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## Taxing the Metaverse: The Next Frontier of Digital Asset Transactions

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The media is abuzz with articles about the metaverse and companies who are announcing their entry into this virtual world.<sup>1</sup> As stated by *The Verge* in 2021: “The metaverse is having a moment.”<sup>2</sup> The metaverse phenomenon was fueled in part by Facebook’s move to rebrand under the name Meta, which was accompanied by the statement that “Meta is helping to build the metaverse, a place where we’ll play and connect in 3D.”<sup>3</sup> PwC and other accounting firms have joined the metaverse rush by opening virtual offices within the metaverse.<sup>4</sup> In February 2022, Am Law 200 firm ArentFox Schiff announced that it was “the first major law firm in the country to join the Metaverse” by purchasing a plot of virtual land on the

Decentraland platform.<sup>5</sup> William Gee, a partner at PwC Hong Kong, explained PwC’s move to the metaverse, stating, “[t]he Metaverse offers new possibilities for organisations to create value through innovative business models, as well as introducing new ways to engage with their customers and communities.”<sup>6</sup> In one evaluation of the size of this rapidly expanding industry, Bloomberg Intelligence estimated that global metaverse revenue could approach \$800 billion in 2024.<sup>7</sup> Practitioners are heading to the metaverse due to its size and potential, and because, like any new industry, it presents a slew of legal and tax issues.

### WHAT IS THE METAVERSE?

But what is the metaverse? In science fiction, the metaverse is a single, universal, and immersive virtual world facilitated by the use of virtual reality and augmented reality headsets.<sup>8</sup> The term “metaverse” was coined in the 1992 science fiction novel *Snow Crash*, as a place in which humans, as programmable avatars, interact with each other in a three-dimensional virtual space.<sup>9</sup> The use of the root “verse” implies that the metaverse is a single world, like a universe.<sup>10</sup> *The metaverse* is conceived of as a single online platform for all virtual activities, providing interoperability for avatars and goods to transfer from one part of the

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<sup>1</sup> See, e.g., Peter Allen Clark, *The Metaverse Has Already Arrived. Here’s What That Actually Means*, Time (Nov. 15, 2021), <https://time.com/6116826/what-is-the-metaverse/>.

<sup>2</sup> Casey Newton, *Mark in the Metaverse*, The Verge (July 22, 2021), <https://www.theverge.com/22588022/mark-zuckerberg-facebook-ceo-metaverse-interview>.

<sup>3</sup> @Meta, Twitter (Oct. 28, 2021), [https://twitter.com/Meta/status/1453795115701440524?ref\\_src=twsrc%5Etfw%7Ctwcamp%5Etweetembed%7Ctwterm%5E1453795115701440524%7Ctwgr%5Ehb\\_2\\_10%7Ctwcon%5Es1\\_1&refurl=https%3A%2F%2Fwww.dailywire.com%2Fnews%2Ffacebook-changes-company-name-to-meta-will-focus-on-bringing-the-metaverse-to-life](https://twitter.com/Meta/status/1453795115701440524?ref_src=twsrc%5Etfw%7Ctwcamp%5Etweetembed%7Ctwterm%5E1453795115701440524%7Ctwgr%5Ehb_2_10%7Ctwcon%5Es1_1&refurl=https%3A%2F%2Fwww.dailywire.com%2Fnews%2Ffacebook-changes-company-name-to-meta-will-focus-on-bringing-the-metaverse-to-life).

<sup>4</sup> Mark Maurer, *Accounting Firms Scoop Up Virtual Land in the Metaverse*, The Wall St. J. (Jan. 7, 2022), <https://www.wsj.com/articles/accounting-firms-scoop-up-virtual-land-in-the-metaverse-11641599590>.

<sup>5</sup> *ArentFox Schiff Makes History as First Major US Law Firm To Enter the Metaverse* (Feb. 15, 2022), <https://www.afslaw.com/perspectives/press-releases/arentfox-schiff-makes-history-first-major-us-law-firm-enter-the>.

<sup>6</sup> Maurer, above, Note. 4.

<sup>7</sup> *Metaverse May Be \$800 Billion Market, Next Tech Platform*, Bloomberg Intelligence (Dec. 1, 2021), <https://www.bloomberg.com/professional/blog/metaverse-may-be-800-billion-market-next-tech-platform/>.

<sup>8</sup> Casey Newton, *Mark Zuckerberg is Betting Facebook’s Future on the Metaverse*, The Verge (July 22, 2021), <https://www.theverge.com/22588022/mark-zuckerberg-facebook-ceo-metaverse-interview>.

<sup>9</sup> Neal Stephenson, *Snow Crash* (Random House Publ’g Grp., 2000).

