A SOUTH AFRICAN PERSPECTIVE ON THE TAX IMPLICATIONS OF VIRTUAL ASSET ACCUMULATION AND TRANSACTIONS STEMMING FROM PERSISTENT VIRTUAL WORLDS

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ABSTRACT

Massively multiplayer online role-playing games are growing in popularity with millions of people participating in these persistent online environments on a daily basis. Accompanying the ever-increasing subscription numbers is an increase in real money trade transactions stemming from these game worlds. The research question to be addressed in this thesis is whether transactions stemming from virtual worlds have real-world taxation consequences. The goal of this research is to determine the taxability of virtual assets obtained in structured as well as unstructured virtual environments and to attempt to establish the differences between capital and revenue receipts in these virtual realms, taking into account the nature of a receipt. The general deduction formula is applied to establish the deductibility of expenditure incurred whilst participating in these virtual environments. Sundry matters such as Value-Added Tax, donations tax, the withholding tax on gambling gains and tax avoidance will also be addressed. The methodology adopted for the research could best be described as interpretative, aimed at analysing and interpreting the relationship between real world taxes and persistent virtual worlds and the transactions that stem from participation therein. The research is based purely on documentary evidence. After applying relevant tax legislation to virtual economies it became evident that merely because virtual assets only exist in virtual reality does not necessarily preclude them real world tax consequences. It was concluded, however, that it is not practical for the South African Revenue Service to monitor all virtual world transactions or for participant taxpayers to calculate the real world value of each and every asset acquired in-world. As a result, it was concluded that real world tax consequences should only be applied in situations where participants actually convert their virtual assets into real world currency.

Key words:

General deduction formula	Gross income
Massively multiplayer online role-playing game	Real money trade
South African resident	Structured virtual world
Taxation	Unstructured virtual world

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FOREWORD

The midday sun hangs high in the summer sky over the Evensong Woods as the residents of Sunstrider Isle busy themselves with their daily chores. The sleepy village on the north-western outskirts of the Blood Elven capital of Silvermoon City serves as a training camp for Blood Elves wishing to hone their combat skills in preparation for the inevitable collapse of the ceasefire between the Horde and Alliance members. Our young hero, Aethas Dawnblade, a Blood Elf of humble beginnings as the son of a blacksmith and a innkeeper, stands before the mystical tower known as the Sunspire. His simple cloth tunic hides the body of a young Elf in the prime of his youth. At each hip, rests a small dagger, both crafted for the Elf by his father. Where he stands now, many a great warrior has stood before him, and although he may not know it yet, it is his destiny to sway the tides of battle. It is his destiny to change the world. This is his story.

"Young Mr Dawnblade," a female voice, reminiscent of his mother's, pierces the air and Aethas swings around to face his addresser. "How wonderful that you should decide to join me this day. Are you ready to begin your training?" Aethas nods his agreement but before he can verbally respond to the question posed to him, the female dives into a dramatic, if well rehearsed, speech as to the importance of the training Aethas is about to endure. Before the young Blood Elf stands Magistrix Erona, clad in a flowing crimson robe and clutching her staff, she exudes a quiet confidence Aethas longs to possess. During her speech, which resembles that of an introductory history lecture Aethas once sat through in his more formative years, the Magistrix offers a curt reminder to Aethas of the corruption of The Sunwel at the hands of Arthas Menethil, former Crown Price of Lordaeron and Knight of the Silver Hand, and the Blood Elves excommunication from their High Elders. As the minutes pass, Aethas begins to lose interest in Erona's retelling of Blood Elf lore, more interested is he in the clouds drifting overhead. Noticing this, the Magistrix, who had up until that point been wrapped up in her own ramblings, orders the young Elf to slay eight mana wyrms as a test of his strength. Excited by the prospect of active combat, Aethas springs to his feet and unsheathes his two plain daggers from their rather more ornate scabbards.

The surrounding fields of Sunstrider Isle are infested with the mana wyrms the Magistrix spoke of. These mana wyrms, serpetine creatures similar in appearance to the nether dragon, are drawn to the burning crystals that are scattered around the region, feeding off their arcane energy. Considered more of a nuisance than an actual threat to the inhabitants of Sunstrider Isle, they provide the perfect opportunity for Aethas to plunge his daggers into the flesh of live creatures, rather than the training dummies he has grown so accustomed to. Strolling through the plains with his daggers raised in an aggressive posture, Aethas spots his prey. A lone mana wyrm has taken refuge from the scorching summer heat under a large tree. The young Elf notices a trembling sensation as adrenaline courses through his veins but within a split second, Aethas makes a mad dash towards the creature, eager to spill the blood of his newly assigned enemy. Running towards the wyrm, to Aethas it feels as if time is standing still, and with a single piercing strike from the dagger in his right hand, Aethas slays the weak mana wyrm. Bending down on one knee, over the corpse of his slain victim, Aethas uses a dagger to remove a torn wyrm scale from above the left eye of the beast. Collecting the scale in this manner will serve as proof of his conquest over his foe. He looks at his left hand and smiles to himself, having realised his body is no longer trembling. Like a battle hardened veteran, Aethas proceeds ruthlessly, without mercy or remorse, to slay the seven remaining creatures requested of him by Erona. Using his tunic to wipe the blood off his blades, the Blood Elf begins the short walk back to the centre of the village and back to Magistrix Erona, who has been watching his progress from the shadows. At the village entrance, Aethas looks back upon the field, upon the eight corpses slain by his blade. Knowing that he has just taken eight lives bothers him little for he knows much more blood will be spilt at his hands. If not, it will be his blood spilt, his life lost.

As Aethas approached her, a wry smile betrayed the Magistrix's outward demeanour. She could sense there was something special about the Blood Elf walking towards her. Aethas offered Erona the scales he had collected as proof, but her eyes remained fixed upon his. She placed one hand on his head and the other reached towards his dagger. A moment passed before she said, "good, but you still have much to learn". As she walked off towards the Sunspire, Aethas placed his hand into his trouser pocket and felt the cold sting of bronze coins rubbing against his warm flesh. Not only had Aethas completed his first of many quests, he also received his first reward for a job well done. His adventure had begun.

The above is a description of *Azeroth*, a structured virtual world from the game, *World of Warcraft*. The inhabitants of *Azeroth* roam their virtual environment, seeking adventure, hunting treasure, slaying enemies, all in the hope of a hero's journey. This pursuit of adventure draws in millions of people from around the world, who pour hours of their lives into games such as *World of Warcraft*. Players embarking on a journey through a structured virtual world will do battle with many enemies, steeling their resolve for the countless battles that lie ahead. Each battle earns the player experience, which strengthens the abilities of the player, enabling him or her to do combat with more deadly opponents. Players even do battle with one another to prove who is the strongest of all. This is the world of the massively multiplayer online role-playing game.

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND TO THE RESEARCH

Across the globe millions of people are, on a daily basis, slaying dragons, rescuing damsels in distress, discovering new territories as well as rediscovering long forgotten lands and even building up their real estate empires. All of these activities are taking place in cyberspace in the plethora of massively multiplayer online role-playing games (MMORPGs) that exist.

Merely a decade ago, the collective active subscriptions of these virtual realms totalled one million users. Flash forward to the present day and active subscriptions have reached 21 million users as at the end of 2011 (MMOData.net: 2011). This rapid growth rate shows few signs of abating, with a slew of massively multiplayer online games to be released in 2012 and beyond. *World of Warcraft*, *Aion*, *Final Fantasy XIV Online* and *Second Life* are just four examples of these virtual worlds and of greater interest than subscription numbers is the trade that takes place in these booming virtual economies. Conservative estimates of the amount of money involved in the trade of wholly virtual goods are set at $2 billion per annum (Wilson: 2009), but leading experts believe this number to underestimate the figure five-fold, placing the actual trade figure closer to the $10 billion per annum mark (Chiang: 2010). Regardless of the exact amount, one thing is certain, "real people are paying real money for entirely virtual goods and services" (Pienaar, 2008: 1). If enough people are trading virtual goods to the extent of these sums of money, then it is plausible to believe that people are earning a living from trading virtual assets. In November 2006 Ailin Graef became the first person, through participation in a persistent virtual world, to have amassed "a net worth in excess of $1,000,000 by reason of activities in *Second Life*" (Seto, 2008: 1) over the course of the two and half years. Five years later, *Second Life*, which is considered to be more of a social and commercial platform than a game, is regarded as a viable means of generating real world income. The virtual world's developer, *Linden Lab*, actively encourages in-world entrepreneurship. In December 2009 the *Crystal Palace Space Station* which exists only in virtual reality in the MMORPG *Planet Calypso* (Wauters: 2010), was auctioned off for 3.3 million Project Entropia Dollars, the equivalent of US$330,000 (Schramm: 2010). Even more startling than the idea of spending that sum of money on something which exists only in a game, is that the buyer, Eric Novak, as well as many others familiar with virtual worlds,

believe that he will recoup his initial capital outlay and start turning a profit within three years, as a result of the taxes Eric may now impose on visitors to his space station (McGuinness: 2010).

The amount of real world money changing hands, coupled with the fact that business-savvy people are able to earn a living from virtual economies, highlights the question of taxation and whether or not real world taxes should be levied against the income earned in virtual environments. Taxation authorities the world over are slowly becoming more and more interested in virtual economies and the notion of applying taxes to virtual transactions (Nuttall: 2007). However, the problem lies in the fact that at the time when current taxation laws were drafted, virtual economies were non-existent and the idea that they could attract real world taxes could not have been envisioned.

Although the notion of taxing receipts generated in virtual worlds is still in its infancy, several international papers have been published on the matter with Camp (2007) and Lederman (2007) being regarded as leading figures in the field and as such their work provides a platform from which all future work can be conducted. In the South African context, a thorough search of electronic databases revealed that the Pienaar (2008) thesis is the only academic research to have delved into virtual economies. Her research focused on whether income earned in virtual worlds will be included in "gross income" as defined in section 1 of the South African Income Tax Act, 58 of 1962, (referred to as the South African Income Tax Act) and therefore be subject to taxation.

Camp's (2007) paper entitled "*The Play's The Thing: A Theory of Taxing Virtual Worlds*" extensively defined what is meant by the idea of a virtual world, drawing a clear distinction between structured and unstructured virtual worlds. Structured virtual worlds resemble traditional role playing games where the game developers create an environment with rich storylines and clear objectives, and an emphasis is placed on adventure and exploration of the world (Chung: 2009). "In contrast an unstructured game has few rules, no objectives and no pre-set roles" (Camp, 2007: 3). In addition to this fundamental distinction which has great

significance in the taxability of receipts generated in virtual worlds, Camp's (2007) research provides an in-depth insight into the nuances of these worlds. Camp (2007) attempted to establish, in terms of United States tax legislation, the ramifications of different income generating activities in structured as well as unstructured virtual worlds. Ultimately Camp determined that provided no real money flows during game play, there will be no tax consequences. The moment a player converts his or her virtual assets into real world currency, that transaction has the potential to incur real world tax implications.

Lederman's (2007) paper, like that of Camp's, also focused on the distinction between unstructured and structured virtual realms, but Lederman also concerned herself with motive: the reasons for users participating, or the nature of their participation, in either of the two world types. In Lederman's (2007) view, massively multiplayer online games with a structured world environment exist for the entertainment of the player rather than to facilitate economic gain. These "game worlds typically focus on conquering challenges, not on commerce" (Lederman, 2007: 1670) and subsequently she argues that the existence of any real world value for in-game items as a result of trade "should not transform game-world success into gross income" (Lederman, 2007: 1671). However, the same cannot be said for unstructured worlds such as *Second Life* and *Entropia Universe* which are designed to support commerce and trade. But more than merely support commerce, participants are encouraged to create virtual items to be traded with other members of the online community. In addition to this, players retain the intellectual property rights to the virtual items they create which leads Lederman to believe that transactions taking place within an unstructured world such as *Second Life* will be more likely to bear appropriate tax consequences.

Virtual trade within structured virtual worlds is becoming a more frequent occurrence and as a result requires careful consideration. With so many people taking part in MMORPGs, players have identified a viable market to be exploited, and it has become increasingly common for skilled players to sell their best characters, strongest weapons and rarest items for real world money over the Internet website *eBay*, a practice known as real money trade. However, game developers have long since argued that in terms of their End User Licence Agreements, characters, weapons, items, etc. which were being sold over *eBay*, actually were

the property of the developers themselves and as such the players have no real world rights over these virtual assets. The online auction giant, *eBay*, responded by banning the trade of these virtual assets, which did little to curb this practice and in essence created a virtual black market for their trade as many websites have been created to help facilitate the real money trade. Exchange rates have even developed enabling people to trade in-game currency for $US adding further credibility to these virtual world economies. It is evident that income can be and is generated from virtual worlds through the sale of rare items and weapons for virtual world currency which can then be converted into actual $US or via real money trade directly for player accounts and assets. At what point does a receipt become taxable? The taxability of receipts involves a consideration of the definition of gross income in section 1 of the South African Income Tax Act, as well as the distinction between the capital or revenue nature of a receipt.

It is simply a matter of time before the South African Revenue Service (SARS) starts to proactively investigate virtual transactions in an attempt to establish their affect on South African taxpayers' "gross income". There may already be scope within the South African Income Tax Act to deal with virtual transactions and the present research may assist in shedding some light on possible gaps within the legislation. The Pienaar (2008) thesis has established a solid platform within the South African context and provides a foundation upon which to build a greater understanding of the tax implications inherent within structured as well as unstructured virtual worlds. The capital-revenue distinction is, however, merely one aspect of the broader picture. Once the question of gross income has been dealt with, this opens the door for a need to establish how other aspects of South African tax legislation. Such considerations to be viewed in the context of virtual worlds include value-added tax, donations tax, the withholding tax on gambling gains and tax avoidance provisions.

1.2 RELEVANCE OF THE RESEARCH

At present, Sarah Pienaar's (2008) thesis appears to be the only academic source of reference on virtual worlds in the South African context. As her paper dealt strictly with the matter of "gross income", this has left a fair amount of South African tax legislation to be investigated

in so far as virtual transactions are concerned. The present research will further broaden the collective understanding of virtual economies and the tax implications they have the potential to create. The research will consider the principles of the South African Income Tax Act as well as the Value-Added Tax Act, 89 of 1991, (referred to as the South African VAT Act) in a new light, by applying them to the relatively new concept of virtual transactions. The work previously conducted by Camp (2007) and Lederman (2007) will be instrumental in the present research, and their research will provide a theoretical platform to be applied to the South African context.

This research will differ from Pienaar's (2008) thesis in that, where that research focused on whether or not income from virtual worlds would qualify as "gross income", the present research will investigate the question of income qualifying for inclusion in "gross income", but it will branch out further, attempting to establish when income will be treated as capital in nature and when it will be seen as to be revenue. Furthermore, the consequences of this distinction will be highlighted in terms of case law. Once inclusion in "gross income" has been established, and after taking into account all exempt income, deductions in terms of the "general deduction formula", which is comprised of section 11(a) and section 23(g) of the South African Income Tax Act, will need to be assessed. Possible interpretations relating to VAT, donations tax and a soon to be introduced withholding tax on gambling gains will also be discussed once "gross income", capital gains and the "general deduction formula" have been dealt with appropriately.

1.3 RESEARCH QUESTION

The research question to be addressed in this thesis is whether transactions stemming from virtual worlds have real-world taxation consequences. The goal of this research is to determine the taxability of virtual assets obtained in structured as well as unstructured virtual environments and to attempt to establish the differences between capital and revenue receipts in these virtual realms, taking into account the nature of a receipt. The manner in which different participants in virtual worlds conduct their game experiences will be a contributing factor when attempting to ascertain the nature of any receipt stemming from a virtual world.

The "general deduction formula" will be applied so as to establish the deductibility of expenditure incurred whilst participating in these virtual environments. Emphasis will then be placed on ascertaining the VAT as well as donations tax consequences that arise from these virtual worlds and the transactions that take place within them. Finally, the possible applicability of the proposed withholding tax on gambling gains and the potential for tax avoidance will be investigated.

1.4 RESEARCH OBJECTIVES

The goal of this research is to establish the taxability of virtual assets obtained in structured as well as unstructured virtual environments. In carrying out the research, the following sub-goals will be pursued:

- developing an understanding of how structured and unstructured virtual worlds operate;
- establishing the income tax consequences of the trade in virtual assets and in particular the difference between capital and revenue receipts in virtual worlds;
- establishing the deductibility of expenditure incurred in respect of virtual world assets and in particular, distinguishing between expenditure that is of a revenue nature and that which is of a capital nature;
- investigating the application of other taxes to transactions in virtual worlds, including value-added tax, donations tax and the withholding tax on gambling gains, as well as possible tax evasion and avoidance problems;
- illustrating through the use of hypothetical examples, how the transactions within structured and unstructured virtual worlds may be subject to the application of appropriate tax legislation; and
- making suitable recommendations relating to the taxation of virtual worlds transactions.

In addressing the goals of the research, comparisons can then be made between South African tax law and the laws of selected developed nations, such as the United States of America, the United Kingdom, Australia, Sweden and China which are already tackling the issue of virtual economies. The comparative studies will enable the author to postulate suitable recommendations so as to draw greater attention to virtual worlds and the tax issues they raise.

1.5 DEFINING THE KEY TERMS

The research will involve the use of certain specific terms which have been defined for purposes of the study.

General deduction formula:

The "general deduction formula" is a combination of the preamble to section 11, section 11(a) and section 23(g) of the South African Income Tax Act, which allow deductions from the income of a taxpayer, provided certain requirements are met. The preamble to section 11 requires the carrying on of a "trade" from which income is derived. Section 11(a) of the South African Income Tax Act requires that there be expenditure and losses actually incurred during the year of assessment in the production of income and not being of a capital nature. Section 23(g) then prohibits the deduction of any expenditure or losses, to the extent that the expenditure and losses have not been laid out for purposes of "trade".

Gross income:

"Gross income" is defined as follows: "in relation to any year or period of assessment, means in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature" (section 1 of the South African Income Tax Act).

Massively multiplayer online role-playing game:

A massively multiplayer online role-playing game (MMORPG), for purposes of this study, is defined as a virtual universe that allows for large numbers of people to play a game simultaneously, in which the player assumes a role and undertakes an adventure.

Real money trade:

Real money trade for purposes of this study is defined as "the buying and selling of virtual property and currency for real-world money" (Howgego: 2007). Although the practice is considered to be a violation of most game developer's Terms of Service, this has done little to prevent users from trading in such a manner.

South African resident:

A South African resident is defined with regard to a natural person "as 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).

Structured virtual world:

Structured virtual worlds, for purposes of this study, are defined as environments where users are provided with structured adventures involving quests, raids and fights against opposing forces (Lederman: 2007). Examples of such structured worlds are *World of Warcraft*, *Aion*, and *Final Fantasy XIV Online*.

Unstructured virtual world:

An unstructured virtual world, for purposes of this study, is as a synthetic environment where the developers provide a basic world structure and the majority of the virtual assets are

created by the players within the virtual community (Lederman: 2007). Examples of this world type include *Second Life* and *Entropia Universe*.

1.6 RESEARCH METHODOLGY AND DESIGN

The approach to be adopted for the research falls into the interpretative paradigm. This is an appropriate approach as the research seeks to describe and explain (Babbie & Mouton: 2009). A *doctrinal* methodology is applied. This methodology has been described (McKerchar: 2008) as a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to the taxation of the acquisition and disposal of virtual worlds assets), the analysis of the relationship between the rules, an explication of areas of difficulty and is based purely on documentary data. The research approach is therefore qualitative in nature, designed to understand the real world tax consequences of virtual world transactions.

The research is based primarily on documentary evidence and as a result an extensive literature survey will be conducted in order to carry out the proposed research. The sources of the data include:

- South African taxing acts;
- South African case law relating to the relevant provisions of the taxing acts;
- international taxing acts and relevant case law;
- journal articles, theses and other research by acknowledged tax authors and experts, particularly the work done by Camp (2007), Lederman (2007) and Pienaar (2008).

The data will be analysed and interpreted in order to determine the tax consequences of transactions in virtual worlds. A hypothetical example will be designed to determine and illustrate these tax consequences. A limitation of the research is that the thesis will focus only on tax consequences faced by taxpayers resident in the Republic.

As far as ethical considerations for the research are concerned, all documents used in the research are in the public domain and as a result no ethical issues arise.

1.7 OVERVIEW OF THE RESEARCH

This chapter introduced the focus of the study and provided a background to the research. The chapter highlighted the research question as well as the objectives of the study. The relevance of the study was discussed in terms of the possible application of the South African Income Tax Act, VAT and donations tax consequences as well as the proposed withholding tax on gambling gains. The chapter concluded with an explanation of key terms to be used in the study as well as the research methodology applied.

The next chapter will focus on the concepts of structured and unstructured virtual worlds and will discuss matters such as virtual asset valuation and real money trade.

Chapter three will assess "gross income" in terms South African tax legislation and case law. Following a thorough examination of what is meant by the term "gross income", the tax legislation in applying South Africa will be applied to various situations so as to establish the "gross income" position of virtual assets as well as real world assets that arise from their disposal.

Chapter four will introduce the notion of a capital receipt so as to be able to focus on the distinction between capital and revenue receipts from events relating to structured as well as unstructured virtual worlds.

Chapter five focuses on the "general deduction formula". The preamble to section 11 of the South African Income Tax Act as well as section 11(a) and section 23(g) are applied to various examples of structured and unstructured virtual world expenditure. The main focus of

the chapter is on the distinction between capital and revenue expenditure in terms of both virtual world currency and real world currency.

Chapter six will examine various other aspects of South African tax legislation within the context of persistent online environments. These aspects will include VAT, donations tax and the 15% withholding tax on gambling gains to be implemented within the Republic of South Africa from April 2012.

Chapter seven will examine the works of Camp (2007) and Lederman (2007) focusing on persistent online environments in the context of the Internal Revenue Code of the United States of America. Although the work of these two academics does not represent the official view of the Internal Revenue Service regarding tax consequences stemming from virtual world transactions, the work does provide some insight into the matter from a legislative viewpoint. In addition, the chapter will put forward the stances of selected tax authorities on virtual worlds and the income participants may derive from them.

The final chapter of the thesis will summarize the findings of the research and highlight the potential for tax avoidance schemes operating though persistent virtual worlds, compounding the need for the South African Revenue Service to pay greater attention to the transactions that stem from these worlds. Recommendations, based on the findings of the thesis, will then be offered.

CHAPTER 2: VIRTUAL RECEIPTS

2.1 INTRODUCTION

This chapter takes the form of a literature review the purpose of which is to provide an understanding of structured as well as unstructured virtual worlds and how they work. Once the difference between these two world types has been established, the various transaction types which take place within a virtual world can be examined, with emphasis being placed on the notions of in-world trade transactions and real-money trade. Ultimately this should serve to provide a context within which South African tax legislation can be applied. This chapter therefore addresses the first goal of the research.

2.2 VIRTUAL WORLDS

2.2.1 A BRIEF HISTORY

In the 1970s multi-user dungeons, which were text-based real-time virtual worlds and essentially the forerunner to massively multiplayer online role-playing games, emerged from computer laboratories at several universities including the creation of *Zork* at Massachusetts Institute of Technology in the United States of America and *MUD1* at Essex University in England (Anderson: 1985). As technology improved it was possible for game developers to move away from text-based games to graphical multi-user dungeons such as *Neverwinter Nights* released in 1991 (Koster: 2002). The emergence of two titles in particular helped the genre garner greater attention from a wider audience in the late 1990s. These two games were *Ultima Online* and *Everquest* and in 1997 the term massively multiplayer online role-playing game was coined by Richard Garriott, replacing graphical multi-user dungeon to describe the genre (Game Entertainment Europe: 2005). The two types of virtual environments, namely structured and unstructured virtual worlds, are discussed below.

2.2.2 STRUCTURED VIRTUAL WORLDS

A structured virtual world is a persistent online environment in which thousands or even tens of thousands of participants, dependent upon server capacity, can interact simultaneously with one another and the environment. By persistent, one means that even while you may not

be actively involved in the game, the world continues without your involvement. The game continues to run even when no players are present within the game world (Lastowka & Hunter: 2003). Participation within a structured virtual world is generally done for entertainment purposes and the prospect of experiencing a hero's journey or for the social value one derives from the large in-world community (Bartle: 2004). For the most part, players spend as much time in these virtual worlds as they would do taking part in any other hobby, but there are participants who approach virtual worlds as an alternate reality, devoting the vast majority of their time to them (Castronova: 2002).

In his 2007 paper, "*The Play's The Thing: A Theory of Taxing Virtual Worlds*", Camp listed three distinguishing features of structured virtual worlds. The first of these characteristics of a structured virtual world is that "it puts players into strongly pre-defined roles within the context of an overall storyline" (Camp, 2007: 4) According to Camp, in a structured virtual world the player is presented with pre-set roles as well as pre-set objectives and challenges and the game itself sets rules for interaction with other players and computer generated non-player characters. The player makes use of an online persona, or avatar, which is a visual representation of the player's character, to assume the pre-set game role and participate within the environment provided by the game. In accordance with each game's Terms of Service agreement, prospective players are required to agree, prior to playing these MMORPGs, to live according to the rules laid out by the game developers in exchange for being able to play the game. Different MMORPGs afford players the opportunity to choose from different pre-set roles. In *World of Warcraft*, for example, a player may opt for the role of a mage, enabling the player to make use of powerful magic spells to attack enemies from afar. The need for spell casting from a distance is compounded by the fact that mages have weak physical attributes and therefore cannot survive in close combat encounters. Alternatively the player may wish for a more direct combat approach in which case the classes of paladin or warrior, with their increased physical attack and defence (World of Warcraft: 2010), would be a wiser choice. Each pre-set role, or class, has specific strengths and weaknesses, in an attempt to balance the mechanics of the game, allowing participants some choice in how they wish to carry out their adventure. Once a player has selected the role for his or her avatar, s/he is free to roam the game world in search of treasure, monsters to slay, quests to complete and guilds with which to join forces. Non-player characters exist within the game world to help drive the

overarching storyline. While offering items such as potions and swords to players, non-player characters are also a means by which game developers provide players with the quests or missions necessary to progress the story along an intended path. Upon completion of the required tasks, players are rewarded with weapons, treasure, skills, etc. and it is evident that non-player characters play a significant role in guiding players through the narrative and ensuring they become immersed in the online environment.

Camp's (2007) second quality of a structured game is that players craft rather than actually create items. Crafting is the process of taking the necessary virtual raw materials, which a player will have accumulated, and converting them into an item. The value of this crafted item should be greater than the sum of the value of the constituent raw materials required to create the item. The list of specific materials required in the crafting of a particular item is collectively known as the "recipe". Jennings (2010) explains that there are three types of players who undertake the venture of crafting in a game genre more orientated towards combat. These are namely the hobbyist, the merchant and the quartermaster (Jennings: 2010). The hobbyist is the player who occasionally makes use of the raw materials acquired during his or her adventures to craft items, with no motive other than to acquire slightly better equipment than the player currently has in his/her possession. The merchant is the player who attempts to make a profit, in-world or otherwise, through the acquisition of the necessary raw materials and transforming them into an item more valuable than the sum of its parts to complete the crafting process. The quartermaster is the player who crafts items for the greater benefit of his or her guild, receiving little if any financial compensation for his or her crafting efforts, but in doing so, builds up his or her own reputation within the guild for which the player is crafting. This allows guild members more skilled in battle to concentrate on combat skills, with the knowledge that the guild's craftsmen will provide the guild with the items necessary for the survival and success of the guild as a whole.

The third and final of Camp's (2007) underlying characteristics of a structured virtual world, is that the game play revolves around the idea of levels. A level is the numerical representation of the strength of a player's avatar. Game developers award experience points for actions undertaken by a player, such as defeating an enemy or completing a quest.

Therefore the more you actively participate in combat, the more experience you accumulate and over time, this increases the level of the character. The higher the level, the greater the chance a player has of being successful in combat situations as a result of the stat increases awarded to players upon levelling up. Stats, common shorthand for statistics, are the numerical values used to indicate proficiency. While mages will have high magic attack and defence stats, the nature of their pre-defined role will dictate that they have low physical stats. Furthermore, increasing your level is necessary for progression within the world. "As players achieve higher levels of skill, the game developers make the quests more difficult and also give more powerful weapons, armour, spells, clothing, mounts and other items to the characters" (Camp, 2007: 5). The system of levels that applies to combat strength, also applies for crafting. Through repetition of the crafting process, a player hones his or her crafting skill enabling the player to produce better quality items.

2.2.3 UNSTRUCTURED VIRTUAL WORLDS

Unstructured virtual worlds, the most popular of which is *Second Life*, are similar to structured virtual worlds in many ways. The world is a persistent one, players participate in the world through the use of an online avatar and the social value a participant derives from the world matches and often surpasses that of its structured counterpart. When trying to understand what an unstructured virtual world entails, it is perhaps easiest to compare it to Camp's (2007) characteristics of a structured virtual world, and examine how it differs from the features of a structured world.

Where structured virtual worlds are concerned Camp (2007) explains that players are provided with pre-set and strongly defined roles within the story of the universe the developers have created. Unstructured virtual worlds, on the other hand, provide no pre-set role other than being an inhabitant of the online universe provided for the player. Players do not have to decide on whether they wish to assume the role of an honourable paladin or the unscrupulous thief; instead players are offered a very limited choice in the basic form of their avatar. To compensate for the lack of species and classes from which a participant can choose, players are able to customize their avatars' appearance to a much greater extent than

is permitted by most structured virtual worlds. Without the existence of pre-defined roles and character stats, players do not have to concern themselves with extensive repetition of skills in order to achieve mastery. As there is no overarching storyline to an unstructured world, there is no need for quests or non-player characters to help drive the narrative in the intended direction of the developers.

