather than play.

The final chapter details significant findings of the research and discusses the tax outcome for South African residents of income earned from structured and unstructured virtual worlds. The chapter concludes the study by highlighting areas flowing from this study that may be suitable for future research.

4 CHAPTER 4: SUMMARY, CONCLUSION AND VALUE OF THE STUDY

4.1 INTRODUCTION

The main objective of this study was to determine what the income tax consequences would be for a South African resident earning virtual income. The study entailed an extensive literature study to determine an understanding of structured (chapter 2) and unstructured (chapter 3) virtual worlds. The reason for trade in both these worlds were investigated and ultimately the tax consequences of income earned from these virtual worlds were critically evaluated from a South African tax perspective based on the previous research performed in the US.

4.2 EVALUATION OF INCOME EARNED FROM STRUCTURED VIRTUAL WORLDS

Even though people's general perception and intuition tends to assume that income received from a structured or game world will not be taxable because it is merely a game, the research indicated that it might not necessarily be the case if South African income tax legislation is applied.

With regards to loot drops, previous research did not agree on the basis why loot drops should not be taxable, but both studies agreed that loot drops should not be taxed unless a cash out transaction takes place. According to South African income tax legislation, loot drops appear to qualify as gross income as it qualifies as an "amount received or accrued in cash or otherwise" as required by the definition.

Previous research concluded that in-world transactions should not be taxable until a cash out transaction takes place. Again, applying South African income tax principles to income earned from structured virtual worlds appear arrive at a different result compared to an application of US tax principles. As with loot drops, in-world transactions qualifies as gross income per the South African Income Tax Act. Real money transactions are the only type

of transaction where both US and South African income tax perspective includes any form of transaction which involves real money trade, in gross income.

4.3 EVALUATION OF INCOME EARNED FROM UNSTRUCTURED VIRTUAL WORLDS

The single biggest difference between structured and unstructured virtual worlds is the fact that unstructured virtual worlds are not considered to be a game. Residents of one of the largest unstructured virtual worlds, Second Life, are encouraged by its creator, Linden Lab, to trade, whether it is to enhance their in-world experience or whether the trade will be in the form of business transactions.

The outcome of the application of South African income tax legislation agrees to a large extent with the findings of the research performed by Lederman, based on US legislation. Whether a transaction took place in-world and the in-world income was never cashed out, or whether the virtual item was sold for real money, both transactions would result in the income generated being included in gross income as defined per the South African Income Tax Act.

However, should a taxpayer become a resident of one of these unstructured virtual worlds and the only reason for trade is the entertainment of the taxpayer, income might be of a capital nature and according to the South African gross income definition, not included in gross income. Every transaction will be evaluated on its own merit, especially because the nature of unstructured worlds tends to favour trade rather than play.

4.4 LIMITATIONS TO THE STUDY AND SUGGESTIONS FOR FURTHER RESEARCH

The study was limited to determine whether the income earned by South African residents who are taxed on their world wide income would be included in gross income as defined by the South African Income Tax Act. Capital gains tax consequences were not considered for any transaction where the income was classified to be of a capital nature. The study did not consider which deductions might be available to taxpayers in terms of the income being included in gross income and no detailed discussion were included to

determine when a taxpayer would only be considered to engage in virtual worlds as a hobby versus when the taxpayer's action would constitute a business.

No international tax rules or double taxation agreements were taken into account with regards to the determination of the tax consequences of the income earned from these virtual worlds.

Other researchers may extend the findings of this research to determine when participating in virtual worlds can only be a hobby and at what point participation will no longer be a hobby but will qualify as a business. The tax consequences of this difference in classification can then be investigated.

4.5 CONCLUSION

“Space was once the ‘final frontier’; today the newest worlds exist in cyberspace.” (Lederman, 2007: 1620). What seems to have been pure entertainment in the past, now seems to have serious tax consequences.

The present study identified the possibility that South African residents will be taxed on their structured virtual world profits unless it can be proven that the taxpayer are merely taking part in the game and participating in trade for entertainment purposes. Transactions can be taking place in-world or with real money. In both instances the income earned will be included in the taxpayer's gross income.

This study and previous international research agrees that income from unstructured virtual worlds need to be included in gross income. There is some debate around the ownership of property and copyright, but from a South African context, even with these uncertainties, in-world income from unstructured virtual worlds still seems to be taxable. Current and previous research agree that any real money transaction which result from the in-world trade should be included in a taxpayer's gross income.

Even though taxpayers might think that it is unreasonable to tax virtual income, the possible consequences of not taxing virtual income will grow and drive tax evasion.

Significant investment has already been made in Second Life (Lederman, 2007: 1667). Should the revenue services world wide allow tax free trading to take place in virtual worlds, businesses will soon realise that they can accept in-world currency and in this way escape the taxman.

This study serves as confirmation that when the gross income definition was initially drawn up, becoming a resident of a virtual world was more unlikely than a trip to space. However, the principles laid down in South African tax legislation are as effective on the transactions created by the latest developments in technology in modern world as it would have been on a normal bread and milk sales transaction when the legislation was initially drawn up.

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