<sup>10</sup> Nick Clegg, *Making the Metaverse: What It Is, How It Will Be Built, and Why It Matters*, Medium (May 18, 2022), <https://nickclegg.medium.com/making-the-metaverse-what-it-is-how-it-will-be-built-and-why-it-matters-3710f7570b04>.

metaverse to another, regardless of the owner of that portion of the metaverse. *The metaverse does not exist yet, and may never exist. While Meta has launched its Horizon Worlds metaverse platform, Meta’s President of Global Affairs was quick to point out, perhaps for antitrust reasons, that “[t]here won’t be a Meta-run metaverse, just as there isn’t a ‘Microsoft internet’ or ‘Google internet’ today.”*<sup>11</sup> Instead, there are currently several competing metaverse platforms, including Meta’s Horizon Worlds, Decentraland, the Sandbox, and Roblox, among others. The term “metaverse” can also encompass older virtual worlds which provide persistent, social connection between users, such as Second Life, Fortnite, Minecraft, and World of Warcraft. In common usage, a metaverse is a network of virtual worlds in which users can interact with one another through via digital likenesses, called avatars.

## WHY SHOULD I, AS A TAX PRACTITIONER, CARE?

For professionals who consider themselves less likely to play Massive Multiplayer Online Role-Playing Games (MMORPGs), participation in the metaverse may still be imminent. Companies have been developing virtual meeting software to compete with traditional videoconferencing platforms which will allow users to virtually interact with their colleagues as avatars. Meta’s Horizon Workrooms app allows avatars to meet in virtual meeting rooms, complete with boardroom tables and whiteboards. Meta’s President of Global Affairs stated Horizon Workrooms allows a user to “exchange glances and private asides with the person next to us, get someone’s attention with a gesture, even read each other’s body language — rudimentary as it is when we are blemish free avatars.”<sup>12</sup> Microsoft has launched the app, Frame, which integrates the ability to conduct metaverse meetings into Microsoft Teams. Frame explains that meeting in the metaverse as avatars provides “the feeling like you’re in the same space as somebody else, [and] can make collaboration more personal, playful, and powerful.”<sup>13</sup>

In addition to the promise of more a “personal” meeting experience, practitioners should take note of the myriad of tax questions generated by the economic transactions currently taking place in these virtual worlds. For those who will choose to stick to Zoom instead of conducting their business meetings

through an avatar, the following example may provide greater general appeal. This year, 2022, is expected to be a record-setting year for the number of weddings due to the rescheduling of ceremonies during the pandemic, with costs for the ceremonies expected to rise as well.<sup>14</sup> But weddings are not just taking place in physical world. Many couples are choosing to hold weddings in the metaverse due to its low cost and the ability of guests from all over the world to attend without having to travel.<sup>15</sup> Metaverse weddings allow all of the couple’s friends and family to attend the wedding from the comfort of their own home and in their chosen avatar, be it a human-bear hybrid, a wizard, or while floating in air. Another consideration favoring metaverse ceremonies is Covid-19 precautions. A couple in India held a virtual wedding in the TardiVerse metaverse in February 2022, allowing them to invite more than the 100 guest-maximum presented by Covid-19 restrictions.<sup>16</sup> While cheaper than weddings in the physical world, users still need to pay to rent a wedding venue in the metaverse, for engineers to code the digital decorations, and to purchase a designed avatar.<sup>17</sup> As described in the next section, the sale and receipt of these metaverse assets can result in taxable events.

## THE METAVERSE IS COMPRISED OF NFTS

Most metaverse assets are nonfungible tokens, or NFTs. NFTs are digital assets recorded on a blockchain ledger to prove ownership and authenticity of a unique item.<sup>18</sup> The global NFT market was valued anywhere between \$17 billion to \$41 billion in 2021.<sup>19</sup> In the wedding example, the purchased flowers and wedding dress are NFTs. The couple may also decide to hand out wedding favors that are NFTs, with

<sup>14</sup> See Tammy La Gorce, *It’s a Boom Year for Brides and Grooms*, N. Y. Times (Feb. 4, 2022), <https://www.nytimes.com/2022/02/04/fashion/weddings/wedding-boom-year.html>.

<sup>15</sup> Amanda Hoover, *Marriage Moves to the Metaverse*, Morning Brew (Apr. 20, 2022), <https://www.morningbrew.com/daily/stories/2022/04/20/marriage-moves-to-the-metaverse>.

<sup>16</sup> NDTV, *Tamil Nadu Couple Host Asia’s First Metaverse Wedding Reception*, YouTube (Feb. 8, 2022), [https://www.youtube.com/watch?v=0Kqn9\\_v9XKI](https://www.youtube.com/watch?v=0Kqn9_v9XKI).

<sup>17</sup> Hoover, above, Note 15.