Camp (2007) indicated that item creation versus item crafting is the second underlying difference between the two types of game worlds. In a structured virtual world, the developers decide what raw materials are necessary to craft an item. These raw materials form the recipe. Once the player has the necessary raw materials to craft an item, and provided the player has the required expertise to do so, then the item can be crafted. The level of skill at which a player crafts is increased automatically through sufficient repetition of the task. In an unstructured world, the developers do not impose the restrictive nature of a recipe, instead players are capable of creating almost anything they can fathom, from real estate to motor vehicles and from fashion accessories to weapons designed for close quarters combat. The only limit is the imagination of the player. In *Second Life* this item creation system is achieved through the use of *primitives* which are the basic building blocks in the *Second Life* universe. The developers provide all participants with access to the necessary computer scripts required to create, rather than craft, virtual items, and through the use of a script designed to assist a player in understanding how to go about creating an item as well as the building blocks provided, players create items for use in the virtual world. Camp (2007) summed up the item creation system succinctly by stating that "it is like playing with LEGOs online".

The final prominent characteristic of a structured virtual world, levelling, is absent from its unstructured counterpart. As characters in unstructured virtual worlds do not possess stats, there is no need for a combat levelling system and similarly, as items are created rather than crafted, there is no need for a levelling system which relies on exclusively on repetition to ensure increased proficiency in the creation of items (Pienaar: 2008).

While player interaction is an important part of a structured game, it is not necessary. The same cannot be said for participation in an unstructured virtual world. Unstructured virtual worlds are created with the intention of facilitating interaction between the inhabitants of the world and therefore the social aspect of an unstructured virtual world is vital. Since "well over 99% of the objects in *Second Life* are user created" (Ondrejka, 2004: 10), player interaction is a crucial factor for the continued existence of unstructured worlds like *Second Life*, as without the creation and subsequent trading of these virtual items the world environment provided by the developers, would remain an empty shell.

MMORPGs with their structured virtual worlds are games, where emphasis is placed on game-play mechanics and a strong narrative. On the other hand, *Linden Labs*, the creators of the unstructured virtual world, *Second Life*, do not consider it, the virtual environment, to be a game at all (Stamper: 2007) as it lacks designated objectives and story. The developers have merely provided participants with an online environment in which they are free to express themselves as they wish without the constraints of pre-defined roles.

2.3 VIRTUAL ASSETS

2.3.1 INTRODUCTION

In both structured and unstructured virtual worlds, there are numerous ways for participants to acquire virtual assets. Virtual assets encompass a wide variety of things including virtual currency, suits of armour, space stations, entire virtual planets, rare weaponry and even the actual characters themselves. Perhaps the most common method of acquiring a virtual asset in a structured virtual world is through the process known as a loot drop. In addition to drops, players acquire goods through quest rewards, crafting (in structured games), item creation (in unstructured games), in-world trade transactions, which make use of an in-game currency and can be subdivided into trade with the non-player characters present within the game world, as well as player-to-player trade and finally, real money trade.

2.3.2 LOOT DROPS

A loot drop is any item obtained from within the environment of a structured world. The drop may arise as a result of defeating an enemy mob or by opening a treasure chest. The actual item received is determined by various factors known to the developers of the game, but is often described as random by the gaming community (WoWWiki: 2010). Loot drops are an integral part of massively multiplayer online games and anyone who has played an MMORPG, at some point is likely to have encountered a loot drop.

2.3.3 QUEST REWARDS

All modern MMORPGs revolve around the completion of quests. Fundamentally there are two categories of quests, namely story quests and side quests. Story quests are the quests that need to be completed in order for a player to be able to progress the narrative. Side quests on the other hand deviate from the main plot, doing little, if anything to help progress the plotline of a game, but enable participants in a world to develop a better understanding of the world and its lore. Both story quests and side quests can be further subcategorized, with common subcategories including kill quests, gather quests, delivery quests and escort quests. This does not mean, however, that quests are limited to these four subcategories and game developers even create quests which incorporate multiple subcategories into one. In exchange for the completion of a quest, players are usually rewarded with experience, virtual items, in-world currency or any combination of the three.

2.3.4 CRAFTING AND CREATION

Item crafting and item creation are distinguishing features of structured and unstructured virtual worlds. While crafting is a common method of obtaining virtual assets in a structured virtual world, it does not have the same influence as item creation in unstructured environments such as *Second Life*. An unstructured virtual world which places no emphasis on loot drops requires item creation for its continued existence as without user generated content the world will stagnate.

2.3.5 IN-WORLD TRADE TRANSACTIONS

As far as in-world trade transactions in structured virtual environments are concerned, the non-player character merchants provide participants with the easiest method of buying and selling virtual goods. These automated merchants are designed by game developers to be at specific locations ensuring the player always has access to them and while these non-player character merchants "buy low and sell high, they are programmed to always buy and sell, and always for a preset price" (Camp, 2007: 9), meaning that while trade with non-player character merchants may not always represent the best value for money, the prices set by these merchants create the outer pricing limits for player-to player trade.

The preset prices of the non-player character merchants creates a situation whereby the laws of supply and demand are ignored, which leads to an inefficient market, while at the same time creating loopholes which can and often are exploited for in-world financial gain. The inefficiency stems from the fact that the demand for and the supply of goods when dealing with non-player character merchants has no effect on the pricing scheme. Occasionally developers may alter the prices at which the non-player character merchants buy from and sell to players in an attempt to better balance the game, but this method is not fluid enough to have a meaningful impact. While these transactions may not always represent the best value for money, the stable pricing system can be exploited from time-to-time. This exploitation of the system is achieved through a process known as farming. Farming is the intentional and methodical obtaining of vast quantities of a particular item, either via crafting or loot drops. The single purpose of this activity is to sell the items to a non-player character merchant who is programmed to buy, regardless of the quantity. If one applied basic economic theory to the scenario, namely an increase in supply with all other factors remaining constant, this would drive down the price a player could expect to receive for the farmed items. Although monotonous, the process can be an extremely rewarding method of increasing the in-world wealth of a character. However if the process becomes too rewarding for too large a population group within the game world, to the extent that it unbalances the game itself, then the developers will need to solve the issue. The solution generally comes in the form of a patch which all players are required to download before they are able to continue playing. The patch may decrease the drop rate for the virtual asset or alternatively may decrease the

price non-player character merchants will offer a player for the item. By doing this, the developers decrease the benefit players derived from essentially exploiting the fact that non-player merchants will always buy any surplus goods that players wish to sell.

Structured virtual worlds have, since their inception, made use of non-player character merchants to facilitate in-world trade. Unstructured virtual worlds on the other hand have limited use for these non-player character merchants, as the majority of all content is user created and traded. Therefore in an unstructured virtual world you create items to trade with other players rather than to trade with non-player character merchants. This circumvents a situation whereby one party to a transaction is pre-programmed to buy and sell at specific prices, as the value of all virtual goods in an unstructured virtual world are determined by market forces.

Player-to-player trade is not limited to unstructured virtual worlds, and its implementation as an alternate method of buying and selling virtual items within structured world games helps to drive their virtual economies. The fact that prospective participants to a transaction are not restricted by preset buying and selling price constraints, allows for flexibility in the virtual market. In player-to-player trade, demand and supply forces affect the prices players can expect to pay and receive for virtual assets. This somewhat diminishes the benefit players may derive from the farming process as it has the potential to flood the market.

2.3.6 REAL MONEY TRADE

The final method of acquiring virtual assets is through the process known as real money trade. The advent of real money trade has allowed players to make a choice about how they wish to obtain an specific item. They can either spend long periods of time defeating enemies with the hope that they will eventually receive the loot drop they desire or they can purchase the specific item from another player for real world, rather than in-world, currency. As a result, there are two types of people who participate in real money trade transactions. The first type, the buyers, are generally "affluent online gamers who lack the time and patience"

(Barboza: 2005) needed to acquire the virtual asset but have the financial resources to pay someone else to do some for them. The second type, the seller, usually has substantial free time at his or her disposal and wishes to dedicate that time to generating wealth through the acquisition and subsequent sale of virtual world assets. Real money trade transactions can, according to Camp (2007), be divided into two specific and separate transactions. Firstly, two interested parties are put into contact with one another via an online auction site specifically created for the purposes of real money trade, and a money transfer is made from the buyer to the seller. The second transaction involves the two players meeting in the game world to transfer the item from the seller's inventory to that of the buyer.

Alternatively, rather than selling a particular piece of equipment, a player may choose to sell an entire character, or an account which can consist of several characters. Again this is done through the use of an online auction site, created specifically to facilitate such transactions. The value of these accounts is based on "the level of the characters being sold and the accompanying items owned by the characters" (Pienaar, 2008: 18).

2.4 REAL WORLD VALUE OF VIRTUAL ASSETS

Determining the real world value of virtual items that exist within an unstructured virtual world such as *Second Life* is a simple task. The simplicity of it stems from the fact that *Linden Lab*, the owners of *Second Life*, has set up a service known as *LindeX* which enables *Second Life* residents to freely exchange Linden Dollars (L$) for US$ and *vice versa* and brokerage fees account for 10% of the company's annual revenue (Wong: 2006). The exchange rate between these two currencies is similar to the exchange rate existing between any two real world currencies. The exchange rate fluctuates as it does in the real world, based on the amount of L$ traded for US$, and this exchange rate generally hovers around the L$260/US$ mark (Second Life: 2010). This fully functioning exchange rate system established by the owners of the virtual world is the reason why virtual asset valuation is so simple, as establishing the real world sale price of any transaction taking place within the unstructured virtual world involves applying the appropriate L$-US$ exchange rate at the time of the sale.

While official exchange rate systems for virtual environments exist, such as the one just discussed, this is the exception rather than the rule. Most structured and unstructured game worlds do not have an exchange rate system established and monitored by the developers. However, this does not mean that ascertaining the real world value of virtual assets, stemming from markets without official exchange rate systems is impossible, as unofficial exchange rate systems are inevitably established.

The fact that many game developers, including *Blizzard (World of Warcraft), NCSoft (Aion)* and *Square Enix (Final Fantasy XIV Online)* do not have a system of exchanging real world currency for virtual world currency provides an opportunity for third parties to facilitate a system if the demand for one is strong enough. As examples, the price of *World of Warcraft* gold and *Final Fantasy XIV Online* gil generally depends on the server on which a player is located (Camp: 2007) and because they are unofficial exchange systems, there are often large discrepancies in the exchange rate. You can expect to receive anywhere between 200 and 275 units of *WoW* gold per US$ (IGE: 2010), and between 6800 (IGE: 2010) and 10500 (OffGamer: 2010) units of *Final Fantasy XIV Online* gil per US$ depending on various factors such as supplier, quantity, faction and server popularity. The demand for the in-game currencies of games like *WoW* has, over the last decade, spawned an entire industry "mostly in China where labour is cheap" (Camp, 2007: 12) dedicated to accumulating in-world funds. These "gold farms" employ hundreds of thousands of people (Barboza: 2005) and by farming items, a process previously discussed, amass items for sale to non-player character merchants who although they pay little, always pay (Camp: 2007). These "harvested" funds can then be resold to people with little free time and enough surplus money to be able to spend it on acquiring virtual currency. As the in-world value of most virtual assets as well as the exchange rate between virtual world currency and US$ is easily ascertainable, this means that calculating the real world value of these virtual assets is possible. These real world values range from a few US$ for basic equipment to a couple thousand US$ for an entire character to tens and even hundreds of thousands of US$ for space stations and planets (Camp: 2007).

2.5 SUMMARY

This chapter presented the opportunity to specifically deal with matters central to the paper itself. The distinction between structured and unstructured virtual worlds was discussed, with reference to Bryan Camp's (2007) three distinguishing features of a structured virtual world, providing an underlying platform from which to highlight the ways in which these worlds differ. Only once an understanding of the world types had been provided, it was appropriate to delve into the various transactions that may result in a person acquiring virtual assets. These were loot drops, item creation, crafting, in-world transactions with non-player merchants and other players respectively and real money trade. Finally, the chapter illustrated how virtual world items have real world value and how one would go about establishing the real world value.

The fact that virtual world currency can be converted to real world currency creates the possibility that virtual assets and currency could be subject to real world taxes. Chapter three will provide insight into "gross income" in terms South African tax legislation and case law. The chapter will highlight the importance of ascertaining the "gross income" of a taxpayer, as without "gross income" a person cannot be subject to income tax. Once all relevant aspects of the "gross income" definition have been covered, an application of the South African tax legislation will be tested against transactions stemming from virtual worlds and the virtual assets they result in to establish if it is possible that such transactions would constitute "gross income".

CHAPTER 3: GROSS INCOME

3.1 INTRODUCTION

The overarching goal of this research is to establish the taxability of virtual assets obtained in structured as well as unstructured virtual environments. In order for a person to have taxable income, he or she must have "gross income" as without "gross income" there can be no normal tax. In order to establish the taxability of virtual assets and transactions stemming from virtual worlds, it is necessary to determine the "gross income" position of such assets and transactions. The purpose of this chapter is therefore, to explain the elements of "gross income" in the South African Income Tax Act. In order for a resident of the Republic of South Africa to have his or her earnings taxed, that income must meet the definition of "gross income" and as certain terms used in the definition of "gross income" are not specifically defined in legislation, relevant case law will be examined to establish what is meant by "gross income". This definition of "gross income" will be applied to the concepts of virtual world transactions and assets which were discussed in the previous chapter.

Section 5(1) of the South African Income Tax Act states that an income tax in respect of taxable income received by or accrued to in favour of a taxpayer, shall be paid annually for the benefit of the National Revenue Fund. In order to ascertain the taxable income of a taxpayer, one is required firstly to exclude from "gross income" any "amounts" that are exempt from tax in terms of section 10 and section 10A of the South African Income Tax Act in order to determine the "income" of the taxpayer and then to deduct or set off any appropriate deductions from/against the "income" of that taxpayer. This makes it evident that "gross income" is a vital component and the starting point in calculating the taxable income of a taxpayer and as a result will need to be examined.

Section 1 of the South African Income Tax Act defines "gross income", in any year or period of assessment, to mean, in the case of a resident, "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature". In the case of a non-resident however "gross income" is defined as "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." The distinction between receipts and accruals of a capital or revenue nature will not be discussed in this chapter as this chapter will treat all receipts as if they were revenue in nature. The following chapter will examine the distinction between capital and revenue receipts. This chapter will therefore present a brief introductory discussion of the other components of the "gross income" definition, before applying the principles to virtual world transactions.

From a reading of the definition of "gross income" it is evident that before one can even begin assessing what is meant by "gross income", it is important to establish when a person will be regarded as a resident for purposes of "gross income", as the research deals only with the tax consequences stemming from virtual world assets and transactions for a resident of the Republic.

3.2 RESIDENCE

3.2.1 INTRODUCTION

Prior to 2001, the Republic applied a source basis of taxation, which meant that amounts were only subject to tax (in South Africa) if they were from a South African source. However this basis of taxation was changed from source to residence for all years of assessment commencing on or after 1 January 2001. The residence basis of taxation in effect can be referred to "as the 'residence minus' system, which means that receipts and accruals of income derived by 'residents' from all sources are subject to tax, but certain limited categories of income arising from activities undertaken outside the Republic are exempt from tax" (De Koker & Williams, 2011: par.5.1). Therefore, where a person is a resident of the Republic, participation in a virtual world outside South Africa will not preclude those receipts that stem from a virtual world, from being potentially included in the "gross income" of the taxpayer.

3.2.2 NATURAL PERSONS

As far as natural persons are concerned, section 1 of the South African Income Tax Act defines a resident as any person who is:

> (i) ordinarily resident in the Republic; or (ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic - (aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and (bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment.

Therefore, apart from being "ordinarily resident", natural persons will be regarded as a resident of the Republic if they pass the physical presence test requiring the natural person to be present in the Republic for more than 91 days in total in the current year of assessment and in each of the previous five years as well as being present for more than 915 days in total in the five years prior to the current one.

Although the South African Income Tax Act refers to being "ordinarily resident" as a measure to determine the residency of an individual, it does not explain under what circumstances one would be considered to be "ordinarily resident". According to De Koker and Williams (2011: par.5.2A) the term "ordinarily resident" has "no special or technical meaning", instead it is a fact based on the enduring connection a person experiences with a single location. In *Cohen v CIR 1946 AD 174, 13 SATC 362* the court suggested that the ordinary residence of a person would be the country the taxpayer regards as home and Schreiner JA (at 371) stated that it is the place to which a taxpayer "would naturally and as a matter of course return from his wanderings". Although the court did not state whether or not it would be possible for a person to be "ordinarily resident" in more than one country at any one time, the application of the definition would indicate that a person's ordinary residence is in the country he or she regards as their primary or principle residence, meaning that ordinary residence in more than one location would not be likely. In *CIR v Kuttel1992 (3) SA 242 (A), 54 SATC 298* the taxpayer had emigrated to the United States of America in 1983 and was subsequently assessed to tax in the Republic on interest and dividends earned from 1984 to 1986. The taxpayer was of the belief that he was no longer "ordinarily resident" in the Republic and should therefore be

exempt from tax on interest and dividends, in terms of the South African Income Tax Act during that period. Upon emigration, the taxpayer "took up residence, established a home, joined a church, acquired an office, registered for social security and bought a car" (Williams, 2009: 13), all of which would seem to support the taxpayer's claim that he regarded himself as "ordinarily resident" in the United States of America rather than the Republic of South Africa. In fact, the taxpayer had few remaining ties to South Africa. His children continued their schooling in Cape Town until their completion, at which stage they too emigrated to the United States of America. Any assets that remained in the Republic remained as a direct result of exchange control regulations and not because the taxpayer continued to view the Republic as home. In the *Kuttel* case, Goldstone JA (at 305) emphasized that for a person to be ordinarily resident in a country he or she must be "habitually and normally resident here, apart from temporary or occasional absences of long or short duration", reaffirming the principle stated by Lord Denning MR (at 704c-d) in *R v Barnet London Borough Council: Ex Part Shah [1982] 1 A11 ER 698 (CA)*. As a result, the court came to the conclusion that because the taxpayer had established a new home outside the Republic he could no longer be considered to be "ordinarily resident" in the Republic following his emigration to the United States of America and therefore was not required to pay tax on interest and dividends earned between 1984 and 1986.

3.2.3 NON-NATURAL PERSONS

Persons other than natural persons, including companies, close corporations, clubs, trusts, etc. are not capable of being regarded as residents of the Republic based on ordinary residence or the physical presence test. Instead they are seen as residents of the Republic if they are incorporated, established, formed or have their place of effective management in the Republic of South Africa in accordance with paragraph (b) of the definition of resident in section 1 of the South African Income Tax Act. As the present research is concerned with individuals participating in virtual worlds and the assets and transactions that stem from these synthetic environments, the residence of persons other than natural persons is not relevant.

3.3 SOURCE

As already stated, the South African Income Tax Act was amended, so that from 1 January 2001 the Republic adopted a residence basis for tax purposes. While this means that residents are taxed on their world-wide income, non-residents are taxed, in the Republic, only on income whose source is situated within the Republic or can be deemed to be from the Republic. As this thesis only focuses on income of residents of the Republic, irrespective of whether those residents have attained their resident status through being "ordinarily resident" or passing the physical presence test, the question of source has little relevance. This is because it is only relevant to the taxing of income received by non-residents from a source whose originating cause is located in the Republic as held in *CIR v Lever Bros & Unilever Ltd 1946 AD 441, 14 SATC 1*.

3.4 THE TOTAL AMOUNT

With residence and source having been briefly examined, one can move on to the criteria necessary for an "amount" to be included in the "gross income" of a resident taxpayer, namely "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature".

In *Lategan WH v CIR 1926 CPD 203, 2 SATC 57* it was determined by the court that the income of a person, natural or otherwise, for purposes of taxation includes more than merely cash. Indeed income includes the value of every form property which would be accepted by a taxpayer in lieu of a cash payment. Therefore the "total amount" in question has a broader meaning than simply cash earned by a taxpayer. Rather, it includes cash, as well as any asset, whether corporeal or incorporeal, earned by a taxpayer. This principle was confirmed *CIR v Butcher Bros (Pty) Ltd 1945 AD 301, 13 SATC 21* and *CIR v People's Stores (Walvis Bay) Pty Ltd 1990 (2) SA 353 (A), 52 SATC* 9 where it was stressed that the word "amount" refers to anything with a money value and therefore precludes any asset where a value in monetary terms is not ascertainable. This emphasized that, provided a monetary value can be attached to an asset; there is an "amount" for "gross income" purposes. Furthermore, it should be noted that the onus lies with the Commissioner to establish the monetary value for a non-cash asset,

and should the Commissioner fail to do so, then there can be no "amount" for purposes of "gross income" (*CIR v Butcher Bros (Pty) Ltd*). While in some cases it may prove difficult to establish this "amount", that does not necessarily mean that there is no "amount".

3.5 IN CASH OR OTHERWISE

The broad meaning of "amount" is further emphasised through the use of the phrase "in cash or otherwise" in the definition of "gross income". In addition to the inclusion of cash and other assets in the "gross income" of a taxpayer, barter transactions can also be regarded as a receipt for "gross income" purposes provided the asset or service received in lieu of cash is capable of being valued in money terms and is capable of being converted into money (De Koker & Williams, 2011: par.2.16).

Taxing a non-cash amount received by a taxpayer also arose in *Stander v CIR 1997 (3) SA 617 (C), 59 SATC 212*. In this particular case, the taxpayer was employed by a Frank Vos Motors, a franchise dealership part of the Delta Motor Corporation (Pty) Ltd group, as a secretary/bookkeeper. Delta Motor Corporation awarded the taxpayer an overseas holiday valued at R14 000 for himself and his wife, which was assessed to tax in the 1990 year of assessment. It was held that in order for the prize to be taxable, it would either have to be regarded as an amount in respect of services rendered or by virtue of employment in terms of paragraph (c) of the definition of "gross income" which provides that, without limiting the scope of the definition itself, it includes "any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered or any amount received or accrued in respect of or by virtue of any employment or holding of any office". Based on the above two criteria it was held, by the court, that the amount did not constitute an "amount" for purposes of paragraph (c) of "gross income". It was contended that the prize was not awarded in respect of services rendered, nor was it by virtue of employment. These criteria were held not to have been met because the taxpayer was employed by and only rendered services to Frank Vos Motors, not Delta Motor Corporation, the company which awarded the prize. The judgment of the *Stander* case was based on two important principles. The first being that the receipt of the prize was not as a direct result of services rendered or

the holding of any office as required in terms of paragraph (c) of the definition of "gross income". The second principle was that the overseas trip awarded to the taxpayer could not be turned into money or the equivalent therefore and as a result could not be regarded as a taxable receipt. It was not until 2007, however, in *CSARS v Brummeria Renaissance (Pty) Ltd 2007 SCA 99 (RSA)*, that the second principle derived from the *Stander* judgment was held to be wrong and that "anything received otherwise than in cash must be valued objectively" (Goldswain, 2009a: 12)

The *Brummeria* case involved three taxpayer companies which, since 1988, had "been developers of retirement villages as contemplated in the Housing Development Schemes for Retired Persons Act 65 of 1988" (Williams, 2009:112). The companies in question entered into written contract agreements with persons interested in acquiring a unit in one of the retirement villages. These agreements stipulated that prospective occupants of the units would provide the companies with interest-free loans which would be used to finance the future construction of the units and in return the lender would be granted the right to a lifelong occupation free of charge in a unit in the village. The company to which the interest-free loan was made would retain ownership of the unit, but would be required to repay the loan, either upon cancellation of the agreement or the occupant's death. "The agreements with each occupier were explicit that the interest-free loans were consideration for the life rights" (Williams, 2009:112).

The Supreme Court of Appeal (SCA) held that the benefit obtained by the taxpayer companies as a result of the interest-free loans had an ascertainable monetary value, necessary for an "amount" to be included in the "gross income" of a taxpayer. The amount of the benefit received by the respective taxpayer companies could be determined objectively by applying the prime overdraft rate against the value of the interest-free loan and adjusted accordingly for any fluctuations in the prime overdraft rate. A distinction should be drawn at this point between the situation where the notional interest a taxpayer could earn on his own financial resources, had he or she invested them, and the situation where a taxpayer is granted an interest-free loan and a notional interest amount is calculated for purposes of "gross income". The SCA in the *Brummeria* case found that where an interest-free loan is granted in

return for some or other *quid pro quo*, the recipient of that loan receives an "amount" for purposes of "gross income" equal to the notional interest expense the taxpayer would have incurred in a market related transaction as the taxpayer has a "right" to that interest-free loan. Conversely, merely holding money does not give one a "right" to interest and therefore no subsequent duty to reflect the notional interest income as an "amount in cash or otherwise" for purposes of "gross income".

3.6 RECEIVED BY OR ACCRUED TO

3.6.1 INTRODUCTION

In order for an "amount", as previously discussed, to be included in the "gross income" of a taxpayer, there must either be a receipt of that "amount" or an accrual. If a taxpayer neither receives an "amount" nor has an "amount" accrue to him or her, such as notional income, then there can be no "amount" to be included in the "gross income" of the taxpayer. Once more, the words "received by" and "accrued to" are not defined in the South African Income Tax Act and as such, examination of case law is necessary to establish what is meant by these concepts.

As one might expect from the wording, there are two scenarios in which income may arise in the hands of a taxpayer, namely when the taxpayer receives the income or when it accrues to the taxpayer. In many, but not all, situations, accrual and receipt happen simultaneously. In general an "amount" will be included in "gross income" at the earlier of the receipt or the accrual of the "amount", therefore where receipt precedes accrual "gross income" arises at the date of receipt" and *vice versa*. It must be noted that the Commissioner is not permitted to include an "amount" in the "gross income" of a taxpayer upon accrual and then once more upon the corresponding receipt of the "amount".

3.6.2 RECEIVED BY

"Received by", in terms of ascertaining the "gross income" of a taxpayer, means that the consideration received, whether it be cash or a non-cash asset, must be received by the

taxpayer on his or her own behalf and for his or her own benefit. This was the decision of the court in *Geldenhuys v CIR 1947 (3) SA 256 (C), 14 SATC 249*, a case in which the taxpayer was the usufructory of a flock of sheep, and as a result of this usufructory interest, was only entitled to the "fruits" of an asset and not the asset itself (this distinction between the "fruits" of an asset and the actual asset will be dealt with at a later stage). The bare dominium holder on the other hand holds the sole rights to an asset. In the *Geldenhuys* case, the taxpayer sold the sheep (the asset) with the consent of the bare dominium holders. The Commissioner then proceeded to include the receipt of the sale in the "gross income" of the taxpayer who held nothing more than a usufructory interest in the asset and was enacting the sale on behalf of the bare dominium holders. The court deemed the Commissioner's application of what constitutes "gross income" to be incorrect, as the proceeds of the sale should have been included in the "gross income" of the bare dominium holders. This principle was further emphasised in *CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (C), 20 SATC 113* where it was held that where an agent receives cash or an asset with an ascertainable monetary value on behalf of the principal, the agent has not received an "amount" for purposes of "gross income" as it has not been received for the agent's own benefit. Rather it has been received for the monetary benefit of the principal and as such should be included in the "gross income" of the principal. In a principal-agent scenario or one involving a loan agreement, the receipt of borrowed money or money received on behalf of a principal does not fall within the definition of "gross income" as the existence of an obligation to repay immediately following the receipt of the "amount" creates a situation whereby there is no "gross income" receipt in the hands of the original recipient (De Koker & Williams, 2011: par.2.5). The notion of a benefit however, should not be considered the sole test in ascertaining whether or not there has been a receipt for purposes of "gross income" as observed by Schreiner JA in his judgment in the *Genn & Co* case (at 123) where he stated that "the presence or absence of a benefit to the taxpayer from something that passes into his possession does not provide a proper test in applying the definition of 'gross income'".

An obligation to pay over funds to the principal was present in *CIR v Witwatersrand Association of Racing Clubs 1960 (3) SA 291 (A), 23 SATC 380*, where the Association held a charity race meeting for the benefit of certain charities. Following the charity race, during which the money was collected, the Association paid over the money to the respective

charities. The Commissioner argued that the money collected during the meeting amounted to a receipt in the hands of taxpayer, in this case, the Association. The Association on the other hand argued that they were acting as an agent for the charities and as such the money should not be taxed upon their receipt of the funds. In the case that ensued, the court sided with the Commissioner, arguing that the Association was not bound by a legal obligation to pay over the funds to the charities, merely a moral obligation to do so. Therefore, it is evident that "once income has accrued to a person it forms part of his gross income and the subsequent disposal of the income by that person does not affect its nature as income in his hands" (De Koker & Williams, 2011: par.2.19).

In most situations entitlement can be regarded as a good measure of whether an "amount" has been received or not and by whom. For the most part, where a taxpayer has a physical receipt, and there is evidence that the taxpayer was entitled to the receipt of an "amount", it constitutes a receipt for the taxpayer's own benefit. But what about the situation where a taxpayer is not entitled to an "amount"? Before discussing the lack of entitlement to an "amount", it is necessary to distinguish between an "amount" that arises as a result of a fraudulent overcharging on the part of the taxpayer and an "amount" that arises from a unilateral taking by the taxpayer which confers no rights upon him or her, such as theft. The "gross income" position affected by theft was set out in the Zimbabwean High Court case of *COT v G 1981 (4) SA 167 (ZA), 43 SATC 159*. Fieldsend CJ (at 162) held that amounts which are stolen do not constitute a receipt, being a unilateral taking which "confers no rights upon the taker to the things taken". In *ITC 1624 (1996) 59 SATC 373* the court was able to distinguish between theft and fraudulent overcharging of customers during the course of the trading activities of the taxpayer. In this second situation, that of the fraud, the court held that the taxpayer did receive the money, the overcharged amount, for purposes of "gross income", because he intended to receive it as part of his business operations (De Koker & Williams, 2011: par.2.5), implying that the court reached this decision based on the observable intention of the taxpayer. The courts consideration of the intention of the taxpayer was again evident in *MP Finance Group CC (in liquidation) v CSARS 2007 SCA 71, 69 SATC 141*. In this case, the court ignored the principle laid down in *COT v G*, which merely had persuasive value being a Zimbabwean High Court case, and made it clear that there is a difference between a commercial relationship and the relationship that a taxpayer has with the *fiscus*. "The tax

consequences flow from the relationship with the *fiscus*, rather than from the commercial relationship" (Goldswain, 2009a: 23).