<sup>18</sup> Alan Cohn, Evan T. Abrams, Meegan Brooks, and Ryan Peirera, *NFTs for Retailers: A World of Promise and Peril* (Jan. 12, 2022), <https://www.stepto.com/en/news-publications/nfts-for-retailers-a-world-of-promise-and-peril.html?tab=overview>.

<sup>19</sup> Bruce Love, *What It Takes to Successfully Service the Booming NFT Market*, Am. Law. (May 10, 2022), <https://www.law.com/americanlawyer/2022/05/10/what-it-takes-to-successfully-service-the-booming-nft-market-405-104104/>.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Bringing the Metaverse to Microsoft Teams*, Frame (Apr. 8, 2022), <https://learn.framevr.io/post/bringing-the-metaverse-to-microsoft-teams>.

one couple giving a custom NFT of their pet dog.<sup>20</sup> The piece of metaverse real estate rented for the wedding venue is likely also an NFT.

Metaverse real estate is currently a hot market, with investors hoping to buy in early and reap “potentially big rewards,” said Janine Yorio, CEO of Republic Realm, a metaverse real estate investor and advisory firm.<sup>21</sup> According to CNBC, sales of real estate in the metaverse topped \$500 million in 2021 and could double in 2022.<sup>22</sup> Like real-life real estate, metaverse parcels gain value by being located within the metaverse near other property of interest. The Sandbox is home to some of the most high-profile metaverse real estate. Parcels that have been dubbed “Sandbox Hill Road,” after Silicon Valley’s Sand Hill Road, border the Bored Ape Yacht Club and a plot owned by Adidas.<sup>23</sup> Already, the Sandbox Hill Road parcels’ value has gone up about 10 times in price, making the property potentially worth many millions of dollars.<sup>24</sup>

For those who have been following the tax treatment of NFTs, the tax issues presented by the metaverse property market become apparent. To date, the IRS has not issued formal guidance on the tax treatment of NFTs. Nonetheless, the IRS is focusing on tax compliance for NFT transactions. The special agent heading the Los Angeles field office of the IRS’s Criminal Investigation division stated that CI was actively training agents on cryptocurrency and NFT regulation because “this space is the future.”<sup>25</sup>

The most common taxable NFT activities include selling an NFT, purchasing an NFT with cryptocurrency, and exchanging an NFT for another NFT.<sup>26</sup> Tax experts have generally concluded that an NFT should be treated for tax purposes as property, and the sale of an NFT is subject to capital gains tax like the sale of other property; however, there is question as to whether some NFTs may be subject to the higher col-

lectibles capital gains rate.<sup>27</sup> Collectibles are defined as any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or any other tangible personal property specified by the IRS as a collectible.<sup>28</sup> The IRS, to date, has not made any statement as to whether NFTs constitute collectibles, and an NFT could not be *tangible* property. Thus, NFTs cannot fall within the catch-all paragraph of §408(m)(2)(F). Many early NFTs arguably met the definition of “any work of art” since they constituted pictures or original artwork. Metaverse NFTs appear farther from the definition of a collectible. Is a wedding dress for one’s avatar a collectible or a work of art? What about a real estate parcel in the Sandbox? The sale or exchange of these metaverse items are likely to be subject to tax at the standard capital gains rate.

## METVERSE TRANSACTIONS USE SOME FORM OF VIRTUAL CURRENCY

Further adding to the complexity of metaverse tax compliance is the fact that most metaverses use a form of virtual currency for all in-world transactions. As explained by Forbes, virtual worlds need virtual currency to spend within them.<sup>29</sup> Some metaverses use a readily tradable form of cryptocurrency. The Sandbox uses the unique currency SAND, which is traded on crypto markets and has a trackable exchange rate with the U.S. dollar.<sup>30</sup> The same is true of Decentraland’s MANA token, which underwent an initial coin offering and is traded across a range of centralized exchanges including Binance, Coindesk, and Kraken.<sup>31</sup> Other metaverses, such as Roblox, allow users to cash out earnings made in-game into fiat currency at a set exchange rate.<sup>32</sup> Meta’s Horizon Worlds is still working on the commercialization of its

<sup>20</sup> Hoover, above, Note 15.

<sup>21</sup> Robert Frank, *Metaverse Real Estate Sales Top \$500 Million, and Are Projected to Double This Year*, CNBC (Feb. 1, 2022), <https://www.cnbc.com/2022/02/01/metaverse-real-estate-sales-top-500-million-metametric-solutions-says.html>.

<sup>22</sup> *Id.*

<sup>23</sup> Raisa Bruner, *Why Investors Are Paying Real Money for Virtual Land*, Time (Jan. 20, 2022), <https://time.com/6140467/metaverse-real-estate/>.

<sup>24</sup> *Id.*

<sup>25</sup> Allyson Versprille, *IRS Seeing ‘Mountains and Mountains’ of Fraud With Crypto, NFTs*, Bloomberg News (Jan. 26, 2022), <https://news.bloomberglaw.com/tech-and-telecom-law/irs-seeing-mountains-and-mountains-of-fraud-with-crypto-nfts>.

<sup>26</sup> Erin Fennimore, *NFT Tax Guide: What Creators and Investors Need to Know About NFT Taxes*, TaxBit (June 9, 2021), <https://taxbit.com/blog/nft-tax-guide-what-creators-and-investors-need-to-know-about-nft-taxes>.

<sup>27</sup> See Greg Iacurci, *Make a Killing on NFTs and Crypto? The IRS May Tax Them Differently*, CNBC (Jan. 11, 2022), <https://www.cnbc.com/2022/01/11/make-a-killing-on-nfts-and-crypto-the-irs-may-tax-them-differently.html>.

<sup>28</sup> §408(m)(2). All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

<sup>29</sup> Bernard Marr, *How The Metaverse Will Change Cryptocurrency*, Forbes (Apr. 25, 2022), <https://www.forbes.com/sites/bernardmarr/2022/04/25/how-the-metaverse-will-change-cryptocurrency/?sh=6af35c144fe4>.

<sup>30</sup> *The Sandbox (SAND)*, CoinDesk, <https://www.coindesk.com/price/the-sandbox/#:~:text=SAND%20is%20the%20native%20cryptocurrency,creating%20revenue%20opportunities%20for%20gamers>.

<sup>31</sup> *Decentraland (MANA)*, CoinDesk, <https://www.coindesk.com/price/decentraland/>.

<sup>32</sup> Heath Haskins, *Roblox 101: How To Make Real Money From Your Video Games*, PCMag (Oct. 4, 2021), <https://www.pcmag.com/roblox-101>.

metaverse and plans to launch a currency to facilitate the in-world sale of goods.<sup>33</sup>

Some metaverses have gained notoriety as providing a primary source of income for users. In Axie Infinity, players buy, train, and breed Pokemon-like creatures that are themselves NFTs, with each creature individually registered on the Ethereum blockchain.<sup>34</sup> These creatures can then be sold for cryptocurrency. Axie Infinity uses two unique tokens, smooth love potion (SLP) and AXS, both of which Axie Infinity creators encourage to be cashed-out and converted to other crypto and fiat currencies.<sup>35</sup> The cash-out model leads to a high volume of transactions; around \$30 million worth of Ether transfers occurred per day in Axie Infinity in August 2021.<sup>36</sup> In developing countries and countries that were particularly impacted by Covid-19, Axie Infinity has become a significant source of income. In the Philippines and Venezuela, players have generated enough income in Axie Infinity to support their families after making an initial investment to breed and train Axies.<sup>37</sup> The Axie Infinity economy is sufficiently large that it has permeated into the physical economy as well. Some merchants in the Philippines *in the physical world* began accepting payment in SLP in lieu of Philippine Pesos.<sup>38</sup>

The Philippine Department of Finance eventually entered the fray, stating that income earned in Axie Infinity, whether “paid by money or in kind,” is taxable income, though the government acknowledged that it did not yet have a system in place to track and collect tax from these digital assets.<sup>39</sup> The Philippine regulator’s statement highlights the tension between tax authorities’ need to prevent this vast swatch of revenue

from avoiding taxation and the difficulties faced in tracking millions of online transactions. While transactions occurring on the blockchain, such as Axie Infinity, are recorded using distributed ledger technology and theoretically are obtainable, in practice, it is difficult for tax authorities to become aware of such transactions in the absence of information reporting.

## HOW ARE METAVERSE VIRTUAL CURRENCY TRANSACTIONS TAXED?

With the volume of revenue being generated within metaverses, the next question is how such income is treated for U.S. federal income tax purposes. Most metaverses use a form of virtual currency that falls within one or more definitions of taxable virtual currency. Rev. Rul. 2019-24 defines virtual currency as a “digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value other than a representation of the United States dollar or a foreign currency.” Under Rev. Rul. 2019-24 and Notice 2014-21, virtual currency is treated as property, and sales or exchanges of virtual currency, or the use of virtual currency to pay for goods or services, is treated as the disposition of property subject to capital gains tax to the extent the value of the property received exceeds the virtual currency’s basis. The receipt of virtual currency also results in taxable income to the extent of the fair market value of the currency received.<sup>40</sup> In supporting its conclusion that the receipt of virtual currency constitutes income, Treasury and the IRS cited to the principle that “all gains or undeniable accessions to wealth, clearly realized, over which a taxpayer has complete dominion, are included in gross income.”<sup>41</sup> Notably, Notice 2014-21 contains the limitation that the guidance only applies to “convertible virtual currency,” which it defines as virtual currencies that have an equivalent value in real currency or that act as a substitute for real currency. This limitation adds little in the metaverse context, where in-game currencies are used in place of fiat currency, and almost all in-game currencies, from MANA to Second Life’s Lindens, have a set or floating exchange rate to U.S. dollars.<sup>42</sup> The scope of the IRS’s definition of virtual currency is very broad and poses hazards for metaverse users.