This distinction is also present in situations where income has been generated by illegal means, as was the case in *CIR v Delagoa Bay Cigarette Co 1918 TPD 391, 32 SATC 92*. In this case the court held that the source of income relates to the commercial relationship, whereas the taxation of "gross income" stems from the taxpayer's relationship with the *fiscus* and therefore the source is irrelevant when determining the taxability of a receipt.

In the *MP Finance Group CC (in liquidation) v CSARS* case, a woman by the name of Marietjie Prinsloo in conjunction with her family and employees made use of several business entities to operate an investment pyramid scheme from 1998 onwards. Inevitably the scheme collapsed and the business entities created solely for the purpose of the implementation of the scheme were declared insolvent. Upon order of the court, these entities were "consolidated into a single close corporation (in liquidation)," (Williams, 2009: 87) namely MP Finance CC (in liquidation). The Commissioner was of the view that this single entity was financially responsible for the tax liable by its original constituent entities and assessed MP Finance CC to income tax for the years 2000 - 2002. The liquidators objected the assessment based on the grounds that the scheme operated by the entities was illegal and as such, the investors were immediately entitled to demand repayment of their invested funds. Upon appeal, the Supreme Court of Appeal stated that Prinsloo and her co-perpetrators were well aware that the scheme was not only insolvent, but fraudulent, and that the entities established to facilitate the pyramid scheme would not be able to pay the investors as previously undertaken. This relationship between the entities and investors was the commercial relationship, distinct from the relationship the entities separately and collectively, as MP Finance CC, had with the *fiscus*. The amounts received from the investors were held by the court to qualify as "gross income" as contemplated in the South African Income Tax Act as the operators of the pyramid scheme obtained them with the intention of retaining them for their own benefit and "such amounts were therefore 'received' even if the scheme was not legally entitled to retain those moneys" (Williams, 2009: 88). Once again, the

intention of the taxpayer to receive an "amount" for his or her own benefit results in an "amount" being included in the "gross income" of that particular taxpayer.

3.6.3 ACCRUED TO

Alternatively, if an "amount" has not yet been "received by" a taxpayer, it may still be included in the "gross income" of the taxpayer if the "amount" has "accrued to" the taxpayer. In the 1926 case of *Lategan WH v CIR* case it was held by the court that "accrued to" could be best summed up to mean "entitled to". De Koker and Williams (2011: par.2.7) state that where an "amount" for purposes of "gross income" accrues to a taxpayer, that "amount" should be included in the "gross income" of the taxpayer in the year of assessment when the entitlement occurs, irrespective of the fact that the amount may only be due and payable in a later year of assessment. In *CIR v Delfos 1933 AD 242, 6 SATC 92* however, the court was divided on the meaning of "accrued to", with Wessels AJ and Curlewis AJ reaffirming the stance held in the *Lategan* case and de Villiers AJ and Stratford AJ opting to view the meaning of "accrued to" as the point in time when "an amount" is "due and payable". This created uncertainty in the Republic concerning the interpretation of the meaning of "accrued to" up until 1990.

The matter was finally settled by the decision in *CIR v People's Stores (Walvis Bay) Pty Ltd*, where customers were sold goods on credit as well as cash by the taxpayer in question, a retailer of clothing. The five judges of the appellate division unanimously held in favour of the *Lategan* ruling which meant that "accrued to" would henceforth be interpreted as the point in time when a taxpayer becomes "entitled to an amount" rather than the point in time when an "amount" becomes "due and payable". However it must be noted that mere entitlement is not sufficient to result in inclusion in the "gross income" of a taxpayer in a particular year of assessment. The taxpayer must be unconditionally entitled to an "amount", a principle which has been confirmed in *Ochberg v CIR 1931 CPD 256, 6 SATC 1* and *CIR v Mooi 1972 (1) SA 675 (A), 34 SATC 1*. Therefore if the "right" to receive a future amount is subject to conditions or stipulations, there can be no accrual as the requirement of "unconditional entitlement" has not been met. Furthermore it is important to remain mindful of the fact that

the inclusion of an "amount" in the "gross income" of a taxpayer, occurs at the earlier of receipt or accrual.

3.7 A SOUTH AFRICAN PERSPECTIVE OF GROSS INCOME IN STRUCTURED VIRTUAL WORLDS

3.7.1 INTRODUCTION

Having established that in terms of section 5(1) of the South African Income Tax Act, the "taxable income" of a taxpayer is his or her "gross income" for the year of assessment less any exemptions and deductions permitted to the taxpayer in terms of the South African Income Tax Act, this chapter also analyzed what constitutes "gross income" in the Republic. The various aspects of the "gross income" definition were evaluated with reference to appropriate case law. With this platform established, it is now possible to apply the definition of "gross income" to structured virtual worlds. In a structured virtual world, there are various ways in which a player may acquire virtual assets. These methods include loot drops, quest rewards, item crafting, in-world transactions and real money trade, all of which were explained in the previous chapter. However, before examining each of these methods of acquiring virtual assets, it is important to explain how these assets would be valued, as without an ascertainable market value, there can be no amount for purposes of "gross income".

3.7.2 VIRTUAL ASSET VALUATION

Without an ascertainable market value, there can be no amount of "gross income" and where the valuation of a receipt is required the onus rests with the Commissioner to determine the fair market value (*CIR v Butcher Bros (Pty) Ltd*). It is of interest to point out that simply because the market value of a receipt may be difficult to determine does not mean there is no value to be attached to an asset. Furthermore, simply because an asset only exists as a series of ones and zeros, that is to say it only exists in virtual reality, does not mean that no ascertainable fair market value can be attributed to the asset. In fact, every virtual asset has a real world value that can be established in some or other manner.

For most of the larger massively multiplayer online role-playing games, black markets have sprung up across the Internet offering to sell in-world currency to players who are prepared to part with real world money, providing a means to value assets in terms of the US$. Section 25D of the South African Income Tax Act provides for the determination of taxable income of amounts earned in a foreign currency. Non-player character merchants provide an in-world valuation of assets which can subsequently be used to ascertain the real world money value of assets acquired in virtual realms. Therefore, if it is assumed that US$1 is the equivalent of say roughly 250 units of WoW gold in these black markets and the Rand/Dollar exchange rate is roughly R7/US$1, then a simple calculation can determine the WoW gold/Rand exchange rate which, using the above figures, would result in an exchange rate of 35.7 WoW gold/R1. Using this exchange rate, a virtual asset valued at 5000 units of WoW gold, would have a real world value in the Republic of roughly R140. Having established how easy it is to value a virtual asset, one can now analyze the potential for "gross income" receipts which may arise through participation in a structured virtual world.

3.7.3 LOOT DROPS

3.7.3.1 INTRODUCTION

In a structured virtual world such as *World of Warcraft*, *Final Fantasy XIV Online* or *Aion*, loot drops are a common occurrence and a vital component of the game world itself. Loot can be regarded as the spoils of battle and therefore loot drops are the process by which a participant may acquire the loot. Generally speaking, a loot drop transpires through one of two methods. Firstly it may take place through the opening of a chest found within the game world and retrieving the contents of the chest. Alternatively a loot drop occurs after a participant in a structured virtual world has defeated an enemy mob. Following the conquest of an enemy the player is entitled to loot the remains of the slain foe in search of virtual assets which have a variety of potential uses. Loot drops themselves can be further divided into two separate classes. The first is a standard loot drop, where the player is entitled to retain any asset acquired on his or her adventures. The second is known as a quest drop, where the player is required to retrieve an item and return it to the quest giver in exchange for experience, virtual items and in-world currency. It is therefore evident that any person who has attempted to explore a structured virtual world for any length of time will have

encountered a loot drop in some form or another. Understanding the definition of "gross income" in the South African Income Tax Act for a resident of the Republic to be "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature", it is possible to assess the "gross income" position of assets acquired by residents through the process of loot drops. The inherent monetary value of virtual assets means that a loot drop has the potential to qualify as "gross income", "even if their owners never physically trade with these virtual items inside the virtual world or with real money" (Pienaar, 2008: 19).

3.7.3.2 ASSETS ACQUIRED FOR OWN BENEFIT

Both the *Lategan v CIR* and the *CIR v People's Stores (Walvis Bay) Pty Ltd* cases emphasized the fact that it is not just cash which is included in the "gross income" of the taxpayer. In addition to cash, an "amount", insofar as it relates to "gross income", will include any asset valued at its cash value. The inclusion of an asset in the "gross income" of a taxpayer is therefore predicated on the assumption that the asset has an objectively ascertainable monetary value. Therefore, were a taxpayer to obtain a virtual asset, which is inevitable when participating in a structured virtual world, then the fair market value of the asset acquired via a loot drop will be included in the "gross income" of that participant, provided the asset is acquired for his or her own benefit.

3.7.3.3 ASSETS ACQUIRED FOR THE BENEFIT OF A THIRD PARTY

While, more often than not, a player participating in a structured virtual world, upon obtaining an item, will have acquired it for his or her own benefit, situations will arise where the player will have actually acquired the asset on behalf of another party. The more common of the two examples of such an occurrence is through non-player character quests. Players during their travels will encounter numerous non-player character quest-givers who request the player to retrieve a particular item in return for a reward. In such a situation where an enemy mob needs to be defeated in order to obtain the loot drop that is to be returned to the quest giver, acquiring the quest item from the drop will not result in a receipt for the purposes of "gross income". This principle of receipt for own benefit was established in the

Geldenhuys case, which held that, should an "amount" be received by or accrue to a taxpayer, then the "amount" is to be included in the "gross income" of the taxpayer at the earlier of receipt or accrual, unless the "amount" has been received by or has accrued to the taxpayer for the benefit of another party. Where the benefit lies with someone other than the taxpayer, then there cannot be said to be a "receipt" for purposes of that taxpayer's "gross income", but rather the "gross income" of the taxpayer who is unconditionally entitled to the "amount" contemplated. Therefore where a player agrees to undertake a quest, one that requires the specific retrieval of a particular item, which may require the player to slay a foe, rather than one that simply requires an enemy to be defeated, then upon obtaining the item, although the player has received an asset, it was not received for his or her own benefit and therefore one cannot say that the receipt of an "amount" has occurred. That item can then subsequently be turned in by the player to the original non-player quest-giver to be rewarded with experience, virtual items, in-world currency or a combination of the three. If the reward consists of a virtual item or in-world currency, this in turn could be taxed (in terms of paragraph (c) of "gross income" as an amount received in return for a service provided to the quest-giver (discussed below).

A second, less common, means of acquiring a virtual item for the benefit of a third party could occur through accepting a "quest" from a fellow player within the game world. In such a scenario, player one would accept a request from another player, player two, to obtain a specific item for the second player in return for a reward. Where the first player accepts the proposal, then just as retrieving a particular asset for an non-player character quest would not be regarded as a receipt for own benefit. Acquiring an asset for the benefit of another player would not be regarded as "received by for the benefit of" the first player who agreed to undertake the quest. Once the item has been acquired by the first player, he or she could return to the second player and exchange the acquired quest item for the agreed upon reward (which itself could be subject to tax as an amount received for performing a service). Alternatively, player one could simply keep the item, ignoring the agreement with player two, and forego the reward offered.

3.7.3.4 OBLIGATION

3.7.3.4.1 INTRODUCTION

In the previous two paragraphs it was submitted that, provided a virtual item is acquired for the benefit of a party other than the taxpayer, then insofar as the taxpayer is concerned, there is no "receipt" for "gross income" purposes. However, merely stating that an "amount" has not been received for one's own benefit but rather for the benefit of a third party is not sufficient to convince the Commissioner that an "amount" should not be included in your "gross income" for the period of assessment under review, as was clear from the decision in the case of *CIR v Witwatersrand Association of Racing Clubs*. There needs to be a legal obligation, binding the taxpayer to hand the item over to the quest giver in return for the reward offered.

It has been shown that when participating in a structured virtual world, one can undertake quests offered by either non-player character quest-givers or fellow players. In the case of a non-player character quest giver, although you are given the opportunity to accept or decline the offer to undertake a quest, this does not amount to a legal obligation, such as a contractual agreement. This lack of a contractual obligation to an non-player character quest giver is further evidenced by the fact that most, if not all, structured world games afford participants the opportunity to abandon any previously accepted non-player character quest without negative consequences. An act of abandonment, were there to be an enforceable contractual agreement in place, would amount to a breach of that agreement. Therefore, the abandoning of a non-player character quest raises several matters that need to be dealt with.

3.7.3.4.2 OBLIGATION TO A NON-PLAYER CHARACTER QUEST-GIVER

In a situation where a participant in a structured virtual world accepts a quest-giver's request to undertake a quest that requires the retrieval of a specific item and the participant abandons the quest before even picking up the item, whether the asset has been received for own benefit or that of a third party does not come into question. The outcome of a scenario where the quest is accepted and then subsequently abandoned after the retrieval of the item necessary for completion of the quest will depend on the manner in which the structured

virtual world developers have arranged the structure of the game mechanics relating to quest items.

Consider the hypothetical situation where a non-player character quest giver has requested the player to slay a particular enemy mob and acquire a rare item. As this is a quest, the game will be structured in a way that upon slaying that particular enemy, the likelihood of obtaining the necessary item will have increased. This likelihood of acquiring a specific item is known as the "drop rate" which refers to the patterns that determine how often loot drops occur as well as the specific loot that is dropped by enemy mobs. Quests have the potential to alter the mechanics of a game by increasing the "drop rate" of a particular item from once every one hundred times when not the target of a quest to a "drop rate" of fifty percent, implying that an enemy mob will drop the required item once every two attempts. This game mechanic of increasing the "drop rate" for quest-related items ensures that players are able to progress their experience without the frustration that can accompany standard "drop rates". As a consequence of the increased "drop rates" that can accompany quests, players who value the items that drop as a result of the increased "drop rates" more than the rewards of the quest, might then be tempted to engage in the activity of "item farming". The ability to successfully farm such a quest item will depend on whether or not quest items remain in a player's inventory after a quest has been abandoned. If after the player has acquired the quest item, but prior to handing the item to the quest-giver for the reward, the player decides to abandon the quest and the game developers have locked that item specifically as a quest item, then the item will vanish from the inventory of the player. However, should the item remain in the inventory of the player, following the abandonment of a quest, then the potential has been created to farm that item.

In the first scenario, where quest items are locked and therefore item farming is not possible through the exploitation of a quest-giver whose quests can be repeatedly accepted and abandoned, items acquired through quest drops would not be acquired for own benefit. Furthermore, in such a situation, the participant in the virtual world who undertook the quest would not be "unconditionally entitled" to the asset and therefore there would be no receipt for purposes of "gross income". Players are bound by the parameters of the game, determined

by the developers of the game, to turn over the item to the non-player character quest giver in return for the quest's reward. Although there is no legal obligation to hand over the asset, the developers have ensured that the item serves no purpose to players other than as a means of obtaining the reward offered by the quest giver. In the alternate situation, where items do not vanish from a player's inventory should a quest to be abandoned, the question of obligation arises. The player who accepts and abandons a quest repeatedly after acquiring the quest item on each occasion is performing a practice known as "item farming". Items acquired in such a manner are acquired for the player's own benefit. The player is exploiting the system in order to acquire large quantities of a particular item, which one would presume he or she intended to sell either to a non-player character merchant or to fellow participants in the game world and therefore each asset would be included in the "gross income" of the taxpayer. Less obvious, insofar as obligation to a third party and the notion of acquiring an asset for one's own benefit, is the situation where a player accepts a quest that requires the retrieval of an item and completes that quest. Although the player, from the onset of the quest had every intention of handing the item to the quest giver rather than "farming", as this player views the rewards from the quest to be of greater value than the quest item itself, the player has no legal obligation to complete the quest. The player could, at any stage subsequent to the retrieval of the asset but prior to the handing over of the item to the quest giver, have abandoned the quest and kept the item. This lack of legal obligation means that the player has in fact acquired an asset for his or her own benefit and the "amount" of the virtual item will be included in the "gross income" of the participant.

3.7.3.4.3 OBLIGATION TO ANOTHER PLAYER

Previously this thesis introduced the notion of accepting to undertake a quest offered, not by a non-player character quest giver, but rather by a fellow player in the structured virtual world. In such a scenario, the "drop rates" from enemy mobs do not change as they do when a non-player character quest, which is built in to the game, is undertaken. Instead "drop rates" will remain constant therefore increasing the amount of time needed to actually acquire higher level items. This increased time would perhaps be the reason why the quest giver wishes to have another participant in the world acquire the item/s on his or her behalf, in exchange for payment. As most people view structured virtual worlds as a game and treat them as such, it

is unlikely that two parties would establish a contractual agreement for such an arrangement. Rather, they would rely on one another's word, which means that once again there would be no legal obligation to follow through, simply a moral obligation. As such, any item/s supposedly acquired for the player offering the compensation in return for item/s, could be included in the "gross income" of the participant who acquired the assets from the enemy mob/s, as the lack of legal obligation means that they would be regarded as having been acquired for his or her own benefit rather than the benefit of the third party (the person offering the reward).

Simply because most people view structured virtual worlds as a game environment, does not mean all participants do so. Some participants are well aware of the business opportunities available to them and therefore it is plausible to assume that some players may wish to have an enforceable contractual agreement in place to protect their own interests. In such a case, where there is a contractual obligation to acquire virtual assets on behalf of the second contracting party, then upon acquiring the item/s following the defeat of an enemy mob, those items will have been acquired for the benefit of a third party and therefore should not be included in the "gross income" of the participant who agreed to undertake and successfully completes the quest previously offered by the other player.

3.7.4 QUEST REWARDS

Quests are an important aspect of structured virtual worlds as they provide a means of plot development in addition to being a source of virtual asset acquisition. As stated in the previous chapter, there are a wide variety of quests which offer a wide variety of rewards ranging from experience to in-world currency, virtual sets of armour to access to new locations. These quests, as has been stated in this chapter already, can be accepted from non-player character quest givers as well as fellow players, and therefore there are two different ways to acquire virtual assets in the form quest rewards.

Where a participant in a structured virtual world completes a quest and receives a reward from either an non-player character quest-giver or fellow player in the virtual world, the player acquiring the reward for providing a service will have in all likelihood received an "amount" as contemplated in the South African Income Tax Act and as a result such compensation should be included in the "gross income" of that taxpayer in terms of paragraph (c) of the definition. Common rewards for quests include experience, virtual items, in-game currency as well as access to new locations within the game world. Virtual items and in-game currency have an easily ascertainable market value as established earlier on in the chapter, and as a result there should be no doubt concerning their inclusion in the "gross income" of a taxpayer. Experience and location access, while still valuable to the player, will prove more difficult to have a monetary value placed upon them by the Commissioner and therefore it is submitted that they would not be included in the computation of "gross income" of a player as an objective valuation does not seem plausible.

3.7.5 ITEM CRAFTING

The practice of item crafting, one fundamental to most structured virtual worlds, provides players with the opportunity to establish a large stock of virtual goods and therefore a potential source of in-world as well as real world income. As crafting is a tool so vital to one's experience in a structured virtual world, it is plausible to argue that every player in a structured virtual world actively participates in crafting in some or other way. According to Jennings (2010) and as stated in the previous chapter, there are three kinds of crafters. These are the hobbyist, the quartermaster and the merchant. The hobbyist is the social player who, while never exploiting the crafting system, understands the value of developing a crafting skill and puts this skill to use for his own personal gain. The quartermaster and the merchant are more serious than the hobbyist in their use of crafting. The quartermaster crafts goods for the benefit of his guild, increasing his standing within the ranks of the guild, whereas the merchant realises that there are financial incentives on offer through the process of item crafting.

There is an "amount" for purposes of "gross income" of a resident during a period of assessment when, excluding receipts of a capital nature, there is a "total amount, in cash or otherwise, received by or accrued to or in favour of such resident". Therefore when crafting items, those virtual assets would constitute the receipt of an "amount", provided those assets can be reliably valued, which this chapter has shown, they can. Therefore, where one ignores the possible capital nature of a receipt, the hobbyist, the quartermaster and the merchant would all be in possession of "amounts" for the purpose of "gross income" when they complete the crafting of an item. In the case of the quartermaster, the item would not have been acquired for his or her benefit, but for the benefit of the guild and would therefore not be included in ‘gross income”.

3.7.6 IN-WORLD TRADE TRANSACTIONS

3.7.6.1 INTRODUCTION

The fourth method of acquiring virtual assets is through in-world trade transactions. These transactions can take place between a player and a non-player character merchant or between two players. Trade between in-world participants and in-world merchants generally occurs in a similar manner between the two different game world types. The method used by players to trade with one another, however, varies from game to game. Regardless of how the transaction is carried out, potential "gross income" consequences arise from these in-world trade transactions.

3.7.6.2 TRADE WITH NON-PLAYER CHARACTER MERCHANTS

In every structured virtual world, almost any item acquired by a player can be sold to the myriad of merchants scattered throughout the game world. Certain items simply cannot be disposed of at all as they are regarded as "key items", items necessary for the progression of the narrative. Other items cannot be disposed of in particular ways, as a result of restrictions placed upon them by the game developers themselves. In *WoW*, for example, these are regarded as "soulbound" items which although they can be sold to non-player character

merchants at a fraction of their true value, they cannot be sold to fellow players where the restriction criteria have been met.

More important than the fact that these merchants buy and sell virtual items from and to virtual world participants, is the fact that they generally ignore the principles of supply and demand. Therefore the price they offer players for a good and the price they sell a good at, remain constant, regardless of how much they are buying and selling. These merchants are programmed by the game developers to buy low and sell high, but they will always buy and sell. The fact that they will always buy from in-world participants, creates opportunities for players to exploit this system for financial gain, whether simply in-world gain, or real world gain.

Non-player character merchants offer players the chance to realise their virtual items, trading them for in-world currency. However, if the value of these items is included in the "gross income" of a player upon acquiring an item either at the loot drop stage or the quest reward stage, then the amount received upon realisation of an item cannot be included in the "gross income" of the taxpayer, as this would mean that the "amount" is included twice in the player's "gross income".

3.7.6.3 TRADE WITH ANOTHER PLAYER

Player-to-player trade, while similar in concept to trading with a non-player character merchant, is handled differently by different game developers. Games such as *World of Warcraft* and *Aion* make use of auction houses to enable players to trade with one another. Sellers place items up for auction and prospective buyers bid on goods as they would in a similar situation outside of the game. While these auction houses provide a viable means of buying and selling, the time it takes before an auction ends can often leave impatient buyers and sellers unsatisfied. *Final Fantasy XIV Online* on the other hand does not make use of an auction house. Instead sellers can hire a "retainer", a non-player character merchant who sells goods for the player to other participants in the virtual environment. A player is able to set the

prices of goods he or she makes available, and the "retainer", effectively acting as a store front for the player, affords the player the opportunity to continue experiencing his or her adventure while still being able to sell goods. In addition to these slightly indirect means of sale and purchase, more structured virtual worlds allow players to participate in direct in-world trade transactions with fellow players.

With the variety of transaction methods available to prospective buyers and sellers, several issues are raised. The first thing to consider is why someone would wish to enter into a sale-purchase agreement with another player, when non-player character merchants, created by game developers and placed within the game world, exist to facilitate just such transactions? This can be explained through the way in which these merchants partake in trade transactions. The merchants are programmed to buy and sell all goods at specific prices which allow little room for flexibility and haggling. Suppose a player wishes to sell an item which has a value of 100 units if it were to be purchased from a non-player character merchant. If that player attempts to sell the item to the merchant, he may only receive 50units for the item. The lack of flexibility on the part of the merchant means that there is no room to haggle over the price and therefore it may not represent a good deal for the player. Fellow players on the other hand provide an opportunity for a bargain to be struck. If the seller can find a prospective buyer who is interested in the item he or she is peddling, then there is the potential for the item to be sold at an amount greater than 50 units while remaining less than the non-player character merchant's sale value of the item of 100 units, leaving both the buyer and seller happy. Secondly, it may simply be that merchants do not have specific items, which can then only be acquired through the completion of specific quests.

In such situations, the manner in which the seller acquired the asset will determine his or her "gross income" consequences for such a sale. If the asset was acquired through a "loot drop" or quest reward, then the "amount" of the asset would have been included in "gross income" of the taxpayer at acquisition rather than realisation. If the sale "amount" of a virtual asset exceeds the "amount" recognized upon acquisition of the asset, then the "amount" received upon disposal is included in the "gross income" of the taxpayer and the original value (the opening stock value in terms of section 22), is claimed as a deduction.

Similarly, if the asset was acquired through a previous in-world trade transaction with either a merchant or a fellow player, then there would have been no "amount" at acquisition and in-world realisation of the asset would result in an "amount" for the purposes of "gross income" and the cost of the asset could be deducted.

3.7.7 REAL MONEY TRADE

3.7.7.1 INTRODUCTION

While most people would be hesitant to accept that a transaction that takes place entirely in a virtual world could have possible tax consequences, transactions which merge reality with these virtual environments are far more credible as far as "gross income" and taxation are concerned. Real money trade, as the name implies, is the trade of virtual assets ranging from weapons to currency and even virtual characters for real world, rather than in-world, currency. While it has been shown that simply looting the corpse of a fallen enemy mob may conform to the South African Income Tax Act definition of "gross income", real money trade is what has attracted the attention of tax authorities the world over. When a taxpayer participates in the sale of a virtual asset, whether that asset is a sword, a space station or an entire account, that player will have realised his or her asset. The taxpayer will have received an "amount" and provided the receipt of that "amount" has been for his or her own benefit, rather than the benefit of a third party, then it is evident that there has been a receipt for the purposes of "gross income". Despite the widespread practice of real money trade, many game developers discourage and even forbid players from engaging in such an activity. Companies such as *Blizzard* explicitly state in their Terms of Service and End User Licence Agreements that real money trade for virtual assets is prohibited. However the inability of game developers to completely police the practice has meant that a virtual black market has been established to facilitate real money trade. The fact that players the world over are profiting from the sale of virtual assets, over which they hold no real rights, raises the question of the taxability of receipts from illegal sources.

3.7.7.2 PROPERTY RIGHTS OVER VIRTUAL ASSETS

Game developers have attempted to ban real money trade as they believe that players have no real world rights over the virtual assets that they accumulate in the game. End User License Agreements and Terms of Service agreements often explicitly state that all virtual assets are the property of the game developers themselves. When it comes to dealing with the income tax consequences of a real money trade transaction, where the seller is a resident of the Republic of South Africa, the issue of "rights" appears to have no significance.

If a player sells an asset over which he or she has no rights, then this would amount to fraud and would be an illegal receipt in the hands of the player. An illegal receipt can still constitute a receipt for "gross income" purposes in South Africa, however. An illegal or immoral trade does not preclude the receipts from the trade from being regarded as "gross income", rather in terms of *ITC 1789 (2005) 67 SATC 205*, it is the underlying transaction that will determine whether a receipt constitutes gross income or not. In *CIR v Delagoa Bay Cigarette Co* it was held that the legality of the source of income is immaterial. It is the taxpayer's relationship with a *fiscus*, not the commercial relationship that results in "gross income". Therefore, ignoring the question of the capital or revenue nature, proceeds that arise through real money trade, will not be excluded from the "gross income" of a taxpayer on the grounds that the seller has no real world rights over the virtual asset/s. This is because the commercial relationship is immaterial and instead, the player's relationship with the *fiscus* is the determining factor that will result in an "amount" being included in the "gross income" of the taxpayer.

3.8 A SOUTH AFRICAN PERSPECTIVE OF GROSS INCOME IN UNSTRUCTURED VIRTUAL WORLDS

3.8.1 INTRODUCTION

Having successfully applied the definition of "gross income" to situations stemming from structured virtual worlds, the same procedure can be followed in applying "gross income" to unstructured virtual worlds. Although not as numerous as their structured world counterparts,

unstructured virtual worlds do represent a large portion of the transactions that stem from virtual worlds as a whole, with *Second Life* being the dominant world at present. As was the case with structured virtual worlds, it is necessary to establish a method of valuing all virtual assets.

3.8.2 VIRTUAL ASSET VALUATION

In order for there to be an "amount" for the purposes of "gross income", there needs to be an ascertainable market value that can be attributed to an asset. In the case of the majority of structured virtual worlds, selling virtual assets for real world money is prohibited. This is because the primary function of a structured virtual world is not to facilitate trade, but rather to allow participants the opportunity to experience a hero's journey. In unstructured virtual worlds there is no hero's journey in fact there are no preset objectives and players are encouraged to express themselves in any manner they see fit. These unstructured virtual worlds seldom impose restrictions upon the sale of virtual assets. *Second Life*, for example, makes use of a fully functional exchange rate system known as the *LindeX* which facilitates the exchange of US$ for Linden$ and *vice versa*, with the exchange rate fluctuating much as it does between two real world currencies. Unlike most of the larger structured virtual game worlds where exchange rate systems are established by third parties, *Second Life's LindeX* was established and is monitored by *Linden Lab*, the creators of the virtual world, making it an official currency exchange system. The existence of this official exchange rate system makes it possible to value virtual assets in terms of real world money. The *LindeX* allows for the conversion of Linden$ to US$, and section 25D of the South African Income Tax Act, which provides for the conversion of income in a foreign currency, means that it is possible to ascertain the real world market value for each and every virtual world transaction.

3.8.3 ITEM CREATION

Virtual assets in unstructured virtual worlds are generally acquired in one of two ways. The first of these is through the process of item creation. In *Second Life* this item creation system is achieved through the use of *primitives* which are the basic building blocks in the *Second Life* universe. These *primitives* are the driving force that enables participants to create a wide

range of virtual items. Unlike the crafting system utilized in structured virtual worlds, the creation of items in *Second Life* is only limited by the respective imaginations of those involving themselves in the world. Scripts are provided to participants as a form of assistance to creation rather than a hindrance and merely serve as an example of what can be achieved. This notion of encouraging participants to be the creators of virtual items is fundamental to an unstructured virtual world. As there are no preset objectives to follow and no overarching narrative for one to become engrossed in, emphasis is placed on social interaction and item creation to drive the game world forward and keep users coming back.