The U.S. tax system’s treatment of virtual currency as property also presents problems for repetitive metaverse transactions denominated in virtual currency.

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[www.pcmag.com/how-to/roblox-101-how-to-make-real-money-from-your-video-games](http://www.pcmag.com/how-to/roblox-101-how-to-make-real-money-from-your-video-games).

<sup>33</sup> Rahul Nambiampurath, *Meta Launching Currency for Use in Horizon Worlds VR App*, BeInCrypto (Apr. 12 2022), <https://beincrypto.com/meta-currency-horizon-worlds-vr-app/>.

<sup>34</sup> Kristine Servando and Ian C. Sayson, *This Video Game Is Turning the Pandemic Jobless Into Crypto Traders*, Bloomberg Wealth (Aug. 25, 2021), <https://www.bloomberg.com/news/articles/2021-08-25/axie-infinity-how-game-is-turning-pandemic-jobless-into-crypto-nft-traders>.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> Lyllah Ledesma, *Axie Infinity Finds Ready Players in Hyperinflation-Racked Venezuela*, CoinDesk (Nov. 23, 2021), <https://www.coindesk.com/markets/2021/11/23/axie-infinity-finds-ready-players-in-hyperinflation-racked-venezuela/>.

<sup>38</sup> Leah Callon-Butler, *Some Filipino Merchants Prefer Payment in Axie’s SLP*, CoinDesk (Aug. 25, 2021), <https://www.coindesk.com/markets/2021/08/25/some-filipino-merchants-prefer-payment-in-axies-slp/>.

<sup>39</sup> Ben O. de Vera, *DOF: Axie Infinity Players Must Pay Income Tax From Trading ‘Pets’*, Philippine Daily Inquirer (Aug. 23, 2021), <https://business.inquirer.net/329458/dof-axie-infinity-players-must-pay-income-tax-from-trading-pets>.

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<sup>40</sup> Rev. Rul. 2019-24.

<sup>41</sup> *Id.* (citing §61(a)(3) and *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)).

<sup>42</sup> See Grace Wong, *How Real Money Works in Second Life*, CNN Money (Dec. 8, 2006), [https://money.cnn.com/2006/12/08/technology/sl\\_index/index.htm](https://money.cnn.com/2006/12/08/technology/sl_index/index.htm).

First, the volume of taxable virtual currency transactions for someone who is engaging in metaverse transactions full-time, such as the Axie Infinity player who earns SLP each day from quests and battles, is enormous. Even if the player earned SLP only once per day, he or she would be subject to tax reporting on 365 separate receipts of cryptocurrency, with income based on the fair market value of the SLP at the time of receipt. In Axie Infinity, the player also pays to breed new Axies with SLP, triggering a second set of taxable transactions to the extent of gain in excess of that which was reported upon receipt of the SLP and used as cost basis. The tax on cryptocurrency transactions is in addition to the NFT tax rules, which would come into play whenever the player sells one of his or her Axies. While the highest number of Axie Infinity users are in the Philippines and Venezuela, the United States comes in third for the number of Axie users, who presumably would be subject to U.S. tax rules.<sup>43</sup>

A second issue derives from the notion that virtual currencies are more frequently used as investments than as currencies with which to purchase goods or services. Because virtual currencies are treated as property for tax purposes, they are not subject to the wash sale rules.<sup>44</sup> Section 1091 disallows losses incurred from the sale or disposition of stock or securities if the taxpayer acquires substantially identical stock or securities within 30 days. Because the wash sale rules do not apply to sales of property, crypto investors realized they could take advantage of volatility in the crypto market to engage in loss harvesting.<sup>45</sup> Uproar regarding potential abuse from crypto loss harvesting led to inclusion of a fix in President Biden's landmark legislation. The Build Back Better Act would amend §1091 to apply the wash sale rules to “[a]ny digital representation of value which is recorded on a cryptographically secured distributed ledger.”<sup>46</sup> The proposed wash sale rules would have significant repercussions on high-volume virtual currency transactions, with the result that those regularly using virtual currency for metaverse transactions would be constantly triggering the wash sale rules. The proposed wash sale rules would cause metaverse entrepreneurs to not be able to recognize losses from decreases in the value of the metaverse currency, and

<sup>43</sup> Kristine Servando and Ian C. Sayson, *This Video Game Is Turning the Pandemic Jobless Into Crypto Traders*, Bloomberg Wealth (Aug. 25, 2021), <https://www.bloomberg.com/news/articles/2021-08-25/axie-infinity-how-game-is-turning-pandemic-jobless-into-crypto-nft-traders>.

<sup>44</sup> §1091(a).

<sup>45</sup> See Katelyn E. Towe, *Washing Losses Away: Why Cryptocurrencies Need a Wash Sale Rule*, 169 Tax Notes Fed. 77 (Oct. 5, 2020).

<sup>46</sup> H.R. 5376, §138153, 117th Cong. (2021–2022).

they instead would need to engage in additional tracking to increase the basis of the currency held by the amount of disallowed loss.<sup>47</sup> While the Build Back Better Act is currently stalled in Congress, the crypto wash sale proposal could reappear in other legislation to the detriment of the metaverse industry.<sup>48</sup>

## INFORMATION RETURN REPORTING FOR METAVERSE TRANSACTIONS

With the increasing popularity of cryptocurrency, Congress recently enacted legislation requiring information reporting for digital assets beginning in 2024. The Infrastructure Investment and Jobs Act of 2021<sup>49</sup> codified a definition of a “digital asset,” which is defined as “any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.”<sup>50</sup> Commentators have pointed out that the §6045 digital assets definition is broader than the virtual currency definition because it can encompass other types of assets, such as stablecoin that is treated as debt.<sup>51</sup> But, importantly to the metaverse industry, a portion of the definition limits it to assets “recorded on a cryptographically secured distributed ledger or” other similar technology. Not all metaverse currencies are recorded on the blockchain. SAND is registered on the Ethereum blockchain. Likewise, MANA, SLP, and AXS are Ethereum-based cryptocurrencies. However, older nonblockchain metaverses, such as Roblox and Second Life, use in-game currencies that are not recorded on the blockchain.<sup>52</sup> Transactions in non-blockchain virtual currencies should not be subject to the §6045 digital asset rules.

The definition of a broker, who is required to report transactions on Form 1099-B, is greatly expanded by the Infrastructure Act. Using the definition of digital

<sup>47</sup> See §1091(a), §1091(d).

<sup>48</sup> For other potential impacts from the proposed wash sale amendments, see Matthew B. Kulkin, Lisa M. Zarlenga, Micah S. Green, and Alan Cohn, *Build Back Better 'Wash Sales' Legislation Would Impact Currency, Commodity, Options, and Digital Asset Markets* (Nov. 2, 2021), <https://www.steptoe.com/en/news-publications/build-back-better-wash-sales-legislation-would-impact-currency-commodity-options-and-digital-asset-markets.html>.

<sup>49</sup> Pub. L. No. 117-58, referred to herein as (the “Infrastructure Act”).

<sup>50</sup> §6045(g)(3)(D).

<sup>51</sup> Cara Griffith, Lisa M. Zarlenga, Carolyn Schenck, Michael R. Fiore, Lawrence J. Zlatkin, and Abraham Sutherland, *Cryptocurrency: What's Next for Regulation and Compliance? (Transcript)*, TaxNotes (Mar. 9, 2022).

<sup>52</sup> See Ayushi Abrol, *The Creator of Second Life to Reclaim Space in the Metaverse*, Blockchain Council, <https://www.blockchain-council.org/news/the-creator-of-second-life-to-reclaim-space-in-the-metaverse/> (last visited June 6, 2022).

assets, the Infrastructure Act amended the definition of a broker to include: “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.”<sup>53</sup> This definition is incredibly broad. Because metaverses facilitate the transfer of cryptocurrency in exchange for virtual goods or services, the new broker definition could implicate all metaverses that use blockchain registered virtual currencies and result in information reporting requirements. The enacted legislation, slated to go into effect in 2024, could have a massive impact on the reporting duties of metaverses. Metaverses will need to prepare by building the reporting infrastructure and compiling the data needed to comply with these duties. The Treasury has been working on regulations to implement the requirements for brokers of digital assets, but these proposed regulations have not yet been issued.<sup>54</sup> Such regulations could provide clarity as to who is intended to be covered as a broker, given the possible overbreadth of the definition. In response to concerns from a group of U.S. senators, Treasury signaled that it plans to exclude crypto miners and stakers from the broker definition.<sup>55</sup> These rules are necessary so all businesses that conduct transactions in cryptocurrency can understand what, if any, reporting obligations they have. The failure of a broker to provide the required information returns is subject to a penalty of \$250 per instance.<sup>56</sup>

The Organisation for Economic Co-operation and Development (OECD) has also proposed tax reporting standards for cryptocurrency. The OECD released the Crypto-Asset Reporting Framework (CARF) on March 22, 2022, as an amendment to the global Common Reporting Standard (CRS). The CARF uses a different definition of its term, “crypto-assets,” and excludes from coverage “closed-loop crypto-assets,” which are defined as crypto-assets that are:

(a) issued as a means of payment with participating merchants for the purchase of goods or services;

(b) can only be transferred by or to the issuer or a participating merchant; and

<sup>53</sup> §6045(c)(1)(D).