Primitives afford each participant in an unstructured virtual world the opportunity to create items through a process less restrictive than the item crafting present in structured virtual worlds. But does virtual item creation result in a receipt for purposes of "gross income" in the virtual hands of the creator? While it is true that upon creation, the creator will have received an asset for his or her own benefit, the objective determination of an ascertainable market value could prove to be a stumbling block in recognizing the asset as a receipt in the "gross income" of the participant. In structured virtual worlds, when a player crafts an item, the player will easily be able to ascertain a market value for the asset. This is either done through the item interface which displays the price of the asset were it to be sold to a non-player character merchant, or through actually attempting to negotiate an in-game trade transaction with a merchant at which point the market value of the asset will be known. In unstructured virtual worlds, non-player character merchants are very rare as trade between users is emphasised as an important means of stimulating the virtual economy. As a result of the lack of developer designated merchants available to participants in unstructured virtual worlds, it is not feasible to objectively determine the market value of an asset upon creation and therefore there can be no "amount" for "gross income" purposes. Instead, this market value will present itself upon realisation of the virtual asset. Realising virtual items through sale agreements would, however, provide the necessary means to determine the ascertainable market value of a virtual item created by a participant in the virtual world.

3.8.4 IN-WORLD TRADE TRANSACTIONS

The second means of disposing of virtual assets in an unstructured virtual world is through in-world trade transactions. In-world trade transactions provide a means for participants to dispose of the virtual items that they acquired either through item creation, or through previous in-world trade transactions.

When participants in *Second Life* create a virtual item, they have acquired an asset which could potentially be included in their "gross income". This inclusion is predicated on the assumption that there is a objectively determinable market value that can be attached to the asset. In the case of virtual items whose market value is not readily available at creation, realisation through a trade agreement provides the catalyst for inclusion in "gross income". Upon the sale of a virtual item, the seller will have received an "amount" for his or her own benefit, the real world value of which is easily ascertainable. In a situation where a participant previously acquired the asset from another participant in the world rather than via asset creation, the same principle will apply. Upon sale of that item, the amount received from the buyer will constitute "gross income" in the hands of the seller. The costs incurred in the acquisition of a such disposed of assets are deductible.

As a result of the official currency exchange system present in *Second Life*, real money trade is not an issue in an unstructured world such as this. This is because the exchange system is in place to facilitate the conversion of real world money into virtual currency, ultimately circumventing the need for real money trade.

3.9 THE REVENUE OR CAPITAL NATURE OF AN AMOUNT

The final component of the definition of "gross income" in section 1 of the South African Income Tax Act was largely ignored in this chapter so as to lay a foundation as to the meaning of the term "gross income". In order to fully understand what constitutes "gross income", however, it is important to know what does not constitute "gross income" and this is where the question of capital receipts is to be introduced. The final component of the

definition in question reads "excluding receipts or accruals of a capital nature". This means that all receipts and accruals fall into one of two categories. Either they are to be treated as revenue in nature, or they are to be regarded as capital. In *Pyott Ltd v CIR 1945 AD 128, 13 SATC 121*, the court held that each and every receipt and accrual is either revenue or capital in nature and to accept the claim that a particular receipt or accrual is neither revenue nor capital would result in a "half-way house" of which Davis AJA (at 121) had no knowledge. While it has just been submitted that a single receipt or accrual cannot be non-revenue and non-capital simultaneously, that does not preclude the receipt or accrual from being apportioned between its capital and revenue elements, as was determined in *Tuck v CIR 1988 (3) SA 819 (A), 50 SATC 98*.

3.10 SUMMARY

Chapter three introduced the concept of "gross income" and its accompanying definition as set out in the South African Income Tax Act. The definition was analyzed with the aid of case law so as to accurately establish what is meant by "gross income". "Gross income" was then applied to various structured and unstructured virtual world situations to highlight the fact that "gross income" as it is presently defined can be applied to assets that only exist in virtual reality. Loot drops, quest rewards, item crafting, item creation and in-world trade transactions, in addition to real money trade, were all shown to have an ascertainable monetary value outside of the game world; each therefore represented the receipt of a "total amount, in cash or otherwise". Therefore the receipt of a virtual asset, whether a suit of armour or virtual world currency, as a result of the accompanying real world monetary value attached to such an asset, means that where one ignores the capital or revenue nature of receipts, the receipt constitutes "gross income" in the hands of participant taxpayers who acquire the asset, provided it is evident that the asset has been "received by, accrued to or in favour of" the taxpayer and for the taxpayer's own benefit.

With Chapter three having broken the definition of "gross income" into its constituent components, substantiating the notion of a taxable revenue receipt in the context of a virtual world, Chapter four will introduce the notion of a capital receipt so as to be able to focus on

the distinction between capital and revenue receipts from events relating to structured as well as unstructured virtual worlds. The principles established in the South African Income Tax Act as well as appropriate case law, will be applied to the notion of virtual transactions to establish the difference between a revenue receipt and a capital receipt in the context of these virtual environments.

CHAPTER 4: THE CAPITAL OR REVENUE NATURE OF RECEIPTS

4.1 INTRODUCTION

The previous chapter introduced the notion of taxing the receipts generated from virtual world transactions. Applying "gross income" principles within a South African context to virtual world transactions it became apparent that these transactions have real world economic and tax consequences and as such the capital or revenue nature of the receipts becomes an important issue in fully evaluating the taxation implications of transactions arising from structured and unstructured virtual worlds. This chapter will take the form of a literature review, in order to better understand the nature of receipts arising from virtual transactions. Several studies abroad as well as the Pienaar (2008) thesis have focused on the taxability of income earned in virtual worlds. After conducting a thorough literature review, however, it became evident that little research has been done to establish when such a receipt is of a capital nature and when it should be treated as revenue in nature. Although the review revealed that little insight would be obtained from previous studies, there is sufficient case law in South Africa to be able to apply the principles of the capital versus revenue distinction to transactions in both structured and unstructured virtual worlds.

Prior to 1 October 2001, taxpayers in the Republic of South Africa did not pay tax on receipts and accruals of a capital nature. As a result, taxpayers would often attempt to pass off receipts as capital rather than revenue in nature so as to avoid paying tax on these amounts. Capital gains tax was introduced in South Africa on 1 October 2001, and although capital receipts are still excluded from "gross income" they are subject to tax in terms of the Eighth Schedule to the Act and included in taxable income in terms of section 26A of the South Africa Income Tax Act. For an individual taxpayer, capital receipts are included at the rate of 25 percent of the net capital gain for the year of assessment (paragraph 10 of the Eighth Schedule). This inclusion rate increases to 50 percent of the net capital gain for the year of assessment in the case of a company. Although capital gains tax is a relatively new concept in the South African tax system, there is a wealth of case law available from the years preceding its introduction, to be applied to determine when a receipt is revenue in nature and when the receipt is capital. There are a number of both objective and subjective tests to determine whether a receipt is capital or revenue in nature and these will be discussed.

The South African Income Tax Act, in section 1, defines "gross income" in the case of a resident as, "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature". This implies that all receipts will be revenue in nature unless they are capital in nature, and therefore excluded from the "gross income" of the taxpayer. It should not be forgotten that while capital receipts are not included in "gross income" *per se*, capital gains at the appropriate inclusion rate are included in taxable income in terms of section 26A and the Eighth Schedule and certain capital receipts are deemed to be "gross income", by virtue of sub-sections of the definition. While this "if not, then" principle is easy enough to understand, the South African Income Tax Act does not define what constitutes a capital receipt, and therefore what is not a capital receipt, which means that the distinction between the two has, over the years, been decided by the courts. It is evident that there is a difference between revenue and capital receipts, but it is also important to know how to distinguish between the two. In *CIR v Visser 1937 TPD 77, 8 SATC 271* a clever analogy was found in an attempt to distinguish between receipts of a capital nature and income receipts. Maritz J said (at 276) that "'income' is what 'capital' produces," or another way of putting it is that capital is the tree and income is the fruits of that tree. When money in the form of capital is invested, the returns that investment gives rise to are the fruit, while the money invested, being the capital asset, is the tree. In the years following the *Visser* case the courts have developed several tests for establishing whether a receipt is to be considered as capital or as revenue in the hands of the taxpayer, which do not render the "tree and its fruit" principle redundant, but rather serve to reinforce the analogy.

Before these tests are discussed, it is necessary to take cognisance of the "burden of proof" as laid out in section 82 (a) to (c) of the South African Income Tax Act which stipulates that the:

> burden of proof that any amount is (a) exempt from or not liable to any tax chargeable under this Act; or (b) subject to any deduction, abatement or set-off in terms of this Act; or (c) to be disregarded or excluded in terms of the Eighth schedule, shall be upon the person claiming such exemption, non-liability, deduction. abatement or set-off, or that such amount must be disregarded or excluded, and upon hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.

Therefore, should a taxpayer wish to claim that an "amount" should be excluded from his or her "gross income" for the year of assessment it is the duty of that taxpayer to discharge the burden of proof. The onus rests with the Commissioner to ascertain a monetary value for a receipt of an amount in the form other than cash, as decided in *CIR v Butcher Bros*, but the Commissioner does not have to prove that a receipt is revenue rather than capital in nature. The courts assess the subjective as well as objective factors specific to the facts of each case, where the objective factors ignore the state of mind of the taxpayer and the subjective factors consider the intentions of the taxpayer. Ultimately this means that there is no hard and fast rule when it comes to distinguishing between a receipt that is revenue in nature and one that is of a capital nature and therefore each case must be decided on the specific merits of that particular case.

4.2 SUBJECTIVE FACTORS

4.2.1 THE GOLDEN RULE

In addition to the objective factors referred to above, subjective factors are taken into consideration by the courts when attempting to determine the nature of a receipt. The most important of these subjective factors is the intention of the taxpayer, the test regarded as "the golden rule" (De Koker & Williams, 2011: par.3.2). When attempting to ascertain whether a receipt should be treated as revenue or capital in nature, specific attention is paid to the intention of the taxpayer on the acquisition and subsequent disposal of an asset. The taxpayer's intentions *vis-à-vis* the asset are important, as what one person may consider to be a capital asset, another person may consider to be a revenue asset. An example of this is shares. One taxpayer may hold shares as an investment whereas another taxpayer may be a share dealer and he or she would hold the same shares as trading stock. Therefore the intention of the taxpayer becomes a pivotal aspect in this regard. Emphasis on the importance of the intention of a taxpayer upon the acquisition of an asset emerged in the case of *Stott v CIR 1928 AD 252, 3 SATC 253*. Generally speaking, if an asset is acquired with the intention of selling it at a profit, then the receipt stemming from that disposal will be treated as revenue in nature. Alternatively, where an asset is acquired for reasons other than resale, then upon disposal of that asset, a capital receipt arises. In order to accurately establish the nature of a receipt stemming from the sale of an asset, the intention of the taxpayer must be investigated

at the time when the asset was acquired; during the period the asset was held (there may have been a change of intention); and finally at the time of disposal.

While it remains true that the intention of a taxpayer regarding his or her assets is an important factor in determining the nature of the receipt upon disposal of those assets, intention is a subjective matter and as a result it can be problematic to ascertain the true intention of a taxpayer. What a taxpayer says is his or her intention, from acquisition through holding until disposal of an asset, may simply be a front to hide the true intention of that taxpayer. The intention of a person is his own personal plan or agenda developed in his own thoughts and his own reasoning but does not necessarily in itself determine the nature of proceeds arising from the disposal of an asset (De Koker & Williams, 2011: par.3.2). This is the subjective nature that is unquantifiable, and leaves room for manipulation on the part of the taxpayer seeking to further his or her own ends. There are however, objective factors such as the formulation of a plan, its implementation and the results that stem from its implementation, which enable the courts to draw a clearer picture of the true intention of a taxpayer, whether those intentions are investment or pursuance of a hobby, or to undertake a scheme of profit making.

4.2.2 IPSE DIXIT

The intention of a natural person is determined by his or state of mind at the time of the transaction. It therefore becomes vital to establish the state of mind in an attempt to establish the true intention of the natural taxpayer. The taxpayer's *ipse dixit* is what he or she says his or her intention was. In terms of section 82 of the South African Income Tax Act the onus is on the taxpayer to prove that an amount should be excluded from gross income. *Malan v KBI 1983 AD, 45 SATC 59* dealt directly with section 82 and the *ipse dixit* of a taxpayer. The court held that because of the burden of proof placed on a taxpayer by section 82, he would be at a tremendous disadvantage if the court did not place a heavy reliance on his *ipse dixit* and while the *ipse dixit* of a taxpayer may not necessarily be conclusive, "if a court has no reason to disbelieve his evidence and that evidence is not contradicted by objective facts," (De Koker & Williams: 2011: par.3.2) then the *ipse* dixit will be treated as conclusive and the

"amount" will be treated as capital. In deciding the merits of the taxpayer's *ipse dixit*, the courts will study the surrounding circumstances and the *ipse dixit* of the taxpayer will be tested against other evidence available.

4.2.3 SCHEME OF PROFIT MAKING

If an asset is acquired and held as an income producing asset and the asset generates a flow of revenue for the holder, then that particular asset has been acquired with the intention of holding it as a capital asset and provided no change of intention by the holder occurs prior to the disposal of the asset, then such disposal gives rise to a capital receipt. Alternatively, were a person to acquire an asset with the intention of realising the inherent value of the asset rather than its income producing potential, that is to have a speculative intention, then upon disposal of the asset, a revenue receipt will arise. In order to establish the intention of a taxpayer on acquisition of an asset it is necessary to ascertain the reason for the acquisition. In *CIR v Pick 'n Pay Employee Share Purchase Trust 1992 (4) SA 453 (A), 54 SATC 271* Tebbutt J (at 271) held that should receipts not be derived from "an operation of business in carrying out a scheme for profit making" then those receipts will be deemed to be non-revenue. The outcome of this case eases the burden of proof placed on the shoulders of the taxpayer to discharge the onus placed upon him or her in terms of section 82 of the South African Income Tax Act, as for a taxpayer to satisfy a court that he or she disposed of a capital rather than revenue asset, all that needs to be proved is that the taxpayer did not embark in a scheme of profit making.

4.2.4 DUAL INTENTIONS

If there is a situation where it can be said that a taxpayer has dual or mixed intentions with regard to an asset, then it is up to the court to ascertain the dominant intention. In *COT v Levy 1952 (2) SA 413 (A), 18 SATC 127* the court was faced with a taxpayer with dual intentions. The court held that where dual intentions exist in the mind of a taxpayer, the non-dominant intention is, while, "in contemplation and even a material factor in the general decision to buy, entirely secondary and did not operate to a substantial extent on the taxpayer’s mind" (De Koker & Williams, 2011: par.3.4) on acquisition of the asset. If no dominant intention

exists, or the taxpayer has alternative intentions in that the taxpayer is, "willing to secure a profit by reselling the asset or by using it to produce income" (De Koker & Williams, 2011: par.3.5) then the asset will be treated as a revenue asset and disposal of the asset will result in a revenue receipt.

4.2.5 CHANGE OF INTENTION

A change in the intention of the taxpayer can lead to a change in the nature of an asset held by the taxpayer. Often the intention of the taxpayer will change from originally holding an asset for investment purposes to an intention to use that same said asset in a scheme of profit making, consequently changing the nature of any receipt stemming from the disposal of that asset from capital to revenue. That is not to say, however, that it is impossible for the intention of the taxpayer to change from one of profit making through resale to one of investment. In *CIR v Richmond Estates (Pty) Ltd 1956 (1) SA 602 (A), 20 SATC 390* it was argued that selling capital assets at a profit does not automatically make the receipts from those sales, revenue in nature. Centlivres CJ, who delivered the judgment of the Appellate Division of the Supreme Court in the *Richmond Estates* case, stated (at 362) that "the fact that a taxpayer decides to sell capital assets at a profit cannot *per se* make the resulting profit subject to tax". The court held that certain properties sold by the company were originally bought for resale at a profit, but were later held as an investment, as a result of a change of intention of the company. This change of intention coupled with the view of the court that a "change of intention implies something more than a mere decision to dispose of an asset of a capital nature" (De Koker & Williams, 2011: par.3.10), resulted in the receipts on the disposal of the properties being treated as capital in nature.

In the previously mentioned case of *CIR v Stott*, the taxpayer had purchased several properties over the period of two decades with the intention of holding them as investments. One of the properties, which was originally purchased with the intention of constructing a residence on the land, was substantially larger than the taxpayer required. The property was subdivided into the residential portion and the non-residential portion. The non-residential portion was further subdivided and sold piecemeal. The taxpayer had also acquired a fruit

farm with the intention of holding it as an investment which was intended to generate income through a long-term lease agreement. This original lease agreement was cancelled following a breach on the part of the lessee and subsequently the property was re-let subject to the condition that the taxpayer might later subdivide and sell the farm, which he eventually did. The Commissioner contended that the taxpayer had, in respect of both pieces of land, changed his intention from investment to a scheme of profit making. With particular reference to the subdivided property, the court declared that the mere fact that the property was subdivided did not instantly convert the nature of the proceeds to revenue. The court was of the belief that there had been no change of intention and the taxpayer was merely exercising his right to realize his assets, the surplus residential land as well as the fruit farm, to his best advantage. In addition to being able to realize one's asset to its best advantage, it should also be noted that simply making a large profit on the sale of an asset will not automatically mean that the sale was in pursuance of a profit making scheme. There must be something more than a mere decision to sell an asset for there to be an actual change of intention. In *John Bell & Co (Pty) Ltd v SIR 1976 (4) SA 415 (A), 38 SATC 87* it was once again held that a taxpayer is entitled to realize an asset to best advantage and that the sale of an asset will not necessarily result in "gross income" unless there is evidence to prove that an asset is being treated in a manner similar to the manner in which a dealer treats his or her trading stock. Something more than mere realization to best advantage is needed. In *SIR v The Trust Bank of Africa Ltd 1975 (3) SA 652 (A), 37 SATC 87* it was emphasized that the taxability of the receipts on the sale of an asset depended upon whether the purchase, holding and sale of the asset were steps in a scheme of profit making or whether the sale constituted a fair realization of a capital asset acquired and held for purposes other than a scheme aimed at profit generation. While a change of intention may indicate a change in the character of an asset, "something more than a mere change of intention is required to effect a change in the character of the assets" (De Koker & Williams, 2011: par.3.10).

4.2.6 REALISATION AND CROSSING THE RUBICON

In the *John Bell & Co* case, mention was made of "something more" that is required that changes the taxpayer's intention to hold it as a capital asset to holding it as a revenue asset. The question of this "something more" could best be answered in *Natal Estates Ltd v SIR*

1975 (4) SA 177 (A), 37 SATC 193 which was a case concerning the sale of land. The land in question had been purchased many years previously with the sole intention of sugar cane farming. It was therefore clearly evident that the intention of the taxpayer *vis-à-vis* his land at the time of acquisition had been of a capital nature. The land was held as capital; however a change of intention occurred prior to the sale. The taxpayer adopted a method of disposal which had all the traits and features that one would expect in a business transaction of a land dealer. In the judgment Holmes JA (at 195) made the following statement with respect to the "something more":

> Important considerations include, *inter alia* …where the owner subdivides the land, the planning, extent, duration, nature, degree, organization and marketing operations of the enterprise; and the relationship of all of this to the ordinary commercial concept of carrying on a business or embarking in a scheme for profit.

On the facts of the *Natal Estates* case, the court found that in the company's conduct, whilst subdividing the land, the planning that went into the project, the large-scale nature of the project, the time taken to complete the project as well as the marketing of the company meant that it was clear that the taxpayer had "crossed the Rubicon" and had entered into a scheme of profit making. Therefore the land constituted trading stock and the receipts from the sale of the land were included in the gross income of the taxpayer. There is a limit to what a taxpayer may do in order to realize an asset to his or her best advantage. According to Goldswain (2009b: 15), when the realization of an asset has transformed into the running of a business or the taxpayer has "embarked upon a profit making scheme" then it can be said that there is more than just mere realization to best advantage taking place.

Berea West Estates (Pty) Ltd v SIR 1976 (2) SA 614 (A), 38 SATC 43 also dealt with a company that acquired land, subdivided the purchased land and then sold the pieces of land for a profit. However this land had been transferred to the company in terms of testamentary wishes. The Appellate division, upon hearing this case, decided that the taxpayer merely took the necessary steps to realize the asset and according to Holmes JA (at 62) the taxpayer did not represent a realization company conducting its affairs in a manner akin to carrying on a trade or business of making profits through the treatment and disposal of land as trading stock. The court was of the view that the manner in which the taxpayer sold the property

suggested that the realization of a capital asset to best advantage took place, rather than a crossing of the Rubicon situation as was present in the *Natal Estates* case.

4.3 OBJECTIVE FACTORS

4.3.1 NATURE OF THE RECEIPT

While certain circumstances exist where the nature of a receipt can be ascertained by considering the subjective intention of the taxpayers, there are situations where objective considerations, and not the mindset of the taxpayer are taken into account. The circumstances of the case are used to determine the nature of a receipt. *COT v Rezende Gold and Silver Mines (Pty) Ltd 1975 (1) SA 968, 37 SATC 39* is one such example of a situation where the courts made use of objective considerations to determine the nature of a receipt. The court found that the monthly payments amounted to rental and commission income, which by reason of their nature were to be treated as of a revenue nature. *ITC 1471 (1989), 52 SATC 96* involved a farm and the building sand present on that farm. In reaching its decision, the court held the building sand to be a "wasting asset" and as a result could not be considered as a "fruit" of the asset as was decided in the *Visser* case. It, the building sand, was also regarded a non-renewable resource and as such, disposal would result in a lower realisable market value of the farm itself. As a result, the building sand could not be viewed as trading stock and its subsequent sale could therefore not be treated as a revenue receipt.

4.3.2 NATURE OF AN ASSET

The nature of an asset plays an important role in determining the nature of a receipt. From an isolated viewpoint, one that ignores subjective factors such as a change of intention, the disposal of a capital asset results in a capital receipt and the disposal of trading stock will lead to a revenue receipt. The moment the fruit is severed from the tree, and the fruit in question is not a "wasting asset" the proceeds from such a disposal will constitute a revenue receipt as evidenced in *CIR v George Forest Timber Co Ltd 1924 AD 516, 1 SATC 20*. If the taxpayer has moved towards the trading of assets then regardless of whether it is a "wasting asset" or not, disposal will result in a revenue receipt.

4.3.3 REASON BEHIND THE RECEIPT

Goldswain (2009b: 7) submits that "[w]here an amount is received by a taxpayer for services rendered, such amount is considered to be income even if such amount is disguised in the form of an inheritance, gift or donation". This means that the underlying substance, rather than the outward form, of a transaction will be the distinguishing factor in ascertaining the nature of the receipt.

4.3.4 DISPOSAL IN THE ORDINARY COURSE OF BUSINESS

Where a merchant disposes of trading stock, which is considered to be a revenue asset, in the ordinary course of his or her business, then any and all receipts that stem from such disposals would be regarded as revenue in nature. Even the receipts stemming from the disposal of capital assets, disposed of in the ordinary course of running a business may be treated as revenue in nature (*CIR v Strathmore Exploration Ltd 1956 (1) SA 591 (A), 20 SATC 375*). In this case the court held that the company had in fact disposed of the mineral rights as well as the land in of the ordinary course of the business, and as a result the receipts were included in the taxable income of the company as revenue receipts.

4.3.5 OTHER OBJECTIVE FACTORS

The length of time for which the taxpayer held the asset can be a useful determinant for whether an asset was held as revenue or as capital. An asset held for a longer period of time, is more likely to been seen as a capital asset than one held for a shorter period of time. The circumstances surrounding the realisation of an asset as well as the history of the holding, for example, documentary evidence of prior offers of purchase of an asset made to the taxpayer that were subsequently declined. The frequency with which the taxpayer buys and sells assets can also be seen as a useful test in this regard. Where the taxpayer frequently buys and sells a particular type of asset, then there is the presumption that such asset is held for a scheme of profit making and will be seen by the Commissioner as a revenue asset. Where a taxpayer sells an asset, which he or she buys and sells in the ordinary course of business, the taxpayer will have greater difficulty in discharging "the onus of showing that the amount is capital"

(De Koker & Williams, 2011: par.3.2). These are a few examples of what the courts will take into consideration when a taxpayer is attempting to prove that a receipt is of a capital nature. All factors are taken into consideration by the courts so as to establish the true nature of the receipt.

4.4 FORTUITUOUS GAINS AND GAMBLING

When attempting to ascertain the nature of a receipt, there are objective as well as subjective factors which are taken into account. Over the years, courts have presided over many cases where the distinction between capital and revenue is specific to a transaction type. Examples include goodwill, Kruger rands, fortuitous gains, gambling and damages and compensation. Where virtual worlds are concerned, the most important of these are fortuitous gains and gambling and as a result it is necessary to establish how to treat receipts stemming from such transactions.

Fortuitous gains include gifts, inheritances, prizes and donations and any amount or asset received in such a manner is generally considered to be capital in nature. However that does not mean that all fortuitous gains should be treated as capital receipts. In *CIR v Strathmore Exploration Ltd* a fortuitous gain was made when the asset was inherited but the recipient subsequently embarked on a scheme of profit making and income derived was regarded as revenue in nature. With regard to gambling activities, sporadic winnings are regarded as capital receipts, however the taxpayer who conducts his gambling activities systematically and in a businesslike manner will be seen to be engaged in a scheme of profit making (De Koker & Williams, 2011: par.3.26). This principle was upheld in *Morrison v CIR 1950 (2) SA 449 (A), 16 SATC 377* where the taxpayer applied his knowledge from his primary business to generate income from gambling activities connected to horse racing and his betting winnings were held to be (at 377) the "proceeds of the employment of his wits and therefore not of a capital nature".

4.5 A SOUTH AFRICAN PERSPECTIVE OF THE NATURE OF RECEIPTS IN STRUCTURED VIRTUAL WORLDS

4.5.1 INTRODUCTION

"Gross income" is defined as "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature". The previous chapter scrutinized "gross income" in terms of South African tax legislation as well as appropriate case law but disregarded the capital or revenue nature of "gross income". The current chapter deals with the nature of receipts, for if one is to exclude "receipts and accruals of a capital nature" from “gross income” it is vital to be able to distinguish between those receipts that are revenue in nature and those that are capital in nature. With a clearer understanding of what is meant by a capital receipt, it is now possible to assess the nature of receipts stemming from structured virtual worlds.

4.5.2 LOOT DROPS

4.5.2.1 INTRODUCTION

In the previous chapter it was explained that there are two kinds of loot drops, namely the standard loot drop, where a player acquires an item for his or her own benefit and a quest drop, where the virtual items are acquired for the benefit of a third party. The third party, in such a scenario, can either be a fellow player exploring the game world or a non-player character quest-giver placed in the game world by the game developers. In Chapter two of this thesis, a loot drop was described as any item obtained from within the environment of a structured virtual world and may arise as the result of defeating an enemy mob or opening a treasure chest. The conditions under which a drop occurs are known to the developers of that particular game. Participants, however, regard the chance of acquiring specific items as a result of loot drops as random. Therefore there is an element of luck involved in a loot drop and as such, a loot drop would conform to the notion of a fortuitous gain, which has the potential to alter the nature of a receipt dependent upon how a participant to the virtual world conducts his in-world experience. The previous chapter also introduced the notion of an "obligation", and discussed the difference between a moral obligation and a legal obligation, where if one excludes the question of the nature of a receipt, a legal obligation when

acquiring an item for the benefit of a third party will not result in a "receipt" for purposes of "gross income" whereas a mere moral obligation to benefit another would result in an "receipt" for purposes of "gross income" in the hands of the player. With the question of the nature of a receipt having been introduced in this chapter, it is necessary to re-examine loot drops in the context of structured virtual worlds.

4.5.2.2 ASSETS ACQUIRED FOR OWN BENEFIT

In the previous chapter it was submitted that in situations where a participant in a structured virtual world acquires assets for his or her own benefit, then those assets are to be included in the "gross income" of that taxpayer, provided the market value of the assets can be objectively ascertained. That conclusion was arrived at, ignoring the nature of the receipts. It has already been submitted in this chapter, that there are various objective as well as subjective tests that are used by the courts to accurately determine the true nature of an asset. This would apply as well to receipts acquired by players in these virtual environments. Section 82 of the South African Income Tax Act requires the taxpayer to provide evidence that a "receipt" should not be treated as a revenue receipt in his or her own hands. The previous chapter showed that an "amount" can include non-cash items provided there is an objective method of valuing the items. Virtual assets resulting from a loot drop can be valued in an objective manner and as a result they can be treated as an "amount" for purposes of the South African Income Tax Act. Whether loot drop assets acquired for the player's own benefit are to be treated as revenue or capital in nature is dependent upon the manner in which each individual undertakes his or her game experience.

Where a player participates in a structured virtual world purely for the enjoyment he or she receives from exploring the world created by the game developers, it is unlikely that loot drops acquired by that player will be treated as revenue in nature. This player is more concerned with the hero's journey than the economic value inherent in the loot drops acquired along the way. The acquisition of these loot drops is a fundamental aspect of the structured game experience. If one were to examine the objective factors surrounding a loot drop the conclusion that one should arrive at is that a loot drop is simply a fundamental mechanic of a

game. Loot drops are an inherent part of any structured world and as a result, merely taking into account the nature of such a receipt, it is likely that a capital receipt will be recognized. Emphasis in this case should be placed on the word game. The majority of people who participate in structured virtual worlds do so for the enjoyment they derive from the game and are not motivated by the prospect of real world financial gain. Similarly, game developers do not expect the majority of players to be concerned with how to use a game, whose primary purpose is entertainment, to increase the player's wealth. Consequently, the ordinary player who acquires loot while attempting to experience the hero's journey should have his or her loot drops treated as capital rather than revenue in nature. In addition to the objective tests applied to loot drops, ordinary players could further back up a claim that loot drops should be treated as capital receipts based on the element of luck involved in their acquisition. While the outcome of a loot drop is governed by patterns and probabilities integrated into the game by the developers, they are generally regarded as random by the wider gaming community and as such an element of chance is attached to standard loot drops. As a result, loot drops can be considered to be a fortuitous gain, and their receipt in the hands of an ordinary participant in a structured virtual world results in a capital receipt, insofar as the objectively ascertained "amount" is concerned. While, the standard response to a loot drop would be to regard the item as a capital receipt, this is not the case where a scheme of profit making is undertaken, such as "item farming" which alters the perceived intention of a player from that of simply playing a game to exploitation of game mechanics for potential financial reward.