<sup>54</sup> Griffith, et al., above, Note 51.

<sup>55</sup> Allyson Versprille, *Treasury Signals Crypto Miners Won't Face IRS Reporting Rule*, Bloomberg (Feb. 11, 2022), <https://www.bloomberg.com/news/articles/2022-02-11/treasury-signals-crypto-miners-won-t-face-irs-reporting-rules>.

<sup>56</sup> §6721.

(c) can only be redeemed for fiat currency by a participating merchant redeeming with the issuer.<sup>57</sup>

The definition of closed-loop crypto-assets helpfully appears to exclude metaverse currencies that can only be used in-game and are not readily exchangeable outside of the metaverse. Examples fitting this definition are Roblox Roblox and Second Life Lindens, which can only be exchanged in-game and are not tradeable on secondary markets, as well as the gold used in the less-commercialized World of Warcraft. But as many metaverses have moved to using a fungible cryptocurrency, the benefits of presented by the increased transferability of cryptocurrency would trigger reporting requirements under the CARF proposal as well.

## HISTORY OF VIRTUAL WORLD TAXATION

While little has been written on the subject of metaverse taxation, analysis of the taxation of virtual worlds is not new. Interest in virtual world taxation rose with the popularity of Second Life and the ability of entrepreneurs to make substantial amounts of income in the game. The example of Second Life, which launched in 2003, can provide a roadmap of what to expect for future metaverse platforms. In Second Life, users interact with others in avatar form and are encouraged to engage in marketplace transactions such as creating and selling real estate (homes, shops, discos, movie theaters, gardens, arenas) and personal items (clothing, body parts, furniture, pictures, vehicles, airplanes, fireworks, art).<sup>58</sup> There are a number of occupations that members of Second Life make their livings from in-world, including jewelry maker, tour guide, musician, landscaper, nightclub owner, and attorney.<sup>59</sup> Unsurprisingly, the services performed in Second Life also include a flourishing sex-worker industry.<sup>60</sup> In 2006, Anshe Chung declared herself the first virtual millionaire based on her Second Life real estate empire.<sup>61</sup> Shortly thereafter, CNET declared that IRS taxation of virtual game assets was “inevi-

<sup>57</sup> <https://www.oecd.org/tax/exchange-of-tax-information/public-consultation-document-crypto-asset-reporting-framework-and-amendments-to-the-common-reporting-standard.pdf>.

<sup>58</sup> Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 *Hastings L.J.* 1, 9 (2007), <https://ssrn.com/abstract=980693>.

<sup>59</sup> Benjamin T. Duranske, *Virtual Law: Navigating the Legal Landscape of Virtual Worlds* (Am. Bar Ass'n, 2008).

<sup>60</sup> S. Nicole Lane, *Cybersex and Sex Work in Second Life*, *Chi. Reader* (May 27, 2020), <https://chicagoreader.com/arts-culture/cybersex-and-sex-work-in-second-life/>.

<sup>61</sup> Roger Parloff, *Anshe Chung: First Virtual Millionaire*, *Fortune* (Nov. 27, 2006), <https://fortune.com/2006/11/27/anshe->

table.”<sup>62</sup> Also in 2006, the Joint Economic Committee of Congress announced it was undertaking a study of the tax issues associated with virtual economies.<sup>63</sup> Then senior economist for the JEC Dan Miller stated, “[i]t will get to the point where the dollar value becomes so sizeable that the IRS would be almost negligent if it didn’t at least look into the potential of taxing these worlds.”<sup>64</sup> Despite the hype, the JEC’s study never materialized.<sup>65</sup>

Nonetheless, the JEC’s inquiry into virtual world transactions spurned numerous articles and academic papers as to how these transactions should be taxed.<sup>66</sup> Several tax scholars suggested that revenue earned from Second Life should be treated as taxable income due to the ability to exchange the Lindens used in-game for fiat currency via Linden Lab’s LindeX Currency Exchange.<sup>67</sup> When asked in 2007 about the IRS’s position on collecting taxes from virtual economies like Second Life, an IRS spokesperson provided the following statement: “Any time someone wins a tangible prize or award, the value is reportable as taxable income. An accumulation of ‘points’ would not result in tax consequences, but redeeming or selling them for money, goods, or services would.”<sup>68</sup> Beginning in 2013, Second Life started issuing Form 1099-Ks to users who received proceeds in excess of \$20,000 from the exchange of Lindens, citing the information reporting requirements under §6050W.<sup>69</sup>

Professor Bryan T. Camp’s seminal 2007 article, *The Play’s the Thing: A Theory of Taxing Virtual*