4.5.2.3 ITEM FARMING LOOT DROPS

"Item farming" is the process of repeatedly performing a task, such as slaying a respawning enemy mob, in an effort to accumulate virtual items, with the intention of amassing a vast wealth of in-game currency. Massively multiplayer online games make use of spawn timers to ensure in-world territories are repopulated with enemy mobs after specific time periods. This respawning ensures the continuous availability of enemy mobs for participants to do battle with, and ultimately acquire "loot drops". It has been stated previously that "loot drops" acquired through ordinary play would be treated as capital in nature as the element of chance attached to a "loot drop" likens it to a fortuitous gain. The same cannot be said for the player who actively farms for items in a systematic manner by exploiting either the enemy respawn

mechanics of a game or the questing system, in an effort to increase his or her in-game wealth.

The respawning of enemy mobs, while fundamental to repopulating areas of a game world, also afford players the opportunity to exploit the respawn mechanics to ensure a steady flow of loot. By continuously killing an enemy mob that drops valuable loot and that will continue to respawn *ad infinitum* at a particular spot, a player could potentially, and often does, amass vast in-game fortunes in a manner not intended by the developers of a game. The enemy mobs will continue to drop loot which can continuously be sold to non-player character merchants regardless of the quantity. Alternatively, rather than exploiting the respawn times of enemy mobs, players could potentially engage in "item farming" through the exploitation of a game's quest mechanics. This raises question of the frequency of a particular type of transaction. This objective test would seem to indicate that where a participant taxpayer conducts the practice of "item farming", the acquisition of virtual assets should be treated as revenue rather than capital receipts. "Item farming" is generally done to accumulate in-world wealth, but that does not automatically mean that a scheme of profit making has been embarked upon. It will be necessary to ascertain the perceived long term intention of the taxpayer to accurately establish whether or not the accumulation of in-world wealth assets in such a manner represents capital or revenue receipts.

In the previous chapter, it was explained that different game developers implement different quest mechanics in their games. Depending upon how the quest mechanics of a game are structured, the potential for "item farming" through exploitation of the system may arise. "Item farming" through the exploitation of quests is only possible where items obtained as part of the quest are not locked specifically into the quest. Where items are not locked into the quest and consequently do not vanish should the player abandon the quest prior to handing the item over to the original quest giver, the potential for "item farming" exists. Should a player repeatedly agree to undertake the quest and abandon it once the item has been acquired, it could be argued that the player is conducting his game play experience in a systematic manner and all loot drops achieved through this process would be regarded as revenue in nature rather than capital.

4.5.3 QUEST REWARDS

Quests, whether they are storyline quests necessary for the progression of the narrative or side quests which provide players with a diversion from the main story while building up the lore of the game world, are integral to the structured virtual world experience. In the previous chapter it was shown that certain rewards from these quests, such as in-world currency and virtual items, could potentially be included in the "gross income" of the player as they can be objectively valued. On the other hand, rewards such as experience and location access lack an ascertainable market value and, as such, are precluded from inclusion in the "gross income" of a participant to a virtual world. Knowing that there are quest rewards capable of being valued objectively in an open market, it is necessary to determine how to establish the capital or revenue nature of these rewards in terms of the South African Income Tax Act.

As quests are an integral aspect of structured virtual worlds, it follows that the rewards that flow from those quests play a vital role in the experience. When participating in a structured virtual world, a player's character increases his or her combat abilities through experience gained. Improving the combat abilities of a character as well as constantly acquiring better equipment are both important factors in enabling the progression of a narrative, as the further into the narrative a player progresses, the more difficult the enemies are to overcome. Therefore, for the majority of players, the tangible quest rewards offer an opportunity of advancing the overarching storyline. Where the reward from a quest is in-world currency, this provides the player with the means to procure equipment of a higher quality than currently owned, thus enabling the player to attempt harder quests and do battle with stronger foes. Alternatively where the reward from a quest is a piece of equipment, the player may use that piece of equipment to increase his or her physical defence, for example, which in turn increases the likelihood of being able to overcome stronger enemy mobs. Alternatively the player may sell that equipment to a merchant in order to raise the necessary in-world currency to be able to acquire a stronger piece of equipment. Therefore, the quest reward system is the way that game developers assist players in furthering their adventure, and for most players, quest rewards are nothing more than part of the story. Their acquisition of such assets would result in capital receipts as there is no systematic scheme of profit making. There are players, however, who exploit repeatable quests so as to amass in-game fortunes

through the accumulation of virtual assets and in-game currency, and subsequently as a result of this practice, would not have these assets treated as capital in nature. That is because those assets arose as a result of a systematic method, the single aim of which is to accumulate in-game currency that is likely to be sold for real world money. Therefore, where quest rewards are obtained through the exploitation of a repeatable quest, like those assets acquired from farming loot drops, those assets whose market value can be objectively ascertained can no longer be considered to be a fortuitous gain and therefore treated as capital. The intentional implementation of a systematic method of asset accumulation is akin to a scheme of profit making and any form of "farming" will result in the proceeds from those activities being treated as revenue in nature and therefore included in the "gross income" of the "farmers" in question.

4.5.4 ITEM CRAFTING

While it is true that item crafting plays an important role in the structured world experience, each of the three separate kinds of crafting roles as highlighted by Jennings (2010) need to be examined separately to be able to accurately determine the nature of receipts stemming from such activities. The hobbyist, quartermaster and merchant all craft for different reasons and these reasons determine the capital or revenue nature of an asset that is crafted by a player. The mindset of a player will determine whether a structured virtual world participant is crafting items as a hobbyist, quartermaster or merchant. Clearly this emphasizes that the subjective factor of the intention of a player plays an important role in determining the nature of an asset. Furthermore it should be noted that intentions can and do change over time. Simply because a player has in the past crafted virtual items as a hobbyist does not mean that this would remain the case indefinitely: a player could alter his or her crafting role to meet his or her needs accordingly.

The hobbyist is a player who simply undertakes item crafting because it is an aspect of the game which provides variation from constantly doing battle with enemy mobs and completing quests. This player's intention is generally just to experience all that the structured game world has to offer and he or she has little desire to exploit the crafting process. If the

intention of the developers of a structured world game is to provide an engaging experience for players, then item crafting, like "loot drops" and quests, is merely a means of providing an entertaining experience. Therefore, if one were to objectively examine item crafting as conducted by the ordinary player in the hobbyist role, assets acquired through item crafting would not be regarded as revenue in nature.

Like the hobbyist, the quartermaster, a player who crafts items for the benefit of his or her guild, would have been a role game developers would have expected to arise as a result of the implementation of item crafting mechanics. In fact, as structured virtual world games place an emphasis on guilds and teamwork towards the latter part of the narrative, the quartermaster is a role that could even said to have been encouraged by game developers. Guilds are often reliant on a select few dedicated item crafters, in the role of quartermasters, who ensure that all guild members are equipped with the best possible swords, armour and other gear. These item crafters therefore play an important part in ensuring the game developers' creative vision is achieved. As quartermasters provide a means to ensure the game mechanics of guilds run efficiently, their existence and their subsequent crafting of virtual items would objectively not be seen as a scheme of profit making, but merely part of the intended game experience. One could argue that in the absence of a service fee charged by a participant taxpayer, the quartermaster is fulfilling the role of an agent. As the quartermaster crafts not for himself, but for his or her fellow guild mates, it is plausible to argue that the quartermaster does not receive these crafted items for his or her own benefit at all. Alternatively, should a participant taxpayer, in the role of a quartermaster, craft items for his or her guild and subsequently charge the guild for services rendered, then such a reward will be included in "gross income" in terms of paragraph (c) of the South African Income Tax Act.

Where the hobbyist and the quartermaster represent the original roles intended for item crafting as envisaged by massively multiplayer online game developers, the merchant fulfils an unintended ancillary role to these original intentions, one that emphasizes a mindset of in-world profit generation. Jennings' (2010) merchant is a player who realises the potential profit making ability inherent in the item crafting mechanics of massively multiplayer online

games. This player amasses the vast quantities of the raw materials necessary to craft particular items and then in a scheme of profit making, rather than for the good of his or her fellow guild members, undertakes to craft items to be sold for in-game as well as real world currency. However, to distinguish between the hobbyist, the quartermaster and the merchant, one cannot simply view item crafting in isolation. The subsequent in-world trade, as well as real money trade transactions influence the decision to label a player as a hobbyist, quartermaster or merchant in so far as item crafting is concerned. Where it is clear that a player has crafted items with the explicit intention to sell those items to non-player character merchants or fellow players, effectively adopting the role of a merchant item crafter, those created items will be treated as revenue receipts in the hands of the player following the actual crafting process, as the merchant role is akin to a systematic scheme of profit making.

4.5.5 IN-WORLD TRADE TRANSACTIONS

The previous chapter divided in-world trade transactions into two component parts namely; trade with non-player character merchants and trade with fellow players. This was done merely to highlight the separate methods of in-world trade, as the nature of a receipt stemming from an in-world transaction is dependent upon the objective as well as subjective factors surrounding the disposal, factors which place little emphasis upon the party with whom the player transacts.

When attempting to ascertain the capital or revenue nature of receipts stemming from in-world trade transactions, whether with non-player or player characters, it is important to establish the intention of the taxpayer as well as whether or not a change of intention has taken place. In-world trade transactions involving assets acquired by a player through "loot drops" or quest rewards in the ordinary course of play will generally have no effect on the taxable income of the player. This is because those assets would previously have been regarded as capital receipts in the hands of the taxpayer at the time of acquisition of the assets. This claim, that the disposal of virtual assets through in-world trade transactions will have no effect on the taxable income of the player, is predicated on the assumption that the player has not changed his or her intention from one of merely enjoying the game as intended

by the game developers to an intention to undertake a scheme of profit making. In such a scenario, the selling of virtual assets that the player acquired via loot drops or as quest rewards for which he or she has no use, would simply be regarded as the realisation to best advantage of one's assets and would reaffirm the intention that was held upon the acquisition of those assets. They are capital assets and their disposal results in capital rather than revenue receipts. Alternatively, where a change of intention has occurred in the mindset of the taxpayer or the initial intention of the player was that of a scheme of profit making, then the disposal of virtual assets through in-world trade transactions will result in revenue receipts in the hands of the player. Where the player's initial intention was one of a scheme of profit making, the disposal will be of little consequence as the assets, upon their acquisition, would have been regarded as revenue receipts. Where there has been a change of intention and virtual items were acquired during the ordinary course of play and held as capital assets, after which the player entered into a scheme of profit making, where more than a mere realisation of assets has occurred, then the original capital receipts recognized at acquisition would at disposal be of a revenue nature. If the asset being disposed of through the in-world trade transaction was acquired through a previous in-world trade transaction, such acquisition amounts to a revenue expense. Although deductions are to be discussed in the following chapter, where a player acquires an asset through an in-world transaction in a scheme of profit making, such acquisition will constitute a revenue expense in terms of section 11(a) of the South African Income Tax Act and subsequently be treated as trading stock.

In addition to examining the intention of a taxpayer involved in an in-world trade transaction, it is necessary to consider the objective factors surrounding the transaction. The most important objective factor to consider when determining the nature of a receipt stemming from an in-world trade transaction is how the participant taxpayer acquired the asset disposed of in the trade transaction. Objective factors such as the length of the period an asset was held for and the number of times a participant enters into an in-world trade transaction, cannot be considered in isolation as these events happen on a regular basis. If the asset was acquired through the ordinary course of in-world participation and subsequently disposed of in the ordinary course of in-world participation, then such a receipt from a trade transaction would be capital in nature. Alternatively, where assets are acquired through "item farming" and subsequently disposed of through in-world trade transactions, it would appear that the

taxpayer has entered into a scheme of profit making and as such the receipts from such trade transactions could be viewed as revenue in nature.

4.5.6 REAL MONEY TRADE

Real money trade, the practice of selling virtual items, for real world currency, was examined in the previous chapter in an effort to determine the taxability of receipts stemming from such transactions. The legality of the practice has often been called into question, with game developers often citing the End User License Agreements and Terms of Service Agreements that accompany their games. Players are required to accept the terms of these agreements prior to participating in massively multiplayer online games, most of which explicitly state that the players have no real world rights over their virtual assets. Thus real money trade is the equivalent of selling another person's property for your own financial gain. The legality of the practice, however, is of little consequence for matters relating to "gross income" as receipts from such a practice are still taxable in the hands of the recipient.

The nature of a receipt determines whether an "amount" is to be included in the "gross income" of a taxpayer in its entirety in the case of a revenue receipt, or only 25% of the "amount" (in the case of an individual) as provided in the Eighth Schedule to the Income Tax Act and in section 26A of the South African Income Tax Act, for a capital receipt. Structured virtual worlds are game worlds with inherent game mechanics and strong narratives. These virtual environments provide a means of entertainment to millions of people all over the world, but the practice of real money trade, the exchanging of real world currency for virtual assets, including swords, currency and even virtual characters, creates potential real world tax implications. The accumulation of in-world assets and wealth could be seen to be part of the experience, provided the assets and wealth are not acquired through the exploitation of the game mechanics. Real money trade, if a once off occurrence could be argued to be the realisation of personal virtual assets to best advantage. Regardless of the virtual assets being exchanged for real world currency, it is important to assess the objective as well as subjective factors surrounding the transaction. Where a participant taxpayer regularly enters into real money trade transactions, it is likely that he or she is conducting a scheme of profit making.

As taxpayers are entitled to realise their assets to their best advantage, merely participating in a real money trade transaction will not be sufficient evidence to conclude that the receipt stemming from such a transaction will be revenue in nature. Participant taxpayers, when conducting real money trade, need to "cross the Rubicon" and embark upon a systematic scheme of profit making, in order for their receipts to be regarded as revenue in nature. In order to determine whether or not a scheme of profit making has taken place, the stated intention of the taxpayer should be assessed in light of the various objective considerations mention in this chapter.

4.6 A SOUTH AFRICAN PERSPECTIVE OF THE NATURE OF RECEIPTS IN UNSTRUCTURED VIRTUAL WORLDS

4.6.1 INTRODUCTION

Section 4.5 attempted to ascertain the capital or revenue nature of receipts that stem from various structured virtual world transactions. The methods of acquiring virtual assets in structured virtual worlds outnumber the methods available in their unstructured virtual world counterparts, but that does not imply that there is no need to determine the nature of receipts that stem from these unstructured world transactions. Where structured virtual worlds are considered to be games, unstructured virtual worlds like *Second Life* are considered to be less like a game and more like a social and commercial platform. The focus of these unstructured virtual worlds, then, is not merely the "entertainment of a resident but also to provide a trade opportunity and ultimately a business opportunity to residents" (Pienaar, 2008: 42). Item acquisition in an unstructured virtual world such as *Second Life* is achieved either through item creation or in-world trade transactions, with the emphasis being placed on in-world trade to ensure the continued expansion of the virtual environment and economy.

4.6.2 ITEM CREATION

Item creation is perhaps the most important element of an unstructured virtual world such as *Second Life*. Unlike structured virtual worlds, unstructured worlds have no preset goals or clearly defined objectives. There is no primary narrative used to entice people to return to the

virtual environment. *Second Life* compensates for this lack of a story-driven adventure by placing an emphasis on item creation. As the virtual world itself relies on the continued presence of community created content, item creation ensures virtual trade and a strong sense of social interaction, components vital to the virtual world's continued success. The limit to the items that a participant can create is imposed by the participant's imagination and the amount of time a person is willing to commit to creating a virtual item. Theoretically, there is no limit to what can be created in the unstructured virtual world of *Second Life*. Establishing a market value for created items in an objective manner can prove to be difficult, as argued in the previous chapter, and therefore the capital or nature of receipts will usually be determined upon realisation rather than creation of the assets.

4.6.3 IN-WORLD TRADE TRANSACTIONS

The second method of acquiring an asset in an unstructured virtual world is through in-world trade transactions with the other participants in the virtual environment. Trade between participants in *Second Life* is encouraged by the developer of the world *Linden Labs*. As players retain the intellectual property rights to the virtual items they create, no legal issues restrict the trading of these virtual assets. In the previous chapter it was submitted that virtual items in an unstructured virtual world such as *Second Life* do not have a readily ascertainable market value upon creation but rather upon their realisation through in-world trade transactions. Knowing that there is an ascertainable market value in real world terms for each and every transaction within the *Second Life* universe, means there is potential to have the "amount" stemming from those transactions included in the taxable income of the participant thus, making it necessary to determine the capital or revenue nature of these receipts.

Simply because participants are encouraged to create and trade virtual items does not necessarily mean that they have undertaken a scheme of profit making by simply participating in the virtual world. The characteristics of an unstructured virtual world such as *Second Life*, which encourage the need for participants to create and trade items, means that the objective factors that are generally taken into consideration when attempting to determine the capital or revenue nature of a receipt may not be relevant. Instead a greater focus is placed on the intention of participants in their trade dealings. As a general rule, a participant in an unstructured virtual world will focus his or her intentions either on the social or the

commercial aspect of the virtual environment. That is not to say, however, that it is impossible for an individual to focus on both aspects of the virtual world, or change his or her focus from the social to the commercial and *vice versa*. This focus represents the intention of a participant taxpayer, not only regarding the virtual environment, but the assets he or she accumulates through participation. Where a participant focuses predominantly on the commercial aspect of the world, it is plausible to assume the taxpayer's intention is one of income generation, and as a result, receipts stemming from in-world trade transactions constitute revenue.

The ease with which virtual currency in *Second Life* can be converted into real world currency and *vice versa*, through the *LindeX*, means that a greater percentage of transactions would involve real world currency than compared to structured virtual world transactions involving real world currency. As in-world trade is encouraged by *Linden Labs*, one could argue that the virtual world was created to facilitate these trade transactions, whereas structured virtual worlds are created to facilitate the telling of a narrative. Therefore by conducting in-world trade transactions a participant may not necessarily be engaging him or herself in a scheme of profit making but may just be experiencing the virtual world in a manner intended by the developers. In such a scenario it will be necessary for the individual to show that his or her actions did not amount to a scheme of profit making but were an attempt to pursue entertainment. If no scheme of profit making is evident, then the accumulation of in-world currency through in-world trade transactions as intended by the world developers would result in capital receipts. Alternatively where the intention of a participant was to enter into a scheme of profit making, regardless of whether or not the participant makes use of the *LindeX* to convert his or her in-game currency into real world currency in a practice known as "cashing out", then that participant has in fact "crossed the Rubicon" as a result of the profit making scheme by which virtual assets were sold within the unstructured virtual world and those receipts would be treated as revenue in nature. Objective factors help determine whether or not the participant taxpayer has embarked on a scheme of profit making. As a taxpayer is entitled to realise their assets to their best advantage, "cashing out" will not automatically mean that the receipts from such a procedure should be regarded as revenue in nature. The length of time between subsequent "cashing out" events and the frequency with which the participant "cashes out" point to the nature of the receipt stemming

from the procedure. Holding virtual world currency for a very short period before "cashing out", or regularly converting virtual world currency into real world currency could objectively be seen as attempts at profit generation, rather than mere realisation to best advantage.

4.7 SUMMARY

After examining, in the previous chapter, the potential "gross income" consequences that may arise through the acquisition of virtual assets and the subsequent transactions that can follow, this chapter involved a discussion of the capital or revenue nature of receipts. Capital gains tax may only have been introduced on 1 October 2001 in the Republic but a wealth of case law existed prior to this date regarding the determination of the nature of a receipt. After examining the relevant case law in the present chapter, it was applied to the methods of acquiring virtual assets and the transactions that result in their disposal in both structured as well as unstructured virtual worlds. Objective as well as subjective factors have been established by the courts as a means of ascertaining the difference between a capital receipt and one that is revenue in nature. Structured worlds, from an objective viewpoint, have their primary purpose as being to provide entertainment to players. Unstructured virtual worlds, on the other hand, provide a platform for both socialization and commercial gain, creating the potential for dual intentions on the part of participants. While objective factors do create a basic classification for the potential nature of a receipt, the subjective factors relating to the intention of a taxpayer play a significant role in the determination of the nature of a receipt. The inherent nature of items acquired through loot drops and quest rewards would dictate that their acquisition would result in a capital result, and it would take some other actions on the part of the taxpayer to alter this nature. The frequency with which a taxpayer enters into transactions and the length of time between transactions offer a strong, if inconclusive, indication of the nature of a receipts stemming from virtual world transactions. Additional factors such as the profession of the taxpayer could be taken into account when attempting to determine the nature of receipts. A taxpayer with a full-time job outside persistent virtual worlds will be less likely to have his or her receipts from these online environments treated as revenue in nature than the participant taxpayer who spends all his or her time online and derives an income solely through in-world participation and the potential transactions such

participation affords a person. It has been submitted that, in the absence of perceived intentions that would lead one to conclude that a virtual world participant is undertaking a scheme of profit making in a systematic and businesslike manner, and the objective factors surrounding the transactions do not indicate otherwise, then receipts stemming from virtual worlds should be treated as capital in nature.

Having distinguished between revenue and capital receipts from virtual worlds, enabling one to determine the "gross income" of a taxpayer, it is now possible to examine the deductibility of expenses in terms of what is generally referred to as the "general deduction formula". This "general deduction formula" is used to determine the taxable income of a taxpayer and through reference to the South African Income Tax Act, as well as appropriate case law, Chapter five will examine the deductions permitted in terms of section 11(a) as well as section 23(g) in the context of structured as well as unstructured virtual worlds.

CHAPTER 5: THE GENERAL DEDUCTION FORMULA

5.1 INTRODUCTION

The income of a taxpayer is determined by subtracting specific exempt incomes in terms of section 10 of the South African Income Tax Act from the "gross income" of that taxpayer. The determination of "gross income" has been discussed extensively in the thesis up until this point, with the nature of income highlighting the difference between revenue income and capital income. Once exempt income is subtracted from the "gross income" of a taxpayer, the taxable income of that taxpayer is calculated by deducting amounts as allowed in terms of the South African Income Tax Act. The deductions allowed in terms of section 11(a) read with section 23(g) of the South African Income Tax Act constitute what is known as the "general deduction formula" which will be covered in this chapter. Specific deductions, much like the specific exempt incomes present in section 10 of the South African Income Tax Act, will not be discussed in relation to transactions in structured and unstructured virtual worlds, as they are unlikely to be relevant

The preamble to section 11 of the South African Income Tax Act requires that, for deductions to even be considered, the person must be carrying on a "trade" and income must be derived from that "trade". Section 11 and 11(a) of the South African Income Tax Act reads as follows:

> for the purpose of determining the taxable income derived by any person from carrying on a trade, there shall be allowed as deductions from the income of such a person so derived -- (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature.

In addition to the above, what is referred to as the "general deduction formula", also includes section 23(g) of the South African Income Tax Act which exists to provide for deductions not allowed in the determination of taxable income and reads as follows, "no deductions shall in any case be made in respect of the following matters, namely -- (g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade." Before examining the two component paragraphs of the "general deduction formula" in detail, it is necessary to examine the preamble to section 11.

5.2 THE PREAMBLE TO SECTION 11

5.2.1 CARRYING ON A TRADE

The preamble to section 11 of the South African Income Tax Act is compromised of two requirements, both of which must be met in order for an amount to qualify as a possible deduction in terms of section 11. The first of these requirements is that the taxpayer must be carrying on a "trade", with the second requirement being that income is derived from the trade in question. This preamble to section 11 therefore emphasises the importance of carrying on a "trade" in order to be able to claim a deduction from "gross income" in terms of section 11(a). Section 1 of the South African Income Tax Act states that "trade":

> includes every profession, trade, business, employment, calling, occupation or venture, including the letting of property and the use or the grant of permission to use any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyrights Act, 1978 (Act No. 98 of 1978), or any other property of a similar nature.

This definition covers a wide variety of activities, however that is not to say that all income generating activities would constitute a "trade", as the term "trade", "does not embrace all activities that might produce income, for example, income in the form of interest, dividends, annuities or pensions" (De Koker & Williams, 2011: par.7.2). Ultimately, the definition of a "trade" in the South African Income Tax Act distinguishes active income generating activities from their more passive counterparts; however certain passive sources, such as rental income, are specifically included.

While section 1 of the South African Income Tax Act provided a broad definition of what constitutes a "trade", the judgment that stemmed from *Burgess v CIR 1993 (4) SA 161 (A), 55 SATC 185* implied that "carrying on a trade" should be interpreted in the broadest possible sense. It was held that one's motive for carrying on a trade is irrelevant. If a taxpayer's sole or main intention is merely to gain a tax advantage as a result of the "trade", this does not detract from the fact that a "trade" as defined is being conducted. Furthermore, the absence of risk will not preclude an activity from being regarded as a "trade". The court came to the conclusion that any profitable activity, even an activity carried out only once, rather than on a

continuous basis, could be regarded as a "trade". *ITC 1476 (1989), 52 SATC 141* established that for a trade to be present there must be an active step taken and subsequently a person, natural or juristic in nature, who invests his or her savings in interest or dividend bearing securities or shares, does not derive an income from a "trade", as these passive income sources are not viewed as the carrying on of a "trade".

The second requirement present in the preamble to section 11 of the South African Income Tax act is that income is derived from the "trade". This does not necessarily mean an activity must be profitable in order for it to be regarded as a "trade". In *Joffe & Co v CIR 1946 AD 157, 13 SATC 354* the judge defined "trade" as the earning of profits, however this contradicts the judgment in *Modderfontein Deep Levels Ltd v Feinstein 1920 TPD* which stated that it is possible for a taxpayer to carry on a non-profit making activity and have it regarded as a "trade". "The absence of a profit does not necessarily exclude a transaction from being part of a taxpayer's trade" (Goldswain, 2009d: 11), provided there is at least an expectation of acquiring a profit or a profit motive which is the driving force behind the activity. In *De Beers Holdings (Pty) Ltd v CIR 1986 (1) SA 8 (A), 47 SATC 229*, Corbett JA agreed that, earning a profit was not the sole identifier of a "trade". Where a taxpayer enters into a transaction with no intention of acquiring a profit, or further still, with the intention of incurring a loss, it is possible that such an activity could be regarded as a "trade" provided a commercial benefit was derived from the transaction. Corbett JA stated that (at 254) "the attainment of a profit is not necessarily the hallmark of a trading transaction. A trader may for commercial reasons be compelled to resell goods at a loss. Conceivably also he may elect to resell goods at a loss in order to gain some other commercial advantage for his business". Where the two requirements of the preamble to section 11, namely that a "trade" is being conducted and that a profit motive is present, are satisfied, an amount could potentially qualify as a deduction from the income of a taxpayer in terms of section 11 of the South African Income Tax Act.

5.2.2 TRADE WITHIN VIRTUAL WORLDS

Both structured and unstructured virtual worlds afford participants the potential means to conduct a "trade", using the persistent environment as a mechanism to carry on a "trade". If a virtual world participant does not meet the requirements, in accordance with the preamble to section 11 of the South African Income Tax Act, then that participant taxpayer may not claim expenditure as deductible under the "general deduction formula". As already stated, these requirements are that a "trade" is being conducted and that income is derived from the "trade" in question. In order for virtual world participation and the subsequent transactions involved to be regarded as carrying on of a "trade", there need to be active steps undertaken in order to achieve a "trade". Where virtual assets are accumulated and subsequently disposed of, as an afterthought, it is unlikely that this will be regarded as an active step in the pursuance of the conducting of a "trade". Conversely, where virtual assets are accumulated with the express intention of entering into trade transactions, it is likely that the participant taxpayer will be considered to be conducting a "trade" for purposes of the preamble to section 11 of the South African Income Tax Act. The second requirement, that income be derived from the "trade" conducted in the virtual world, alludes to the need for any activity encompassing a "trade" to have an underlying profit motive even if the trade is not profitable *per se*. Therefore, if the second requirement of the preamble to section 11 is to be met, in the context of a participant taxpayer attempting to conduct a "trade" in either a structured or unstructured virtual world, there needs to be an underlying intention to generate a profit. Absence of any such profit motive, will mean that the participant taxpayer is not carrying on a "trade" and this will result in expenditure not being permitted in terms of the "general deduction formula".

5.3 SECTION 11(a)

5.3.1 INTRODUCTION

Section 11(a) of the South African Income Tax Act which forms part of the “general deduction formula” provides for a number of requirements that must all be met before an amount will qualify as a deduction. These requirements are discussed below.

5.3.2 EXPENDITURE AND LOSSES

Section 11(a) of the Income Tax Act refers to both expenditure as well as losses without highlighting any difference between the two. Courts have debated what constitutes a "loss" and what constitutes "expenditure". There may well be no real ascertainable difference between the two but in *Joffe & Co v CIR* the court contended that while there is no obvious difference between expenditure and losses, a loss could simply refer to expenditure of an involuntary nature. In *Port Elizabeth Electric Tramway Co Ltd v CIR 1936 CPD 241, 8 SATC 13* the court considered this term "losses" to relate to losses of floating capital. In *ITC 1628 (1997), 60 SATC 33* losses were incurred in the discounting of promissory notes. The question posed to the court was whether or not the taxpayer was entitled to claim the losses as a deduction in terms of section 11(a) of the South African Income Tax Act. It was held by the court that the losses were related to the need for working capital and therefore were not to be considered to be capital in nature. It was further held that the discounting of the promissory notes was done in order to make working capital available and was related solely to the income producing activities of the taxpayer. As a result, the court came to the conclusion that the losses incurred in discounting the promissory notes were deductible in terms of section 11(a).

5.3.3 ACTUALLY INCURRED

Section 11(a) of the South African Income Tax Act makes specific use of the phrase "actually incurred" rather than "necessarily incurred", a distinction of substantial importance when considering the deductibility of "expenditure and losses" in terms of section 11(a). Whether or not an expense is necessary is regarded as immaterial. Provided the "expenditure or loss" is "actually incurred", it meets the requirement as set out in section 11(a). In order for a taxpayer to claim a deduction, the expenditure or loss which he or she wishes to deduct must have been incurred. Therefore the word incurred means that either cash was laid out or a liability has been incurred in terms of which the taxpayer owes money. In *Port Elizabeth Electric Tramway Co Ltd* Watermeyer AJP was of the opinion that incurring expenditure did not necessarily mean that it was paid. Instead, the fact that a liability has been raised was enough to constitute incurring an expense. In deciding whether or not expenditure and losses have actually been incurred, courts often examine the obligations that arise from contractual

agreements between parties. In a situation where an expense already incurred cannot be quantified, an estimate of the expense must be made based on the information available. Such a scenario must be differentiated from one where there is uncertainty over whether or not the taxpayer will pay an expense. An unconditional liability of uncertain value can be claimed as a deduction provided an estimate of the expense incurred can be made *(Edgar Stores Ltd v CIR 1988 (3) SA 876 (A), 50 SATC 81).* Alternatively, if the uncertainty revolves around whether or not the taxpayer has incurred a liability at all, no deduction may be claimed. In *Nasionale Pers Bpk v KBI 1986 (3) SA 549 (A), 48 SATC 55* the taxpayer company attempted to deduct provisions for staff bonuses. The bonuses would only be paid following compliance with certain conditions. The court held that these provisions were contingent in nature and the raising thereof did not amount to "expenditure or losses actually incurred". Where a provision is contingent, a deduction may only be claimed when the necessary conditions are met and the expense is "actually incurred" (*CIR v Golden Dumps 1993 (4) SA 110 (A), 55 SATC 198*).

5.3.4 DURING THE YEAR OF ASSESSMENT

Although not specifically stated in section 11(a) of the South African Income Tax Act, the courts have established that "expenditure and losses actually incurred" are deductible in terms of section 11(a) in the year of assessment during which the expenditure was incurred. While the general rule is that, "deductible expenditure is restricted to that incurred in the year of assessment" (De Koker & Williams, 2011: par.7.7), two statutory exceptions exist. Section 23F(1) and (2) of the South African Income Tax Act ensures that deductions claimed under section 11(a) for the acquisition of trading stock is “claimable in the same tax year as the accrual of income to the taxpayer in relation to that trading stock” (Williams, 2009: 282). Section 23H limits the amount of a deduction which may be claimed in terms of section 11(a) in any tax year to the “pro rata amount of goods actually supplied or the services actually rendered or other benefit supplied to the taxpayer in that same tax year” (Williams, 2009: 283).

5.3.5 IN THE PRODUCTION OF INCOME

In order for "expenditure and losses" to qualify as a deduction from the "income" of a taxpayer in terms of section 11(a) of the South African Income Tax Act, the "expenditure and losses" must have been incurred in "the production of income". Section 23(f) prohibits a deduction from the "income" of a taxpayer, where the "expenditure and losses" incurred resulted in exempt income, that is, an amount is included in the "gross income" of the taxpayer, but as it is exempt in terms of one of the subsections of section 10, it is not included in "income". The meaning of the phrase "in the production of income" was considered in *Port Elizabeth Electric Tramway Co Ltd* where it was held that there must be a clear link between an act giving rise to expenditure and the subsequent earning of income. This particular case involved an employee of a taxpayer transport company, who worked as a driver for the company and sustained severe injuries in an accident which resulted in the employee's death. As the accident occurred while transporting goods in accordance with the employee's duties to the company, the employee was entitled to claim compensation from the taxpayer company. The company resisted the compensation payment and the employee, prior to his death, initiated legal proceedings to obtain compensation for his injuries. Ultimately the court found in favour of the employee and the company was compelled to pay compensation to the dependents of the deceased employee. The questions raised were whether the compensation payment as well as the legal costs involved in the action amounted to expenses incurred "in the production of income". The general consensus amongst the judges was that in order for the taxpayer company to be able to successfully carry out its business operations, the employment of drivers was a necessity. Furthermore, any employment carried with it the potential to incur expenditure through compensation payments, where employees sustained injuries during the fulfilment of their employment duties. Therefore, compensation payments could be seen as an aspect of the business, "so closely connected to the income-earning act from which the expenditure arose as to form part of the cost of performing it" (De Koker & Williams, 2011: par.7.8), a necessary concomitant of business activities and as such should be regarded as deductible in terms of section 11(a). The legal costs incurred in resisting the claim for compensation, on the other hand, were not viewed as expenditure incurred "in the production of income" and as a result no deduction was permitted in terms of section 11(a). From this case stemmed two questions that need to asked and subsequently answered in order to ascertain whether expenditure was incurred "in the production of income". These are:

1. What action gave rise to the expenditure?

2. Is this action closely connected with the income-earning activities?

Provided that expenditure is incurred in pursuing an income-producing activity and it can reasonably be concluded that the expenditure resulted "in the production of income" then it follows that a deduction should be permitted in terms of section 11(a) of the South African Income Tax Act. This notion of an action resulting in expenditure and how closely related it is to income generation has, over the years, been accepted by courts as an appropriate means of establishing whether or not expenditure was incurred "in the production of income". Schreiner JA, in *CIR v Genn & Co (Pty) Ltd* stated (at 76) that: "[i]n deciding how the expenditure should properly be regarded the court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects."

The facts in *Joffe & Co* resembled those of the *Port Elizabeth Electric Tramway Co Ltd* case. The taxpayer company was engaged as reinforced concrete engineers by a construction company. An employee of the construction company was injured whilst performing his work duties on a contract held by the taxpayer company, and subsequently passed away as a result of the injuries sustained. The dependents of the deceased made a claim for compensation which the taxpayer company contested. Ultimately the taxpayer company was required to pay damages to the dependents of the deceased and incurred the costs of the case. While this case did present similarities to that of the *Port Elizabeth Electric Tramway Co Ltd* case, the two differed in that the taxpayer company was found to have been negligent and this negligence resulted in the fatal accident. Subsequent to the finding of negligence on the part of the taxpayer company, the Commissioner refused to allow the compensation payment as a deduction in terms of section 11(a) as negligence is not a necessary concomitant of running a business and therefore should not be regarded as "in the production of income". The court concurred with the argument raised by the Commissioner, stating that the damages paid by the taxpayer company did not represent an inevitable concomitant of the company's operations and as a result the expenditure was not deemed to be deductible in terms of section 11(a).

5.3.6 NOT OF A CAPITAL NATURE

The final requirement in terms of section 11(a) in order for expenditure to be deductible from the income of a taxpayer is that it should not be of a capital nature. Just as the Income Tax Act does not specifically distinguish between income of a revenue and capital nature, it does not differentiate between capital and revenue expenditure. Over the years judicial decisions have aided in the attempt to distinguish between capital and non-capital expenditure, but it has proved "impossible to extract a universal test that will provide for all situations" (De Koker & Williams, 2011: par.7.9). Centlivres JA in delivering the court's judgment in the *Sub-Nigel v CIR 1948 (4) SA 580 (A), 15 SATC 381* case stated (at 396) that it is "impossible to give a definition of what is expenditure of a non-capital nature which will act as a touchstone in deciding all possible cases". Instead several useful if inconclusive tests have been established, which emphasise the need to examine the surrounding circumstances in order to accurately ascertain whether expenditure was laid out for capital or revenue purposes.

Watermeyer CJ in *New State Areas Ltd v CIR 1946 AD 610, 14 SATC 155* separated capital expenditure into floating as well as fixed capital expenditure. He stated (at 163) that "[w]hen the capital employed in a business is frequently changing its form from money to goods and vice versa and this is done for the purpose of making a profit, then the capital so employed is floating capital". Fixed capital expenditure on the other hand involves a greater degree of permanence and such expenditure may qualify for capital allowances but will not qualify for a deduction under section 11(a) while floating capital expenditure is deductible. Watermeyer CJ went on further to differentiate expenditure incurred to perform the income-earning operations of a business from expenditure laid out for the income-earning structure of a business. In *SIR v Cadac Engineering Works (Pty) Ltd 1965(2) SA 511 (A), 27 SATC 61* reference was again made of income-earning operations and income-earning structure. Where expenditure is more closely linked to the income-earning structure of the taxpayer, rather than the income-earning operations, that expenditure will be deemed to be capital in nature.

The English case, *British Insulated and Helsby Cables Limited v Atherton 1926 AC* has provided South African courts with another test to determine whether or not expenditure is of a capital nature. This test establishes that expenditure resulting in an enduring benefit is of a capital nature. There is, however, no standard amount of time which must pass in order for an enduring benefit to be created. Rather, the circumstances before and after the expenditure was incurred should indicate as to whether a benefit should be regarded as enduring or not. Where expenditure results in an enduring benefit to an organization, being brought into existence, that expenditure will be regarded as capital rather than revenue in nature and a deduction in terms of section 11(a) will not be permitted.

5.3.7 SECTION 23(g)

Section 23 of the South African Income Tax Act provides for certain types of expenditure for which no deduction is permitted. While the majority of these provisions are unlikely to impact expenditure incurred through virtual world participation, the negative portion of the general deduction formula, namely section 23(g) should be scrutinized. This negative portion prohibits a taxpayer from claiming as a deduction in terms of section 11(a) any expenditure, to the extent to which it has not been laid out for the purposes of trade. Where expenditure has been incurred with a dual purpose, it is possible to apportion the expenditure in such a manner so as to only claim as a deduction, that part of the expenditure that was incurred for the purposes of conducting the "trade".

5.4 A SOUTH AFRICAN PERSPECTIVE OF THE GENERAL DEDUCTION FORMULA IN STRUCTURED VIRTUAL WORLDS

5.4.1 INTRODUCTION

Up to this point, the chapter has discussed the preamble to section 11 of the South African Income Tax Act as well as section 11(a) and section 23(g). While the preamble stipulates that a trade must be conducted in order for any deductions under section 11 to be claimed, section 11(a) in conjunction with section 23(g) comprise what is known as the "general deduction formula". This combination of sections sets out the requirements that must be met in order for

a deduction to be claimed against the income of a taxpayer. This general deduction formula only permits the deduction of revenue expenditure from the income of a taxpayer. Certain deductions in respect of capital expenditure deductions are provided for elsewhere in the South African Income Tax Act and will not be discussed.

In chapter three of this thesis it was shown that it is possible for "gross income" to be generated in the hands of a person through participation in structured virtual worlds. While the majority of these participants do so for purposes other than financial gain, there are those who seek to acquire monetary reward through their participation in these game worlds. Where a player participates in a structured virtual world for purposes of entertainment, no trade is being conducted and as a result no deductions may be claimed in terms of section 11(a) of the South African Income Tax Act. On the other hand, players who undertake their game play experience in a manner aimed at making a profit could be seen to be carrying on a trade in playing the game.

When examining the word "trade" as present in section 1 of the South African Income Tax Act, the definition implies that as long as there is an active undertaking in an attempt aimed at monetary gain, then a trade exists. This means that where a player in a structured virtual world undertakes to manipulate the game environment in an attempt to generate real world financial gain, then a trade will exist and the preamble to section 11 of the South African Income Tax Act will have been met. Once it has been established that a "trade" is being conducted, it is possible to examine the two types of expenditure a participant in a structured virtual world may incur, namely virtual world currency expenditure and real world currency expenditure.

5.4.2 VIRTUAL WORLD CURRENCY EXPENDITURE

5.4.2.1 INTRODUCTION

A person who participates in a structured virtual world environment will inevitably incur various in-game expenses during the course of his or her game play experience. Such

expenditure ranges from the procurement of virtual items from non-player character merchants as well as virtual world participants to service charges incurred to have pieces of equipment repaired. Virtual items, much like real world expenses, can either be regarded as revenue or capital expenditure. Determining the distinction between a these two in a structured virtual world will aid in determining what virtual world currency expenditure may be claimed as a deduction in terms of what has been referred to as the general deduction formula.

5.4.2.2 VIRTUAL ITEMS

Fundamentally, most virtual items which exist in a structured virtual world can be placed into either one of two categories. Either the virtual good is a consumption item or it is an equipment item. Consumption items, such as health potions which are used by a person to recover their player character's stamina are used once and then are depleted. Equipment items on the other hand are used on a more permanent basis as they are used by the player and deteriorate over time through usage, rather than disappearing from the player's inventory after a single use.

In order for deductions to be claimed against the income of a taxpayer in terms of the general deduction formula, the preamble to section 11 requires that there be a "trade" conducted by the taxpayer wishing to offset expenditure against his or her income. This requirement of a trade is important in the context of a structured virtual world as there is a distinction between a player who participates in the game environment for recreational purposes and a player who participates in the game environment with profit generation as his or her ultimate goal. Where a player participates in a structured virtual world, in the manner intended by the game's developers, then the player will not be conducting a "trade" and no expenditure will be deducted by that taxpayer in terms of section 11 of the South African Income Tax Act. Alternatively, where a player conducts his game play experience in a manner directly aimed at acquiring real world currency through an active scheme of profit making, then the requirement of the preamble to section 11 will have been met as the player is conducting a trade as defined. In such a situation, where the preamble to section 11 has been met, then it is

possible to examine the potential for the deductibility of expenditure in terms of section 11(a) which stipulates that deductions are permitted where "expenditure and losses have actually been incurred in the production of the income, provided such expenditure and losses are not of a capital nature".

Therefore, when treating participation in a structured virtual world as a hobby, the preamble to section 11 of the South African Income Tax Act will prevent any deductions being claimed against the income of that taxpayer. When a structured virtual world is used as a gateway to the pursuance of a profit making scheme, and the requirement of the preamble to section 11 is met, then section 11 introduces further requirements that must be met in order for any deductions to be claimed.

When purchasing a virtual item that is either a consumption item or an equipment item, the purchaser will have incurred an actual virtual "expenditure or loss" as virtual currency would have been exchanged for the virtual item. Furthermore that "expenditure or loss" will have been "actually incurred" by the purchasing player character regardless of whether the purchase was made with virtual currency or on credit, provided the item was purchased by the purchasing party for his or her own benefit, rather than acting as an agent on behalf of a third party. The third requirement of section 11(a) is that any expenditure or losses actually incurred by a participant in a structured virtual world should be incurred "in the production of income". A player who conducts his entire game play experience in a manner that indicates a planned scheme of profit making, would surely have his or her expenditure laid out for virtual items, whether consumption items or equipment items, treated as "in the production of income" and consequently such expenditure could be deductible against his or her income. Where a player has dual intentions, however, it is likely that one intention will be overwhelmingly dominant and that intention on the part of the participant should be used to determine whether the aim of the player is to treat the game as a hobby or as a means to acquire real world currency.

The final requirement of section 11(a) is that expenditure must not be "of a capital nature". Earlier, this chapter made reference to the income-earning operations and income-earning structure of a business as a means of differentiating between capital and revenue expenditure, as well as the notion of an enduring benefit being derived from expenditure. When comparing consumption items to equipment items it is clear that expenditure laid out on consumption items would be regarded as part of the income-earning operations of a player and expenditure laid out on equipment items would fall under income-earning structure. This would therefore imply that consumption item expenditure would be regarded as revenue expenditure whereas equipment item expenditure would be seen as capital expenditure. This claim is further supported, if one considers the idea of an "enduring benefit". Although there is set period of time for which a benefit should endure for it to be considered to be an enduring benefit, the procurement of an equipment item could well be viewed as expenditure with an inherent enduring benefit to a participant in a structured virtual world. As consumption items are “single use” items, they clearly grant no "enduring benefit" to the purchaser and should be treated as revenue expenditure. Equipment items on the other hand offer a continual benefit to a person participating in a structured virtual world and as a result, expenditure laid out on such virtual items would be seen to have an "enduring benefit" and such expenditure would be capital in nature. As a result, such expenditure would not be deductible in terms of section 11(a) of the South African Income Tax Act, but there are various provisions in the South African Income Tax Act that are set aside specifically to deal with allowances for capital expenditure deduction. Of particular interest is section 11(d) which allows as a deduction, expenditure incurred in the repair and maintenance of capital assets.

5.4.2.3 SECTION 11(d)

Expenditure incurred in the repair and maintenance of business assets do not qualify as a deduction in terms of section 11(a) and the "general deduction formula" as such expenditure is regarded to be of a capital nature. Section 11(d) of the South African Income Tax Act, however, allows as a deduction "expenditure actually incurred during the year of assessment on repairs of property occupied for the purpose of trade or in respect of which income is receivable". While the South African Income Tax Act does not define what constitutes a

repair, the following guidelines as to its meaning were established in *CIR v African Products Manufacturing Co Ltd 1944 TPD 248, 13 SATC 164*:

- a repair is considered to be restoration by renewal or replacement of a constituent part of the whole;

- the materials used in the repair need not be identical to the materials originally used;

- repairs differ from improvements and renewals encompass major reconstruction while improvements aim at creating a better quality asset;

- an improvement of an asset results in a better quality asset which has the potential to improve income earning capacity.

In order for repair expenditure to be required, it is necessary that the asset has been damaged or deteriorated and the repairs indicate the intention of the taxpayer to return the asset to its original state and condition. Equipment items in structured virtual worlds provide an "enduring benefit" to participant taxpayers meaning they constitute capital assets and as a result, section11(d) of the South African Income Tax Act would be applicable in situations where virtual world currency expenditure is incurred in the repair and maintenance of such assets.

5.4.2.4 VIRTUAL SERVICES

Virtual currency expenditure can also extend beyond virtual items into virtual services. The most common of these virtual services are provided by non-player character merchants who are able to repair a player character's equipment for a fee. The need for repair stems from the fact that equipment items deteriorate over time through use, with greater deterioration resulting in a lowering of the inherent statistics of the piece of equipment. For example a greatly deteriorated sword will do less physical damage to enemy mobs than a similar sword which has undergone zero deterioration. Regular maintenance of equipment items, through repair services offered by non-player character merchants, ensure these items remain in optimum condition and ultimately grant player characters the full benefit of having them. In terms of section 11(a) such repair service expenditure would meet the requirements of "expenditure and losses, actually incurred, in the production of income" for any in-world

participant who has undertaken a systematic scheme of real world profit making. Once more however, such expenditure will not comply with section 11(a) on the grounds that it is capital in nature. This conclusion is based on the assumption that equipment items are treated as capital expenditure at the point of purchase and subsequent maintenance expenditure of these items is incurred in pursuance of an "enduring benefit". Therefore, no deduction of service expenditure laid out for the repair of equipment items would be permitted in terms of section 11(a) but qualifies for a deduction under section 11(d), the requirements of which were discussed in section 5.4.2.3 of the thesis.

As expenditure laid out for equipment items and the service fees incurred by players when repairing their equipment is regarded as capital in nature, it is not necessary to apply the negative portion of the "general deduction formula" to them. Section 23(g) of the Income Tax Act must however, be applied to expenditure laid out on consumption items by structured virtual world participants who conduct their game play experience in a manner aimed at generating real world financial gain. Section 23(g) precludes a taxpayer from claiming as a deduction any expenditure to the extent that it is not specifically laid out for the purposes of his or her "trade". Therefore, should a structured virtual world participant divide his game play experience into a hobby portion and an income generating portion, no revenue expenditure incurred in the pursuance of his or her hobby will be permitted as a deduction from his or her income. Instead, only the revenue expenditure incurred when profit making is the player's aim will be deductible in terms of the "general deduction formula".

5.4.3 REAL WORLD CURRENCY EXPENDITURE

5.4.3.1 INTRODUCTION

In addition to expenditure that a person may incur in-game while participating in a structured virtual world, there are also various real world expenditures that should be taken into account in so far as the "general deduction formula" is concerned. Such expenditure includes the hardware and software required to ensure access to a structured virtual world as well as the subscription fees necessary for continued participation in the game world.

5.4.3.2 HARDWARE

Participation in a virtual world requires that the necessary infrastructure be in place on the part of prospective participant. By infrastructure is meant the appropriate hardware that must be in place. Hardware primarily refers to the platform from which a massively multiplayer online game may be played. The majority of these massively multiplayer online games require a *Windows* operating system in order to function, implying that a computer, laptop or desktop, is a necessity. In certain circumstances, these massively multiplayer games are accessible through console gaming systems such as *Sony's PlayStation3* or *Microsoft's Xbox360.* In addition to the gaming platform, an active internet connection is necessary to connect a participant to the game server. This internet connection can either be achieved through a wired digital subscriber line or through a wireless network connection. Regardless of the combination that provides a prospective participant to a structured virtual world with a means of access, it is evident that expenditure must be laid out on hardware as a starting point for access to a structured virtual world.

As with virtual world currency expenditure, the requirements of the preamble to section 11, section 11(a) and section 23(g) need to be met in order for a deduction to be claimed against the income of a taxpayer under the "general deduction formula". The preamble to section 11 dictates that in order for deductions to be claimed against income, it is necessary for the taxpayer to be conducting a trade as defined, meaning that there needs to be some or another active step in the pursuance of financial gain. The virtual world participant who views these structured virtual realms as entertainment will therefore not meet the requirement set out in the preamble to section 11. Players, who prioritize financial gain over entertainment, provided they can prove that active steps have been taken in realising their goal of financial gain through the video game, will meet the preamble's requirement.

With the preamble having been satisfied, players conducting a trade will have their expenditure scrutinized in terms of section 11(a) of the South African Income Tax Act. These expenditures have already been discussed. The gaming platform through which participation in a structured virtual world is achieved is the first of these real world currency expenditures

to be considered. Regardless of the type of platform used, players who gear their game play experience towards the attainment of real world financial gain are certain to "actually incur" real world "expenditure and losses in the production of income". For deduction in terms of the "general deduction formula", it is necessary to distinguish capital expenditure from its revenue counterpart as expenditure of a capital nature is not permitted as a deduction in terms of section 11(a). As was the case with virtual world currency expenditure, the distinction between the two can be determined using the test established in *New State Areas Ltd* and *Cadac Engineering Works (Pty) Ltd* of differentiating income-generating operations from income-generating structure, as well as the test of an "enduring benefit" referred to in *British Insulated and Helsby Cables Limited v Atherton*. The gaming platform as well as the modem used to enable internet connectivity would constitute expenditure of a capital nature as it represents the income-generating structure which provides an "enduring benefit" to the taxpayer who participates in structured virtual worlds for the purpose of monetary gain. This conclusion that this expenditure gives rise to an "enduring benefit" stems from the fact that such pieces of hardware are likely to be long-term expenditure on the part of the participant, not to be incurred regularly. As a result of the "enduring benefit" granted to a taxpayer from such hardware purchases, no section 11(a) deduction would be permitted and any potential deduction claim would have to be based on the specific sections providing for capital allowance deductions as set out in the South African Income Tax Act.

Other expenditure also falling under the category of hardware that would form part of the income-generating structure of a player's participation in a structured virtual world would be the digital subscriber line rental in the case of participants with a wired network connection and the data packages offered by internet services providers in the case of both wired and wireless network connections. However, unlike a gaming platform or a modem used to achieve access to the internet, line rental and data fees are generally paid on a monthly basis and could be more closely linked to the income-generating operations rather than structure of a taxpayer's "trade". As a result, such expenditure is more likely to be viewed as revenue in nature and as a result meet the criteria of "not of a capital nature" as set out in section 11(a) of the South African Income Tax Act. Therefore such expenditure could then have the negative portion of the general deduction formula, section 23(g), applied to it to determine the extent of the deductions permitted. Section 23(g) as previously stipulated, limits any potential

deduction claim to the expenditure specifically laid out for the purposes of "trade". As it is unlikely that a participant taxpayer would use his or her internet connection entirely for the purposes of generating income through the exploitation of the structured virtual world assets, it would not be possible for a person to claim their entire monthly expenditure incurred on line rental and data packages as a deduction against their income. Section 23(g) does, however, permit the apportionment of expenditure into constituent parts with only the portion laid out for purposes of trade being considered as a deductible expenditure in terms of the "general deduction formula", possibly apportioned on the basis of time spent participating in the virtual world.

5.4.3.3 SOFTWARE AND SUBSCRIPTION FEES

In addition to the hardware expenditure a prospective player to a structured virtual world is likely to encounter, there are other direct costs associated with the each particular game. Popular massively multiplayer online games such as *World of Warcraft* and *Aion* require of prospective participants to the persistent game world to purchase a copy of the game itself as well as pay a monthly subscription fee for the continued entertainment the game developers perceive the game will provide players with. As with all other expenditure discussed in this chapter, the preamble to section 11 requires that a "trade" be conducted, meaning that players who participate in a structured virtual world for entertainment purposes will not be permitted any deductions in terms of section 11(a) for any software and subscriptions. This expenditure for the player who conducts his game play experience in the pursuance of a "trade" will amount to "expenditure or losses, actually incurred, in the production of income". This places emphasis once more on the distinction between capital and revenue expenditure as well as section 23(g) for ascertaining the deductibility of expenditure.

The purchasing of a game, regardless of whether it is a physical or a digital copy, provides a prospective participant to that structured virtual world with a legitimate means of accessing that game's server. This expenditure is, except in extreme circumstances, once-off and provides the platform from which to play the game. Effectively, this expenditure creates an "enduring benefit" for the purchaser of the game and, provided the prospective participant

plans to embark on a systematic and active profit making scheme as a result of which he or she will be carrying on a "trade", the expenditure will form part of that taxpayer's income-generating structure. Therefore expenditure laid out for a copy of a game will be regarded as capital in nature and will not qualify for deduction in terms of section 11(a) of the South African Income Tax Act. Subscription fees, on the other hand, lack the attribute of an "enduring benefit" required for expenditure to be seen as capital in nature and are more closely linked with the income-generating operations than the income-generating structure of a "trade" and would therefore be treated as revenue expenditure, meeting the section11(a) requirement of expenditure "not of a capital nature". As the expenditure laid out for the purchase of the game itself would be regarded as capital in nature, the application of section 23(g) would not be necessary. The same cannot be said for any subscription fees paid by a participant taxpayer as such expenditure has been argued to be revenue in nature. A taxpayer would only be permitted to claim subscription fee expenditure as a deduction to the extent that such expenditure has been laid out for the purposes of that taxpayer's "trade". As the subscription fees would be incurred with the sole intention of allowing a taxpayer access to a game world, provided that taxpayer is participating in the structured virtual world with only real world currency gain in mind, then said expenditure will be deductible in terms of the "general deduction formula". Again, it must be noted that if a dual purpose exists, it is possible to apportion expenditure between its trade and non-trade components.

5.5 A SOUTH AFRICAN PERSPECTIVE OF THE GENERAL DEDUCTION FORMULA IN UNSTRUCTURED VIRTUAL WORLDS

5.5.1 INTRODUCTION

Like their structured virtual world counterparts, unstructured virtual worlds create the potential for various virtual world as well as real world currency expenditures. While potential sources of expenditure may not be as numerous as those found when participating in a structured virtual world, the nature of an unstructured virtual world such as *Second Life* means the provisions of section 11(a) and section 23(g) are more likely to directly affect a higher percentage of in-world participants. This claim stems from the primary focus of the respective world types. While it is not impossible to conduct a financially viable trade

through the exploitation of structured virtual world assets, the primary objective of these games is to provide participants with a form of entertainment, not a platform from which to generate financial wealth. Unstructured virtual worlds and *Second Life* in particular, place a greater emphasis on user-created content and in-world trade to drive the virtual economy.

5.5.2 VIRTUAL WORLD CURRENCY EXPENDITURE

Unstructured virtual worlds such as *Second Life* have two primary driving forces behind them. These are the social aspect as well as the economic aspect and generally user participation will be focused on one or the other, seldom both. In *Second Life* the limitations placed on virtual asset creation are so minimal that the imagination of the user and the amount of time a user is prepared to dedicate to item creation are perhaps the only real limitations to what can be created. Virtual world currency expenditure in a persistent virtual world such as *Second Life* is incurred for either social or economic motives. The participants who purchase virtual items to increase their social standing amongst the in-world community are disregarded for the purposes of this thesis. The participants who incur virtual world currency expenditure with the aim of profit generation, either short term or long term, are of greater interest. The assets held for shorter periods of time are generally treated as either trading stock or speculative holdings by in-world participants and usually include items of virtual clothing or furniture. Longer term holdings are generally viewed as assets whose value will appreciate over time and include things such as virtual real estate. It is possible for two separate participants to view similar assets as capital or revenue depending upon their intention. With a basic understanding of the potential virtual world currency expenditure that may be incurred by a participant in an unstructured virtual world, it is now possible to assess the position of such expenditure in terms of the "general deduction formula".

As always, when dealing with the general deduction formula, the preamble to section 11 of the South African Income Tax Act provides an appropriate starting point to determine the deductibility of expenditure against the income of a taxpayer. This preamble makes it a necessity for a "trade" to be conducted and income to be generated from the "trade" in question. In an unstructured virtual world the distinction between those who use it as a social

platform and those who use it as an economic platform is clear. It is, however, important to remember that an active step must be taken for a profit making scheme to be considered a "trade". The purchase of virtual property with the intention of allowing it to appreciate over a period of time before selling it at a profit does not constitute an active step. Where it can be shown that a taxpayer has taken an active step or steps in his income generating activity to the extent that it can be considered a "trade" and income is generated from that "trade" then the requirements of the preamble to section 11 of the South African Income Tax Act have been met. Section 11(a) requires that in order for deductions from the income of a taxpayer to be allowed, there must be "expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature." The fact that expenditure may not be capital in nature merely precludes a deduction from being claimed in terms of the "general deduction formula". Various provisions are present in the South African Income Tax Act which deal with these capital allowances. Virtual items purchased with the intention of resale or aiding in the conducting of a "trade" have the potential to be regarded as deductible expenditure in terms of section 11(a).