*Worlds*, explained that the article was both timely due to the size of the virtual economy and premature, because there was “no indication that the IRS is remotely interested in the topic,” despite the possibility that §6045 already imposed information reporting requirements on operators of virtual worlds.<sup>70</sup> An article from 2009 posited that the U.S. tax system will pay more attention to virtual transactions when one of three events occur:

1. courts grant property rights to virtual world participants in the virtual items they amass;
2. vendors begin accepting virtual items (such as virtual currency) on a regular basis in exchange for real goods and services; or
3. Congress adopts legislation requiring owners of virtual worlds to report certain transactions to the IRS.<sup>71</sup>

All three of these events have come to fruition. First, the rise of NFTs has provided recognizable ownership and certain property rights in virtual goods. Second, cryptocurrency markets have generated readily exchangeable virtual currency used in both the physical and the virtual worlds. Third, Congress has enacted provisions in the Infrastructure Act amending §6045 to require information reporting on transfers of digital assets, providing administrability for taxation income generated in virtual worlds. The landscape is now ripe for focus on the taxation of virtual worlds.

## CONCLUSION

While many think of the metaverse as a new arena, the digital asset tax rules can help guide us to expected tax outcomes for the virtual world. That said, the existing paradigm that every cryptocurrency transaction is a taxable exchange of property is not suitable to the volume and structure presented by metaverses, where millions of cryptocurrency transactions occur daily as payment for goods and services. The current digital asset tax regime will prove onerous to users and the metaverse industry in terms of compliance, recognition events, tracking of transactions, and information reporting. Legislators and the IRS should focus on how to adapt the tax rules to avoid hindering the burgeoning metaverse industry and consider approaches that more closely align the tax treatment of virtual tokens with their use as currency in metaverse transactions.

<sup>70</sup> Bryan T. Camp, *The Play’s the Thing: A Theory of Taxing Virtual Worlds*, 59 *Hastings L.J.* 1, 70–71 (2007), available at <https://ssrn.com/abstract=980693>.

<sup>71</sup> Zachery Jones, *Why the IRS Has Not Taxed Income from Virtual World Transactions . . . Yet*, 118 *Yale L.J. Pocket Part* 142 (2009), [https://www.yalelawjournal.org/pdf/744\\_s5oswfyfya.pdf](https://www.yalelawjournal.org/pdf/744_s5oswfyfya.pdf).

[chung-first-virtual-millionaire/](#).

<sup>62</sup> Daniel Terdiman, *IRS Taxation of Online Game Virtual Assets Inevitable*, CNET (Dec. 4, 2006), <https://www.cnet.com/tech/gaming/irs-taxation-of-online-game-virtual-assets-inevitable/>.

<sup>63</sup> Press Release, Joint Economic Committee Chairman Jim Saxton, *Virtual Economies Need Clarification, Not More Taxes* (Oct. 17, 2006), [https://www.jec.senate.gov/public/\\_cache/files/08e6fa84-ee4f-4267-9f47-ad0ad33a072d/pr109-98.pdf](https://www.jec.senate.gov/public/_cache/files/08e6fa84-ee4f-4267-9f47-ad0ad33a072d/pr109-98.pdf).

<sup>64</sup> Jamie S. Switzer and Ralph V. Switzer, *Taxation of Virtual World Economies: A Review of the Current Status*, 7 *J. of Virtual Worlds Res.* 1, 5 (2014).

<sup>65</sup> *Id.*

<sup>66</sup> See Dustin Stamper, *Taxing Ones and Zeros: Can the IRS Ignore Virtual Economies?* 114 *Tax Notes* 149 (2007).

<sup>67</sup> Flora Graham, *Slapping a Tax on Playtime*, BBC News (Nov. 25, 2008), <http://news.bbc.co.uk/1/hi/technology/7746094.stm>; David J. Mack, *iTax: An Analysis of the Laws and Policies Behind the Taxation of Property Transactions in a Virtual World*, 60 *Admin. L. Rev.* 749 (2008).

<sup>68</sup> Grace Wong, *Second Life’s Looming Tax Threat*, CNN Money (Mar. 9, 2007), [https://money.cnn.com/2007/03/02/technology/sl\\_taxes/](https://money.cnn.com/2007/03/02/technology/sl_taxes/).

<sup>69</sup> Linden Lab, *Required Tax Documentation*, Second Life Commerce Blog (Nov. 19, 2013), <https://community.secondlife.com/blogs/entry/1094-required-tax-documentation/>; Linden Lab Official: *Required Tax Documentation FAQ*, Second Life Wiki, [https://wiki.secondlife.com/wiki/Linden\\_Lab\\_Official:Required\\_Tax\\_Documentation\\_FAQ](https://wiki.secondlife.com/wiki/Linden_Lab_Official:Required_Tax_Documentation_FAQ).