These virtual items must be divided into two specific and separate categories. The first of these is what the participant actually sells to other members of the in-world community. Such stock can either be self-created or purchased from other community members. In *Second Life* no costs are incurred in the creation of items, so there is no expenditure to consider should a participant make his or her own stock. Expenditure laid out on the purchase of stock, on the other hand, creates a potential deductible expenditure in terms of the general deduction formula. The second class of virtual items include assets used to enable the operation of the participant's virtual "trade" and includes virtual land and property. Where virtual world currency is used to procure either of these types of unstructured virtual world assets, it is clear that a participant will have "actually incurred" expenditure, ensuring the first two requirements of section 11(a) have been met. It is also necessary that any such expenditure be incurred "in the production of income". In the *Port Elizabeth Electric Tramway Co Ltd* case, and as previously referred to in this chapter, there are two considerations to be evaluated to accurately ascertain whether or not expenditure was incurred "in the production of income". The two questions are whether the action gave rise to the expenditure and how closely connected that action is with the income-earning activities of the taxpayer. Where

expenditure can be shown to be in the pursuance of an income-producing activity (a "trade") then the expenditure can be said to have been incurred "in the production of income". The purchase of stock for resale as well expenditure laid out for virtual property from which to operate, while different in their nature, would both be viewed as closely connected to the "trade" of a participant taxpayer.

The final requirement of section 11(a) is that expenditure, in order for it to be deductible in terms of the "general deduction formula", must not be capital in nature. This is where the purchase of virtual items treated as trading stock would differ from the purchase of virtual property from which the taxpayer can operate his or her "trade". In the *New State Areas Ltd* case, in addition to establishing the difference between the income-earning operations of a taxpayer and the income-earning structure of a taxpayer, the court also made a distinction between floating capital expenditure and fixed capital expenditure. Floating capital expenditure, which can take the form of trading stock, is deductible in terms of section 11(a) whereas fixed capital expenditure is not. Therefore expenditure laid out for trading stock would be regarded as floating capital expenditure, part of the income-generating operations of an unstructured virtual world participant while expenditure laid out on virtual property used to conduct a "trade" would constitute fixed capital expenditure as it represents a part of the income-earning structure of the taxpayer. Virtual land and buildings will not in every case be treated as capital assets. Participants in *Second Life* could treat such assets as trading stock or speculative assets, rather than long term capital holdings, with the result that their purchase becomes deductible expenditure in terms of section 11(a).

Section 23(g) precludes claims for deduction of expenditure against the income of a taxpayer, to the extent that the expenditure is not laid out for the purposes of "trade". The previous paragraph established that only expenditure laid out for virtual items to be treated as trading stock by the taxpayer will be regarded as potentially deductible up to this point. Therefore, provided expenditure laid out for the procurement of trading stock is laid out for the purposes of "trade", section 23(g) will not disallow such deductions against the income of the taxpayer. Should the participant purchase virtual assets that would normally constitute trading stock in his hands, but acquires them in a personal capacity outside that of the trading operation, then

such expenditure will be disallowed as a deduction in terms of the negative portion of the "general deduction formula".

5.5.3 REAL WORLD CURRENCY EXPENDITURE

The real world currency expenditure necessary for participation in the unstructured virtual world *Second Life* for the most part mimics that incurred to achieve participation in a structured virtual world. Expenses will include hardware in the form of a desktop or laptop computer, as well as a modem, data fees and for certain users, subscription fees in order to gain a premium membership to *Second Life*. As these resemble the real world currency expenditures necessary for structured virtual world participation it is possible to apply the same findings to expenditure incurred for unstructured virtual world participation. It was found that expenditure laid out on hardware such as computers and modems, although incurred in the production of income, amounted to capital expenditure and as a result could not be deemed deductible in terms of section 11(a) of the South African Income Tax Act. Data package costs and subscription fees on the other hand are more closely linked to the income-generating operations of a taxpayer than his or her income-generating structure and as a result such expenditure would be regarded as revenue in nature and therefore deductible in terms of section 11(a) subject to section 23(g) which will disallow as a deduction any expenditure to the extent not laid out for the purposes of "trade". Therefore data package costs can, once more, be apportioned between entertainment and "trade" purposes.

5.6 SUMMARY

This chapter introduced a discussion of the preamble to section 11, as well as section 11(a) and section 23(g) of the South African Income Tax Act, a combination referred to as the "general deduction formula". These sections of the South African Income Tax Act were then in turn applied to the various forms of expenditure, both virtual world currency and real world currency, that one would encounter should he or she wish to participate in either a structured or unstructured virtual world. The preamble to section 11 introduced the need for a "trade" to be conducted as well as income to be derived from any such "trade", with "trade" excluding most passive modes of income generation. The greater part of the discussion of the

application of the "general deduction formula" to virtual world expenditure focused on the distinction between capital and revenue expenditure with capital expenditure being specifically excluded from being claimed in terms of section 11(a) of the South African Income Tax Act. It was also noted that although capital expenditure is not deductible in terms of the "general deduction formula", specific provisions in the South African Income Tax Act, which were not covered in this chapter, make allowances for capital deductions. Finally, section 23(g), the negative portion of the "general deduction formula", further emphasised the fact that expenditure laid out for the purposes of "trade" can be deducted in terms of section 11(a) and the deduction of any expenditure to the extent that it is not incurred for said "trade" is prohibited.

Chapter six will deal with various other aspects of South African tax legislation in the context of persistent virtual worlds and participation therein, including VAT, donations tax and the soon to be implemented 15% withholding tax on gambling gains.

CHAPTER 6: SUNDRY ASPECTS OF SOUTH AFRICAN TAX LEGISLATION IN THE CONTEXT OF PERSISTENT VIRTUAL WORLDS

6.1 INTRODUCTION

Income tax is not the only tax that may have an effect on transactions in persistent virtual worlds. The present chapter aims to address various aspects of other South African tax legislation relating to persistent virtual worlds. Value-added tax, donations tax and the 15% withholding tax on gambling gains are all relevant in the context of structured and unstructured virtual worlds and as a result the chapter will investigate their application within the context of these virtual worlds.

6.2 VALUE-ADDED TAX

6.2.1 INTRODUCTION

The Value-Added Tax Act 89 of 1991 (referred to as the South African VAT Act) originally levied VAT at a rate of 10%, but from 7 April 1993 this was increased to 14% and has remained at this level since. Input tax is the tax incurred by a VAT vendor in respect of goods and services supplied to him or her, with output tax being the tax charged by a VAT vendor on the supply of goods and services in the furtherance of an enterprise. Where the input tax of a vendor exceeds his or her output tax, VAT is refundable to the vendor and where the output tax exceeds the input tax, VAT is payable by the vendor to the South African Revenue Service. The timing of this payment or refund is dependent upon the specific VAT accounting basis of the vendor, which could be either of the invoice or payments basis. Under the invoice basis, VAT is accounted for at the earlier of when the invoice is issued or when payment is received. In respect of the payments basis, input tax is accounted for when payments are made and output tax accounted for when payments are received. However, where a VAT vendor who makes use of the payments basis as his or her VAT accounting basis, "makes a supply of goods or services (excluding fixed property) for a consideration of R100 000 or more he must account for VAT on the invoice basis in respect of that particular transaction" (Brettenny, 2010: 8). In terms of the South Africa VAT Act, in order for a transaction to attract VAT, there are certain requirements that must be met. There must be a supply of goods and services by a vendor in the course or furtherance of an enterprise.

6.2.2 SUPPLY OF GOODS AND SERVICES

The first element or requirement for a transaction to attract VAT is that it should constitute a "supply" as defined in section 1 of the South African VAT Act. This definition incorporates as a "supply", any sale, rental agreement, credit instalment agreement as well as any and all other forms of supply. Furthermore, this definition makes allowances for barter transactions and the expropriation of assets to be regarded as a "supply". The "supply" must be of either goods or services as defined in section 1 of the South African VAT Act in order for VAT to be attributed to a transaction. This is the second requirement. "Goods" in this case include corporeal items, fixed property which, amongst other things, includes land as well as improvements to land, real rights, including servitudes and usufructs, and the definition of "goods" specifically includes electricity. Money, revenue stamps and certain rights arising from mortgage bonds as well as pledges do not meet the definition of "goods". While there are certain limitations imposed by the South African VAT Act as to what constitutes "goods", the definition as a whole is very broad. Similarly, "services" is also very widely defined in section 1 to include the "granting, cession or surrender of any right or the making available of any facility or advantage". Should a "supply" not actually constitute the supply of “goods” but is not specifically excluded from the definition of “goods” in section 1 of the South African VAT Act, then such a “supply” may constitute a “supply of services”.

In addition, the "supply of goods or services" must be for "consideration" as without "consideration", a "supply" will not form part of the carrying on of an enterprise as defined in section 1 of the South African VAT Act. "Consideration" is defined in section 1 of the Act:

> in relation to the supply of goods and services to any person, includes payment made or to be made (including any deposit on any refundable container and tax), whether in money or otherwise, or any act of forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain.

Therefore, the value of a "supply" plus the VAT attributable to the "supply of goods or services" equals the "consideration" for the "supply".

6.2.3 VAT VENDOR

The next requirement to be met in order for a transaction to attract VAT is that the "supply of goods or services" as outlined above should be conducted by a VAT vendor. A VAT vendor is any person, natural or juristic, who is, or who is required to be registered in terms of the South African VAT Act. "Person" as far as section 1 of the South African VAT Act is concerned includes public authorities, municipalities, companies, trusts, deceased and insolvent estates, individuals and even partnerships which, while not regarded as a separate person for income tax purposes, are regarded as separate from their individual members for VAT purposes. Furthermore it is possible for a person to be registered as a VAT vendor without legally being obligated to do so. This difference between voluntary and compulsory registration is an important distinction as far as the South African VAT Act is concerned. A person is compelled by the South African VAT Act to register as a vendor for VAT purposes at the end of a month where taxable supplies for the 12 months prior to that point in time exceeds R1 million or at the beginning of a month where it is foreseeable that the taxable supplies of that person will exceed R1 million over the next 12 months. Voluntary registration as a vendor is permissible where an enterprise is being conducted and taxable supplies for the person exceed R50 000 during a 12 month period; or when there is an anticipated acquisition of an enterprise, operating as a going concern, whose taxable supplies exceed R50 000 during the previous 12 months. A vendor is required to levy VAT output tax on his taxable supplies and may claim VAT input credits on specific purchases. Conversely, where a person is not a vendor for VAT purposes, no VAT is levied on supplies and no input credits may be claimed on purchases and expenses. Therefore voluntary registration is beneficial in certain situations, such as where the vendor supplies zero-rated goods, as voluntary registration results in the levying of VAT on all taxable supplies but also allows the VAT vendor to claim input tax credits in the case of goods and services acquired from vendors.

6.2.4 IN THE COURSE OR FURTHERANCE OF AN ENTERPRISE

6.2.4.1 INTRODUCTION

That a transaction should constitute the supply of goods or services by a vendor in the course or furtherance of an enterprise is the fourth requirement necessary for a transaction to attract VAT in South Africa. An "enterprise" is defined in section 1(a) of the South African VAT Act as "any enterprise or activity carried on continuously or regularly in the Republic or partly in the Republic by any person in the course or furtherance of which goods or services are supplied for consideration, whether or not for profit".

As it is necessary for there to be a continuous commitment to an enterprise, it is unlikely that once-off transactions would attract VAT. This is because there is no enterprise and subsequently there can be no conducting of a transaction in the furtherance of an enterprise. Furthermore, where a person is a vendor who is carrying on an enterprise, only transactions entered into in the furtherance of the person's enterprise will attract VAT. The application of VAT to a transaction is not limited to transactions involving revenue assets, the disposal of capital assets are also subject to VAT, provided the seller is a VAT vendor and the supply of capital assets are not otherwise zero-rated or exempt supplies.

6.2.4.2 ENTERPRISE WITHIN THE REPUBLIC

When dealing with the VAT implications of an enterprise involved in virtual asset transactions, it is important to determine where such an enterprise is situated. The nature of virtual worlds, in that they enable persons from different countries and even continents to interact within one another, means questions may be raised as to from where exactly an enterprise, for purposes of the South African VAT Act, is being operated. The location of an enterprise needs to be established for both voluntary and compulsory registration. For a person or company conducting an enterprise, as defined in the South African VAT Act, to voluntarily register as a VAT vendor it is required that the enterprise in question is conducting its activities within the Republic of South Africa. Similarly, for compulsory registration, it must be proved that the enterprise is operating within the Republic.

For any transaction involving virtual assets, there will be three locations of interest. These three locations are; the real world location of the seller, the real world location of the buyer and the real world location of the server responsible for maintaining the virtual world. While it is true that the virtual world server is vital for a person, natural or juristic, to conduct an enterprise through virtual worlds, it is submitted that it is merely a mechanism through which transactions can be achieved. As a result, it is not the primary location, one from which it can be said that an enterprise is operating. Instead, the location from where an enterprise (operating in a virtual world) can said to be operated will be the physical real world location of the person registered as a VAT vendor.

6.2.5 TIME AND VALUE OF SUPPLY

6.2.5.1 TIME OF SUPPLY

The general rule for the time of supply is set out in section 9(1) of the South African VAT Act. In accordance with this section, the time of supply is adjudged to occur at the earlier of the date of the invoice or the date that any payment or consideration is received by the supplier. It should be noted that a tax invoice is not necessarily needed to trigger the time of supply as any document notifying an obligation to make payment will constitute an invoice for purposes of the South African VAT Act. Section 20(1) of the South African VAT Act does, however, require that the supplier issue a tax invoice within 21 days of the date of a supply. Possession of a tax invoice grants a VAT vendor the right to claim input tax while the liability for output tax is triggered by any document notifying an obligation to make payment.

In addition to this general rule for the time of a supply as briefly discussed above, there are special time rules, applicable to certain scenarios, which override the general rule. While there are numerous situations whereby special time rules apply, the only one of any importance in connection with persistent virtual worlds is where the supplier and the recipient are connected persons. Where the two parties to a transaction are regarded as connected, the time of supply of goods is considered to be when the goods are taken and services when they are rendered, unless an invoice is issued or payment is made before this time, in which case this rule does not apply.

6.2.5.2 TIME OF SUPPLY WITHIN PERSISTENT VIRTUAL WORLDS

The time of a supply with regard to a transaction either within a persistent virtual world or stemming from a persistent virtual world, will adhere to the general rule as laid out in section 9(1) of the South African VAT Act. In accordance with this section, either the date of the invoice or the date of payment is regarded as the time of supply. If one considers persistent virtual worlds and the manner in which people conduct transactions through these virtual environments, it is unlikely that the documentation of transactions will ever be commonplace. The anonymity that accompanies these persistent virtual worlds means that participants are generally unwilling to enter into credit transactions, demanding payment either before or at the point of sale. This means that the time of supply will generally coincide with the point in time when a transaction takes place, as the consideration to be received by the supplier will often, if not always, be received at this point rather than at a future date.

6.2.5.3 VALUE OF SUPPLY

Just as general and special time rules exist, there are general and special rules for the value of the supply of goods or services in terms of the South African VAT Act. The general value rule is set out in section 10(3) of the South African VAT Act and distinguishes between two types of supplies. The first type of supply is where consideration is received in the form of money, in which case the value of the supply will be the money received less the portion that represents VAT. The second type is where consideration is received in a form other than money. In such a scenario, the open market value of the supply, at the time of supply, less the portion attributable to VAT will be the value of the supply. With regard to the special valuation rules, apart from section 10(4) dealing with connect persons; the majority are not relevant when considering transactions in persistent virtual worlds. Where the two parties to a transaction are regarded as connected persons, the supply is deemed to be made for market value regardless of whether or not consideration in the form of money was received by the supplier.

6.2.5.4 VALUE OF SUPPLY WITHIN PERSISTENT VIRTUAL WORLDS

In situations where VAT is levied on transactions stemming from persistent virtual worlds, the value of such supplies will be the consideration received by the supplier in the form of cash, less the portion attributable to VAT. Alternatively, where the consideration received by the supplier is in a form other than cash, section 10(3) of the South African VAT Act stipulates that the open market value of the supply will be used to determine the value. In structured as well as unstructured virtual worlds, transactions are conducted with both real world currency and virtual world assets used to facilitate trade. Where virtual assets, either in the form of virtual world currency or items are used to facilitate a trade transaction, the open market value of the supply, at the time of supply, less the portion attributable to VAT will be the value of the supply

6.2.6 ZERO-RATED SUPPLIES

While 14% is the applicable standard rate for VAT in South Africa, there are certain supplies which are taxed at 0% or are specifically exempt in terms of the South African VAT Act. If a supply does not fall into either of these two categories, zero-rated or exempt, then VAT is levied on it at the standard rate of 14%. Zero-rated supplies, while charged at 0% VAT, are taxable supplies and as a result, a vendor is able to claim back all input tax connected with such a supply. In the context of persistent virtual worlds, there are two types of zero-rated supplies which should be scrutinized, namely exported goods and exported services.

"Exported" with reference to "goods" is defined in section 1 of the South African VAT Act as the "supply of movable goods under either an instalment credit agreement or sale". Such transactions can be enacted in one of the following ways: direct exports, indirect exports, goods delivered by the vendor to a foreign-going ship or aircraft for use in such ship or aircraft and goods supplied under rental agreements for use in an export country or customs controlled area. Only the first of these four situations has relevance in the context of virtual worlds and will be discussed. For the supply of movable goods to qualify for a zero-rating, they must be supplied under a sale or instalment credit agreement, consigned and delivered to an address in a designated export country through a designated commercial port which must

be substantiated by documentary proof in the form of an invoice in conjunction with export documentation. Of interest is the need for "goods" to be tangible movable items and the need for documentary evidence supporting the claim of an exported supply. Similarly, the exported supply of services requires documentary proof. Services supplied to non-residents, but rendered within South Africa, may be zero-rated if they are supplied directly to the non-resident and the non-resident is not in South Africa at the time when the services are supplied.

6.2.7 A SOUTH AFRICAN PERSPECTIVE OF VALUE- ADDED TAX IN PERSISTENT VIRTUAL WORLDS

The application of value-added tax in the context of structured as well as unstructured virtual worlds is of significance as a result of the potential for profit generation which stems from these game worlds. While recreational participation in structured virtual worlds is more prevalent than participation where a scheme of profit making is undertaken, there are still a significant number of persons who choose to and are successfully able to derive profit from these games. Unstructured virtual worlds on the other hand appear to have a more equal split between participants driven by the social aspect of the world and those who wish to generate revenue. As in-world financial gain in both world types, which can in turn be converted to real world currency, is derived through the sale of virtual assets, it is necessary to establish whether such transactions could have VAT consequences. As far as virtual worlds are concerned, from a South African perspective, in order for a transaction to attract VAT there must be a supply of goods and services by a vendor in the course or furtherance of an enterprise as detailed previously in this chapter.

As a "supply" includes sales as well as barter transactions, this means that transactions involving exchanging virtual assets for in-world currency as well as for other virtual assets constitute a supply and could potentially attract VAT if virtual assets are considered to be either "goods or services" as defined in section 1 of the South African VAT Act. The definition in section 1 of the South African VAT Act states that "goods" include corporeal items, fixed property (including real rights in things and fixed property) and electricity.

Virtual assets, whether present in a structured or unstructured virtual world, cannot be considered to constitute corporeal items, fixed property or electricity. However, as virtual assets are not specifically excluded from the definition of "services", their disposal could be regarded as the supply of a service and, as such, subject to VAT.

Once it has been confirmed that there is a supply of either goods or services, it is necessary for the supply to be made by a person, natural or juristic, who is a registered VAT vendor. It is not necessary for the buyer to be a VAT vendor for a transaction to attract VAT. However, where the buyer is a VAT vendor, that person will be permitted to claim input tax on such a transaction where the seller is also a registered VAT vendor making a non-exempt or zero-rated supply. Compulsory registration for VAT is applicable where taxable supplies exceed R1 million over a 12 month period. While the majority of people attempting to generate an income through virtual world participation may never reach this amount that does not mean that it is an impossible figure to achieve. Voluntary registration, however, can apply if taxable supplies exceed R50 000 over a 12 month period, a figure very easily attained. Finally, in order for a virtual transaction to attract VAT, the transaction must be in the course or furtherance of an enterprise. An enterprise requires continuity and therefore a once-off sale of a virtual suit of armour (for example) is unlikely to be regarded as an enterprise. For a transaction to attract VAT, the seller must be conducting him/herself in the furtherance of an enterprise. Once it is evident that all four requirements have been met, it is possible for a transaction taking place in a structured or unstructured virtual world to attract VAT.

In situations where a VAT vendor purchases goods or services or incurs expenses payable to another vendor within the confines of a persistent virtual world environment, the transaction will attract VAT and the purchaser will be able to claim back from the Commissioner, as input tax, the VAT value attached to the transaction. As "goods" insofar as the South African VAT Act is concerned requires for the "goods" to be tangible, virtual assets do not amount to "goods" as defined but are rather seen as "services". Therefore where virtual assets are supplied as services to non-residents, but related to an enterprise within South Africa, such assets may be zero-rated if they are supplied directly to the non-resident and the non-resident is not physically in South Africa at the time when the services are supplied. Such a scenario

will, provided appropriate documentation is maintained, result in input tax exceeding output tax from such virtual world transactions, enabling the vendor to offset his or her input tax against the output tax of other transactions he or she enters into or to claim a refund from the Commissioner where input tax exceeds output tax in a tax period. In addition to the "supply of goods and services" within a virtual world for in-world currency, it is also possible for a participant taxpayer to "supply" either virtual goods or virtual services for real world currency. Such transactions are more likely to interest SARS should they occur, as it would prove difficult for SARS to monitor and levy VAT on in-world transactions involving virtual world currency.

6.3 DONATIONS TAX

6.3.1 INTRODUCTION

Donations Tax is a tax imposed in terms of sections 54 to 64 of the South African Income Tax Act on the transfer of assets between persons. Rather than being a tax on income, donations tax is a tax on the transfer of wealth. Only residents of the Republic of South Africa are liable for the payment of the tax. In order for donations tax to be levied, it is necessary to identify whether there has been a disposal of property by a resident where the disposal constitutes either a "donation" as defined or is a deemed donation that is not specifically exempt from the tax. Once it has been ascertained that the disposal should be subject to donations tax it is necessary to value the disposal, subtract the general exemption available (amounting to R100 000 per year) from the value of a taxable donation and finally apply the 20% donations tax rate to the value of the taxable transaction. The tax liability imposed under donations tax rests with the resident, referred to as the donor.

Property, in relation to donations tax, is defined in section 55(1) the South African Income Tax Act as "any right in or to property, whether it is movable or immovable, whether it is corporeal or incorporeal, wherever it is situated". This definition ensures that virtually any asset owned by a taxpayer can be regarded as property for purposes of donations tax. Section 55(a) of the South African Income Tax Act also defines the term "donation" as "any gratuitous disposal of property, including any gratuitous waiver or renunciation of a right".

Marais JA expressed the opinion (at 22) in *Welch's Estate v C:SARS 2005 (4), SA 173 (SCA)* that fundamentally a donation requires "that the disposition be motivated by pure liberality or disinterested benevolence and not by some self-interest or expectation of a *quid pro quo* of some kind from whatever source it may come". Therefore, for a disposal to be gratuitous it needs to be for no consideration or free and the disposition must have been motivated by "pure liberality" or "disinterested benevolence", as a motivation other than pure generosity or benevolence is not a donation (De Koker & Williams, 2011: par.23.3). Deemed donations, where property is disposed of for a consideration deemed to be inadequate by the Commissioner, are also subject to donations tax in terms of the South African Income Tax Act. The value of a deemed donation is value of the property less the inadequate consideration paid by the person acquiring the property.

6.3.2 EXEMPTIONS

Section 56(1) of the South African Income Tax Act provides an extensive list of specific situations where donations tax is not payable on the value of the property disposed of. These specific exemptions will not be discussed in terms of structured and unstructured virtual worlds as it is unlikely that scenarios involving them would arise. The general exemptions provided for in section 56(2) and which are available to natural and non-natural persons, however, are of interest in the context of virtual worlds.

If the person in question is not a natural person, then the general exemption available to the taxpayer person amounts to R10 000 per year of assessment. This R10 000 exemption is granted on the sum of all casual gifts and where a gift exceeds R10 000 in value, the Commissioner does not consider that the first R10 000 of this gift qualifies for the casual gift exemption, but the total value of the gift is subject to donations tax. The general exemption available to a natural person is R100 000 per year of assessment and covers all forms of property disposed of, not just casual gifts.

6.3.3 A SOUTH AFRICAN PERSPECTIVE OF DONATIONS TAX IN PERSISTENT VIRTUAL WORLDS

In persistent virtual environments and structured virtual worlds more specifically, the disposal of virtual assets through donations to fellow world participants is a regular occurrence. While donations may not be as common in an unstructured virtual world environment that does not mean that it is inconceivable for such an event to transpire. As it has already been shown that virtual world assets possess real world value, it is likely that the disposal of a virtual asset in a manner that resembles a donation could attract donations tax in the Republic of South Africa.

When participating in a structured virtual world environment it is very likely that a participant will make donations, including deemed donations and donations as defined in the South African Income Tax Act, at various times during his or her game play experience. Guilds play an important part in enabling players to progress through the more difficult regions of a structured virtual world and most virtual world participants opt to join one at the earliest available opportunity. Being a member of a guild often grants various benefits to virtual world participants and in return guild masters generally request that members make donations to the guild to ensure the continued expansion of the guild's influence. Such donations usually take the form of either in-world currency or weaponry to better equip guild members. These virtual assets may not be tangible, but they have definite real world value and "property" for the purposes of donations tax includes incorporeal assets. Thus the donation of such items by a guild member to his or her respective guild can potentially be subject to donations tax. Deemed donations could also take place between in-world participants where a virtual asset is disposed of for considerably less than its market value, with the value of the donation being the difference between the consideration received by the seller and the fair market value of the virtual asset disposed of. While the disposal of moderately valuable virtual assets such as in-world currency and items may be a more common occurrence than the donation of entire character accounts, this does not imply that the donation of entire characters will not potentially attract donations tax. Where one person essentially gives away his or her character, which has real world economic value, through a

transfer of the game access account, presumably as he or she has grown tired of the game, the imposition of donations tax is likely.

Unstructured virtual worlds lack the element of teamwork that is needed in a structured virtual world in order for participants to succeed in progressing along the narrative. There is no need for participants to work together as there is no overarching goal to be achieved. Instead unstructured virtual worlds place an emphasis on the commercial and social elements inherent within the framework of the virtual realm. Ultimately what this means is that, although donations are not implausible in the context of an unstructured virtual world, they will not be as prevalent as they are in a virtual environment where experiencing a hero's journey is favoured above profit generation.

Regardless of whether donations as defined or deemed donations take place in virtual worlds, both structured and unstructured, it is likely that they could attract donations tax. Fortunately for the majority of participants in these virtual realms, the value of the annual general exemption available to them in terms of the South African Income Tax Act should ensure that there is no need to pay donations tax. This annual general exemption of R100 000 for natural persons is sufficient to ensure that most casual participants are not liable for donations tax. However, as virtual assets can be worth as much as R2 million, it is plausible to assume that residents of South Africa may dispose of virtual assets for little or no consideration resulting in either donations or deemed donations that should attract donations tax.

6.4 WITHHOLDING TAX ON GAMBLING GAINS

Chapter four of this thesis introduced the idea of gambling gains in the context of the capital or revenue nature of receipts. It was submitted that where receipts from gambling arose through sporadic winning activities, such receipts would be treated as capital in nature. Conversely, where there is evidence that gambling activities were conducted in a systematic manner, resembling that of a business, such receipts are treated as revenue. From April 2012 the South Africa Revenue Service wishes to implement a new withholding tax on gambling

gains. The intention is to tax all gambling winnings in excess of R25 000, including those generated through lottery winnings, at a flat rate of 15%. The majority of events or transactions that take place within structured as well as unstructured virtual worlds bear little resemblance to gambling. It is perhaps only loot drops, present in structured virtual worlds, that could be thought to resemble gambling. This is because of the luck or chance involved in the loot drop process, as only the developers are aware of exactly what virtual items a participant will acquire upon defeating a particular enemy and how regularly such items will be dropped by the defeated enemy.

In order to ascertain whether or not this proposed withholding tax would be applicable in the case of loot drops, it is necessary to consider the definition of "gambling". "Gambling" does not appear in the South African Income Tax Act, instead, the definitions of "gambling activity" and "gambling game", as present in the National Gambling Act, 7 of 2004 (referred to as the National Gambling Act) will be used to ascertain the meaning of "gambling". In accordance with section 1 of the National Gambling Act, a "gambling activity" is any activity described as such in section 3 of the Act, while a "gambling game" is any activity meeting the description laid out in section 5 of the Act.

Section 3 of the National Gambling Act states that a "gambling activity" involves placing or accepting a bet, participating in a "gambling game", or any amusement game where legislation dictates that the game be licensed. Betting, dealt with in section 4 of the Act, is regarded as the staking of money or anything of value on a fixed-odds bet, or on the outcome of any event. An activity is considered to be a "gambling game" if the two following requirements are met:

- the activity is played upon payment of any consideration, with the chance that the person playing the game might become entitled to; or receive a pay-out; and

- the result might be determined by the skill of the player, the element of chance, or both.

While it is true that the acquisition of loot drops involve skill on behalf of the in-world participant and an element of chance or luck, there is no consideration offered by the participant prior to engaging in the loot drop procedure. The player stakes nothing of value on the outcome of a loot drop and as a result, it would not be viewed as a "gambling activity" in terms of the National Gambling Act. Subsequently, the withholding tax on gambling gains would not be applicable in either a structured or unstructured virtual world.

6.5 SUMMARY

Chapter six briefly discussed the South African VAT Act as well as several concepts central to the Act. Potential VAT consequences of transactions stemming from structured as well as unstructured virtual worlds were subsequently scrutinized in terms of the South African VAT Act. The chapter highlighted the fact that virtual world participants can and do generate real world gains through their involvement in these synthetic worlds. Virtual assets were likened to the supply of taxable services in terms of the South African VAT Act and as a result, if a participant taxpayer is registered as a vendor for VAT purposes or is required to be registered, potential VAT consequences arise from the transactions stemming from virtual world participation.

In addition to the potential VAT consequences that may arise from virtual world transactions, sections 54 - 64 of the South African Income Tax Act were applied to transactions stemming from virtual worlds. These sections deal with the potential donations tax consequences that arise from the gratuitous disposal of assets and it was concluded that the disposal of virtual world assets for no consideration or for a consideration substantially lower than the fair market value could attract donations tax if the value exceeds the annual exemption available in terms of section 56(2).

Finally, the chapter briefly addressed the soon to be introduced 15% withholding tax on gambling gains and attempted to apply the tax to the loot drop procedure present in structured virtual worlds. Using definitions in the National Gambling Act, it was determined that loot

drops do not represent a "gambling activity", as participation in a loot drop procedure is not contingent upon the taxpayer staking anything of value on the outcome of the loot drop. Therefore, as no activities stemming from structured or unstructured virtual worlds meet the definition of a "gambling activity", the 15% withholding tax on gambling gains was found to not be applicable.

Chapter seven will take the form of a literature review, examining predominantly the work of Camp (2007) and Lederman (2007) in the context of structured and unstructured virtual worlds and the economic wealth a taxpayer may derive through participation in such an environment. While their work does not represent the official legal view of the tax consequences of income resulting from virtual world transactions, it does assess their potential taxability in terms of the Internal Revenue Code of the United States of America. The stances, on the matter of income stemming from virtual world transactions, of tax authorities from selected countries will also briefly be discussed.

CHAPTER 7: COMPARATIVE STUDIES

7.1 INTRODUCTION

Up to this point, this thesis has focused on persistent virtual environments and the ramifications they could potentially have in terms of South African income tax legislation. On an international level, taxation experts are slowly beginning to scrutinize the potential taxation consequences that may arise from participation in persistent virtual worlds. While the taxation authorities in certain countries such as the United Kingdom, Australia, Sweden and China have adopted particular stances in matters relating to persistent virtual worlds, very little work has been done to evaluate the taxation consequences of transactions stemming from virtual worlds in an academic context. The work of Camp (2007) and Lederman (2007) is the only work available delving into the issue of taxing income earned in virtual worlds. Pienaar's (2008) thesis has provided a foundation upon which the present thesis has been based. Through examination of the American stance towards income generated from virtual world transactions, using the work of Camp (2007) and Lederman (2007), as well as the position adopted by various tax authorities in selected countries, this chapter aims to establish an overarching global view of the tax treatment of virtual world transactions. With the final chapter aiming to provide suitable recommendations in the South African context as to the tax treatment of transactions stemming in and from persistent virtual worlds, this chapter aims to inform those recommendations based on a more global view of addressing the issues created by these transaction.

7. 2 THE INTERNAL REVENUE CODE OF THE UNITED STATES OF AMERICA

7.2.1 INTRODUCTION

The Internal Revenue Code of the United States of America (referred to as the US Internal Revenue Code) imposes tax in terms of section 1 on "taxable income" which is defined in section 63 as "gross income minus the deductions allowed by this chapter". In the United States of America, the "foundational legal concept" (Camp, 2007: 14) of the US Internal Revenue Code, is that of "gross income" which is defined in section 61 as "all income from whatever source derived". For taxpayers in the United States of America, this means that they

have "gross income" whenever they receive "anything of economic value, whether in the form of cash, property or services" (Camp, 2007: 14). *Commissioner v Glenshaw Glass, 348 U.S. 426 (1955)* emphasized the principle that the form of the income is less important than the access to the income. This is as a result of "income" being defined by the court to mean "any undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion". While the definitions of "income" and "gross income" as present in the US Internal Revenue Code are very broad and according to Camp (2007: 14) the Supreme Court aimed to ensure these definitions were as wide as constitutionally possible and there are no Constitutional limits on what Congress may tax, the Constitution "does impose limits on how Congress may tax" (Camp, 2007: 16). However, these Constitutional limits on how tax may be collected, have done little to hinder the expanding scope of what may be treated as "gross income" in terms of the US Tax Code in what Camp (2007: 21) refers to as a "constitutional carte blanche"..

Camp (2007: 24) explains that three "operational limits or exceptions" do, however, exist which have a profound influence on what is deemed to constitute income and ultimately decrease the scope of what a taxpayer should include in his or her "gross income" for a period under assessment. These three limits, representing "instances of economic income", arise as a result of the significant difficulties that would be present themselves in the "measurement, payment and compliance" with the US Internal Revenue Code should the exceptions not be enforced by the Internal Revenue Service (IRS), the Courts and Congress.

The first of these limits as discussed by Camp (2007) is "priceless" income for which there is no ascertainable market value. In terms of the US Internal Revenue Code, the legal concept of "income" requires there be a readily ascertainable fair market value and if no objective method of market valuation in US currency can be determined, there is no reportable income.

The second limit is that of "unrealized" income. Camp (2007) argues that before an accession to wealth can be reported as "gross income", there must be a realization of the "income" in question. This realization of income can be achieved either through the rendering of services

or the disposal of assets. When a service is rendered, the realization of income stemming from that service occurs when "a taxpayer receives, directly or indirectly, cash, property or services in exchange for past, present or future services" (Camp, 2007: 29). With regard to the realization of income through the ownership of assets, two means of "gross income" production exist. Firstly the asset may be "income" producing, in that it generates wealth for the owner merely through ownership, "for example, shares may generate dividends and a house might create rental income" (Pienaar, 2008: 21). Secondly, the disposal of an asset may result in the owner receiving "income". It would be inaccurate to categorically state that unrealized economic gains are to be excluded from the "gross income" of a taxpayer. Rather, in order for "income" to be regarded as reportable and therefore included in the "gross income" of taxpayer, it is necessary that increases in wealth are deemed to be realized either by "the IRS, the Courts, or Congress" (Camp, 2007: 37). To say that income is unrealized is to say that access to it has not yet been attained or realized.

"Lack of either ascertainable fair market value or a sufficient realization event are not the only operational limits on the reach of §61" (Camp, 2007: 37). "Imputed" income is the third and final operational limit or exception. On a daily basis, a taxpayer is likely to derive satisfaction from his or her own personal circumstances. According to Camp (2007: 37) taxpayers realize economic value from self-benefiting activities as well as through the use of their own assets, both of which result in "imputed" income. Pienaar (2008: 23) adds that "[i]mputed income from services means that every person performs services for their own benefit" which have economic value, but their value is not included in a taxpayer's "gross income" even where there is an ascertainable market value that can be attached to the self-benefiting service and the taxpayer "clearly realizes the benefit" (Camp, 2007: 37). "Imputed income" remains non-taxable "income" as it is not feasible for the taxation authorities to attempt to enforce a system that accurately measures the economic utility experienced by each and every taxpayer through his or her self-benefitting services. Similarly imputed income from assets means a value can be attached to the economic benefit a taxpayer derives from using an asset he or she already owns. Pienaar (2008: 23) submits further that "imputed" income from assets has a value and as a result the "same rule applies as with imputed income from services" and the value of the "imputed" income is not included in the "gross income" of a taxpayer.

With this broad understanding of what constitutes "gross income" within the context of the US Internal Revenue Code as well as the various operational limits in existence, it is now possible to evaluate the potential tax consequences that may arise from in-world as well as real money trade transactions.

7.2.2 VIRTUAL ASSET VALUATION

Chapter three of this thesis introduced "gross income" with the South African Income Tax Act defining "gross income" in the case of a resident taxpayer as "the total amount in cash or otherwise, received by or accrued to or in favour of such resident, during such period of assessment, excluding receipts or accruals of a capital nature" (in section 1 of the South African Income Tax Act). The first portion of this definition, "the total amount in cash or otherwise", agrees with the operational limit of "priceless" income. Just as South African case law has emphasised the need for a readily ascertainable fair market value to be attached to "income" in order for it to be included in the "gross income" of a taxpayer, the US Internal Revenue Code stipulates that an objective market value is necessary for there to be reportable income. Cash, property, even barter transactions have an ascertainable fair market value which can be attached to them. Similarly, the value of virtual assets in both structured and unstructured virtual worlds can easily be determined. While the unstructured virtual world, *Second Life*, has official channels through which trading US$ for Linden$ and *vice versa* takes place, making virtual asset valuation a simple task, the majority of structured virtual worlds make do with currency exchange markets. Regardless of their legality, these black markets ensure that virtual asset valuation is possible for assets present in structured virtual worlds. With readily ascertainable fair market values available for all assets in both world types, the "priceless" income exception is not available to taxpayers. It is this ascertainable market value which complies with the "gross income" requirement of a "total amount in cash or otherwise" (in the South African context) and overcomes the "priceless" income exception (in the American context) that "makes the case for taxation strong" (Camp, 2007: 47).

7.2.3 LOOT DROPS, ITEM CRAFTING AND QUEST REWARDS

7.2.3.1 INTRODUCTION

Loot drops, item crafting and quest rewards are all fundamental concepts central to most if not all structured virtual worlds, currently in existence and as a result, any person who has played an MMORPG will have encountered them in some form or another. The majority of these structured virtual world participants may never sell the virtual assets they acquire through loot drops, item crafting or quest rewards for real world currency, however the fact that all virtual items have real world economic value means that potential tax issues, in terms of the US Internal Revenue Code may arise through mere participation (Lederman, 2007: 1641). Loot drops can be regarded as a form of prize for excellence in battle, the spoils of victory, and section 74 of the US Internal Revenue Code states that "amounts received as prizes" constitute "gross income". This recognition of loot drops as prizes coupled with the ascertainable fair market value attributable to virtual world assets means that the first operational limit of "priceless" income as discussed by Camp (2007) is not applicable and it falls to the remaining two operational limits to exclude loot drops from the "gross income" of a participant taxpayer in terms of the US Internal Revenue Code. Items crafted by players as well as rewards received through the completion of quests, while not quite prizes, but rather the result of tasks performed within the game world, still have ascertainable fair market value in the real world and they too, will not be regarded as "priceless" income.

The second operational limit, that of "realization" plays an important role in determining the taxability of loot drops, crafted items and quest rewards in terms of the US Internal Revenue Code. Camp (2007: 47) argues that when a player acquires loot, through one of the three mentioned possibilities, he or she has only obtained a "paper gain in wealth". Although these virtual assets have an ascertainable real fair market value, the taxpayer's ability to convert the virtual assets into "usable wealth is too remote and contingent on factors beyond his [or her] control" (Camp, 2007: 47). In order to accurately establish whether or not the "realization" exception can be applied to virtual assets acquired through a loot drop, item crafting or quest rewards, it is necessary to establish whether or not a participant has any real world rights over the virtual assets he or she acquired. The stronger a participant's rights over his or her acquired virtual assets, the weaker that participant’s argument for the "realization" exception.

7.2.3.2 PROPERTY RIGHTS OVER VIRTUAL ASSETS

For a participant in a structured virtual world, a debate rages as to whether that player has any real world rights over the virtual assets in his or her possession. The debate centres around the End User Licence Agreements and Terms of Service Agreement potential participants are required to accept prior to entry into these structured virtual worlds. By accepting the terms present in these agreements, participants essentially waive any right to claim that virtual assets accumulated in-world, are the property of the participant. In return for their acceptance, game developers grant prospective participants entry to their virtual environment and the chance to experience the game world they have created. Ultimately, according to Lederman (2007), the question of whether rights over virtual assets rest with in-world participants or game developers, hinges on End User Licence Agreements and Terms of Service Agreements in the context of American copyright law, but as this issue falls beyond the scope of the present thesis it will not be discussed in any detail.

While the issues surrounding property ownership rights have little significance in the South African context, as discussed in chapter three, they do impact the ability of a participant taxpayer to have virtual assets excluded from his or her "gross income" based on the "unrealized" income exception in the US Internal Revenue Code. If one were to accept that a participant in a structured virtual world holds no real world rights over the assets he or she acquires via loot drops, item crafting or quest rewards, then the mere act of acquiring virtual assets would probably not result in a need for the participant to report his or her loot drops as "gross income". This is because there is a "strong argument that no realization occurs" (Bingisser, 2008: 5) when a participant acquires virtual assets in such a manner. Alternatively, if virtual assets acquired via loot drops, item crafting or quest rewards are the property of the participant, then according to Camp (2007: 55) they are akin to real world receipts and the claim that they represent unrealized gains becomes less credible.

7.2.3.3 IMPUTED INCOME

7.2.3.3.1 CAMP'S VIEW

Camp (2007: 56) believes that while it is true that participation in structured virtual worlds and the subsequent accumulation of virtual assets as a result of loot drops, item crafting and quest rewards are likely to result in increases in economic wealth, the participant taxpayer should not have to regard such instances as receipts for purposes of "gross income". This is because of the "imputed" income exception, which is the realization of economic value through self-benefiting activities or the benefit that arises through asset ownership. Camp (2007: 56) is of the view that participation in a structured virtual world provides the participant taxpayer with "in-kind benefits" which arises outside of normal market transactions and could be seen to either represent "self-provided services or, perhaps, enjoyment of self-owned property". The self-benefiting activity is the active participation in the game world and ownership of the game affords the taxpayer with the opportunity to indulge in active participation. Participation in the game world and loot drops in particular are likened to gambling, as a result of the inherent random nature or chance that accompanies the loot drop procedure. Playing a game is compared with gambling, where a player wants to get as much 'play' as possible for the original cash used to buy casino chips (Camp, 2007: 59).

7.2.3.3.2 LEDERMAN'S VIEW

While Camp argues that loot drops, item crafting and quest rewards represent either self-benefiting activities or a benefit derived from a participant-owned asset, meaning they constitute imputed income and should not be regarded as "gross income" in the hands of a participant taxpayer, Lederman (2007: 1646) is of the opinion that loot drops, crafted items and quest rewards are all obtained through "substantial investment of time and effort on the part of players". As a result of this substantial time and effort, virtual assets acquired through loot drops, item crafting and quest rewards should not be regarded as true windfalls, in the same vein as lottery winnings. Lederman (2007: 1646 - 1648) uses principles laid out by Professor Joseph Dodge (2000) in "*Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the 'Chain of Right Doctrine' to Found Objects, Including*

Record-Setting Baseballs" to explain the potential taxation consequences that may arise from loot drops, item crafting and quest rewards.

If loot drops are considered to be the property of the structured virtual world participant who acquired them then their acquisition results in an increase in economic wealth. This increase in wealth means that loot drops "do not fit well under the rubric of imputed income" (Lederman, 2007: 1645). Instead, their receipt is more akin to a windfall such as lottery winnings or real world items found on a sidewalk. However, as a result of the time and effort that goes into accumulating virtual assets through loot drops, item crafting and quest rewards, they are not true windfalls. True windfalls are distinguished from what Dodge calls "taken" items, items which require more effort to obtain than an average windfall. According to Lederman (2007: 1647) Dodge argues further that there is no distinction between "taken" items and "self-created" items, with "self-created" items being produced through the direct efforts of the taxpayer as oppose to "taken" items which result from the labour or significant capital investment of persons other than the taxpayer. The necessary time and effort that goes into acquiring structured virtual world assets through loot drops, item crafting and quest rewards resemble "taken" items as the participant taxpayer relies on the efforts of the game developers to create the virtual items. "Taken" items and "self-created" items are "taxed not on receipt but instead on disposition, regardless of whether they are personal-use items or are treated as business inventory" (Lederman, 2007: 1648). Alternatively, if virtual assets accumulated through in-world participation are not the property of the participant taxpayer, then loot drops, crafted items and quest rewards are a service rendered to the taxpayer in return for in-world participation (Pienaar, 2008: 24).

Accepting the premise that assets acquired in a structured virtual world through loot drops, item crafting and quest rewards are the property of the recipient participant means that their receipt results in an increase in economic wealth. This increase in economic wealth ensures that the "priceless" exception is not available to participant taxpayers, while accepting that the participant holds real world rights over wholly virtual assets means there is potential for "realization" and according to Camp (2007) the second operational limit is not applicable. Camp (2007) argues that there is a case for loot drops, crafted items and quest rewards to be

regarded as "imputed" income based on the notion that there is realization of economic value through self-benefiting activities or a benefit that arises through asset ownership, with loot drops in particular, bearing a strong resemblance to gambling winnings. Lederman (2007) while disagreeing with the claim that the accumulation of structured virtual world assets amounts to "imputed" income, argues that they do not represent "gross income" in the hands of a participant taxpayer. Such items represent "taken" items which should be taxed on disposal rather than receipt.

7.2.4 ITEM CREATION

Item creation, a game mechanic vital in persistent virtual environments such as *Second Life*, ensures the continued growth of the unstructured game world through user-created content. Unlike item crafting, which makes use of specifically defined recipes to craft items, item creation is a more flexible system, allowing a greater degree of freedom as to what can be created. If one considers that the two predominant reasons for participation in an unstructured virtual world such as *Second Life* are commercial and social, it is obvious that many of participants who undertake to create items are doing so for commercial reasons. Subsequently, where a virtual participant creates virtual items as commercial items, such items should be viewed as business inventory. With "gross income" being defined as all income from whatever source derived and "income" being defined as any undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion, it falls upon the three operational limits to have items created in an unstructured virtual world excluded from the "gross income" of a participant taxpayer.

With unstructured virtual worlds placing a great deal of importance on user-created content, it is clear that item creation is a concept fundamental to the continued existence of these virtual environments. Virtual world participants create virtual items and subsequently enter into transactions for the exchange of virtual assets and currency. Much as structured virtual world assets have an ascertainable real world currency value, virtual assets which exist wholly in the virtual reality of an unstructured world, can be reliably valued in real world currency. This ascertainable fair market value in the real world attributable to items created in

unstructured virtual worlds means that the operational limit of "priceless" income will not exclude their value from the "gross income" of a participant taxpayer.

When evaluating the taxation consequences, in terms of the US Internal Revenue Code, that stem from loot drops, item crafting and quest rewards, a participant's real world rights over virtual assets was called into question. Accumulation of assets and their subsequent inclusion in the "gross income" of a participant taxpayer appeared to hinge on whether or not the virtual assets acquired through loot drops, item crafting and quest rewards are the property of the participant taxpayer. The distinction between property of the participant taxpayer and property of the game developer affects the second of Camp's (2007) operational limits, "unrealized" income. In the unstructured virtual world of *Second Life*, no such conundrum exists as virtual world participants hold the rights to their created content, meaning that all their virtual assets are their own property. As these items are the property of the virtual world participant who creates them, this means that there is a strong argument that such assets do not meet the "unrealized" exception as they are akin to real world receipts (Camp, 2007: 55). The ascertainable real world value attached to created items, in conjunction with the real world rights a participant has over his or her created virtual items allowing for the realization of assets, means that the "unrealized" exception is not applicable to items created within unstructured virtual worlds.

The final operational limit proposed by Camp (2007) was that of "imputed" income. A receipt may be excluded from the "gross income" of a participant taxpayer where that receipt constitutes the realization of economic value through self-benefiting activities or the benefit that arises through asset ownership, and is ultimately regarded as "imputed" income. The unstructured virtual world of *Second Life*, allows participant taxpayers to retain the rights to their created virtual items. Once again, these real world rights coupled with the ascertainable real world market value attributable to all virtual goods means that the creation of virtual items results in real wealth and as such, according to Lederman (2007) the "imputed" income exception should not be applicable. Where virtual items are not the property of the participant taxpayer, they resemble "taken" items whilst virtual assets that are the property of the participant are referred to as "self-created" items. Regardless of the name attached to virtual

items created in an unstructured virtual world, they should be "taxed not on receipt but instead on disposition, regardless of whether they are personal-use items or are treated as business inventory" (Lederman, 2007: 1648).

7.2.5 IN-WORLD TRADE TRANSACTIONS

In-world trade transactions are regular occurrences within structured as well as unstructured virtual worlds. As the US Internal Revenue Code stipulates that all receipts are deemed to be income in terms of section 61, receipts stemming from in-world trade transactions need to fall "within one of the three great exceptions to the reach of §61" (Camp, 2007: 46) to be excluded from the "gross income" of a participant taxpayer. These three operational limits, as previously mentioned are "priceless", "unrealized" and "imputed" income.

The receipt that stems from an in-world trade transaction in either a structured or unstructured virtual world could not be said to constitute "priceless" income. This is as a result of the readily available fair market value that can be attached to all virtual assets. As all virtual assets have a value denominated in the virtual environment's currency, and all virtual currency can be converted into real world currency, this ensures that there is not only a readily ascertainable virtual fair market value, but there is also a real fair market value that can be attached to the receipts stemming from in-world trade transactions. Ultimately, this means that the "priceless" income exception is not available for increases in wealth stemming from in-world trade transactions.

As was the case with loot drops, item crafting, item creation and quest rewards, the "unrealized" income exception with regard to in-world trade transactions hinges on the property rights held by a virtual world participant over virtual assets. In the majority of structured virtual worlds, game developers hold the rights to all virtual assets acquired by in-world participants and as such their acquisition represents a license to use them rather than a right to their ownership. This license is granted to virtual world participants, and subsequently provides a strong argument for the "unrealized" income exception. Virtual

assets acquired through loot drops, item crafting and quest rewards were previously said to not constitute "gross income" in the hands of the recipient taxpayer, as the receipt of these assts does not amount to a realization of wealth. Similarly, subsequent in-world trade transactions involving these assets would not be considered accessions to wealth as virtual world participants are merely making use of the license granted to them by game developers. Receipts stemming from in-world trade transactions occurring in an unstructured virtual world such as *Second Life*, on the other hand, are unlikely to have the operational limit of "unrealized" income available. This is as a result of the property rights a participant has over the virtual assets in his or her possession. These rights over virtual assets mean that the "unrealized" income exception, "would be of little help to a gamer hoping to avoid tax on in-world trades" (Lederman, 2007: 1653) as such transactions are likely to be considered realization events.

"Imputed" income offers the third and final avenue through which the receipt of "income" may be excluded from the "gross income" of a participant taxpayer. This kind of income is the wealth that arises through the realization of self-benefiting activities or the benefit that arises through asset ownership. Through participation in a virtual world and the subsequent completion of in-world trade transactions, Camp (2007: 56) argues that there is a receipt of "imputed" income rather than the realization of real economic wealth. This realization only occurs if and when the virtual world participant finally cashes out.

7.2.6 REAL MONEY TRADE

While the tax position of loot drops, crafted items, created items, quest rewards and the receipts stemming from in-world trade transactions may be open to interpretation, "all completed research agrees that real money trade or real money transactions give real economic value to virtual worlds and they are the reason why income from virtual worlds would attract the attention of tax authorities" (Pienaar, 2008: 28). Real money trade is the practice of procuring virtual assets with real world currency. If one considers the three operational limits proposed by Camp (2007), namely "priceless", "unrealized" and "imputed" income, it is clear that receipts stemming from real money trade should be included in the

"gross income" of the taxpayer. This is because none of the exceptions mentioned will preclude the inclusion of the receipt from "gross income". There will always be a monetary value attached to real money trade transactions. There is a realization of wealth in trading virtual world assets for real world currency. The income is not "imputed" income as the realization of wealth occurred through a trade transaction rather than through self-benefiting activities or a benefit attached to ownership of property.

7. 3 CURRENT TAX STANCES OF OTHER NATIONS

7.3.1 INTRODUCTION

Apart from the preliminary research conducted by Camp (2007) and Lederman (2007), there has been little advancement in assessing the taxability of receipts stemming from virtual worlds in the context of the Federal Tax Code of the United States of America. Amongst others, Bingisser (2008) and Seto (2008) have re-examined the work of Camp and Lederman without making major strides. Beyond the scope of the Federal Tax Code of the United States of America, only the work of Sarah Pienaar (2008) examining the '*South African Tax Implications of Income Earned in Virtual Worlds'* has emerged following an exhaustive literature survey. Although it is true that Edward Castronova has been assessing the economic implications of virtual worlds and the transactions that take place within them since his 2001 paper titled *'Virtual Worlds: A First-Hand Account of Market and Society on the Cyberian Frontier'*, it was not until the 2007 works of Camp and Lederman that the issue of taxing virtual world income started to generate greater interest outside the United States of America. The majority of people unfamiliar with virtual worlds assumed tax free gains could be made through virtual worlds, likening the currencies of these worlds to that of play money, the virtual "equivalent of '*Monopoly* Money'" (Nuttall: 2007). While it would be correct to assume that a person is not taxed on their winnings in a game of *Monopoly*, the same conclusion should not be drawn with regard to virtual world items and currency, as these virtual assets have been shown to real world value, where *Monopoly* money does not. Despite the lack of academic research on the topic of taxing virtual world assets, various tax authorities across the world have moved to clarify their stance on the matter.

7.3.2 THE UNITED KINGDOM

In the United Kingdom, the taxation of receipts stemming from structured as well as unstructured virtual worlds is regarded as "an uncertain and developing area of tax law" (Prowse: 2009) and as a result, Her Majesty's Revenue and Customs (HMRC) "apply general principles to arrive at the current tax treatment under existing law, and the UK Government will then decide whether or not that tax treatment is an appropriate tax treatment, taking into account a range of policy issues" (Nuttall: 2007). Although HRMC has yet to publish any guidance on the matter of in-world trade transactions, "there are comparable precedents, such as individuals trading on *eBay*" (Prowse: 2009).

When dealing with *eBay* transactions, HRMC has sought to distinguish between persons acting as traders and those acting in a private non-entrepreneurial capacity. In terms of the tax legislation, there is a rather broad if circular definition of what constitutes a trade. In terms of this definition a trade "includes every trade, manufacture, adventure or concern in the nature of trade" (Nuttall: 2007). Persons who buy and sell goods on *eBay*, quickly and with the intention of being as profitable as possible, are considered to be conducting a trade for income tax purposes. However profit generation does not automatically constitute the carrying on of a trade. HRMC has provided guidance as to what is excluded from the definition of a trade including the occasional realisation of unwanted personal items through internet auction. In addition to the income tax and national insurance contributions that accompany trade transactions, a person may have to register for VAT. Furthermore, it has been emphasised by HRMC that transactions involving intangible assets are not precluded from being subject to income tax in terms of Income Tax (Trading and Other Income) Act 2005.

Barter transactions in the United Kingdom are taxable, meaning that real world currency is not necessary for an amount to be regarded as taxable. Through a barter transaction a person will have received an in-kind benefit, the fair market value of which can be calculated and taxed even if no physical receipt of currency occurs. Similarly, the receipt of an asset could be seen as receipt of economic benefit, the value of which is easily ascertained. While the

accumulation of virtual wealth may occur for all virtual world participants, there is the matter of betting and gambling to be considered, which are not seen to constitute trading. As there is an element of luck attached to the loot drop procedure as previously defined in this thesis, the value derived from a loot drop may be considered to be a gambling gain. Furthermore, in the United Kingdom, there is "an exemption from tax on capital gains for winnings from gambling" (Nuttall: 2007). Where a systematic organized method exists through which gambling winnings are acquired, a trade will be said to have been conducted and the winnings would be treated as revenue in nature and subject to income tax.

While it seems plausible that in terms of the tax legislation of the United Kingdom, that the value of virtual world transactions could be included in the taxable income of participant taxpayers "there are indications that the tax authorities could take the position that tax is only payable when virtual currencies, such as Linden Dollars, are converted into real currency" (Nuttall: 2007). While virtual assets have a readily ascertainable fair market value, general consensus within the United Kingdom is that "HMRC should not apply tax until virtual currencies are exchanged for 'real' currency" (Nuttall: 2007).

7.3.3 AUSTRALIA

Although no academic research has been conducted in the context of Australian income tax law, in October 2006 the Australian Tax Office stated that regardless of the circumstances surrounding the accumulation of monetary benefit, normal tax rules will apply. Where a "virtual transaction has real world implications, it can be attributed a monetary value, it attracts the attention of the tax office" (Miller: 2006). While this does not clarify whether or not simply accruing virtual assets, which have real world monetary value, will amount to a receipt for income tax purposes, it is evident that converting virtual assets, items and currency into real world currency results in a taxable receipt. Furthermore, there are general sales tax considerations which accompany virtual world transactions. Where a person's turnover of virtual assets exceeds A$50 000 in a tax year, that person is required to register for general sales tax, a VAT equivalent.

7.2.4 SWEDEN

According to Nuttall (2007) the Swedish Tax Agency stated in February 2007:

> We're not interested in ordinary gamers. More than 99 per cent of them play internet games for the sake of playing and most people keep their virtual money on their game account. However, if they move it out of the virtual world into the real world, then we're interested in them.

Once again, a national tax authority places an emphasis on the act of converting virtual assets into real world currency rather than the simple accumulation of virtual assets.

7.2.5 CHINA

In September 2008, the Chinese State Administration of Taxation issued a reply in response to "*Imposing Individual Income Tax on the Revenue Derived from Online Trade of Virtual Currency by Individuals"*. The reply, according to Prowse (2009), stated that, amongst other things, revenue derived from the trade of virtual items and currency fell within the scope of individuals' income tax. At the end of October 2008, the Chinese government went one step further to introduce a tax specifically for income generated in persistent online environments. According to Juliet Ye (2008) of the Chinese Wall Street Journal the State Administration of Taxation imposes "a personal income tax of 20% on profit from virtual money" where an in-world participant can show proof of the original purchase price of an asset. If such evidence is not available, then a tax rate of 3% is imposed on the value of the transaction.

7.3 SUMMARY

This chapter primarily assessed the taxability of income stemming from structured as well as unstructured virtual worlds in the context of the Internal Revenue Code of the United States of America. A review of the work completed by Camp (2007) and Lederman (2007) was conducted. Camp's (2007) work was based on the three operational limits of "priceless", "unrealized" and "imputed" income. These three types of income while resulting in economic benefit, according to Camp, should not result in a receipt for the purposes of "gross income". The accumulation of virtual assets, including items and currency, are in Camp's view, receipts that should not be valued for income tax purposes until a virtual world participant

actively converts virtual wealth into real world currency. Lederman (2007) argues however that the accumulation of virtual assets does not constitute "imputed" income. Instead these virtual items represent "taken" items, distinguished from "self-created" items, which should be taxed on disposal rather than receipt.

Following that, the chapter briefly reviewed the various stances of the tax authorities of the United Kingdom, Australia, Sweden and China in relation to income stemming from virtual worlds. The brief nature of the review of the stances emphasises how little consideration has been given to virtual world items and currency up until this point outside of the United States of America. In the United Kingdom HMRC has yet to issue any official guidance on the topic of virtual world transactions. Instead, general principles will be applied to specific transactions with most experts arguing that taxation should only occur when virtual assets are converted into real world currency (Prowse: 2009). In Australia, ambiguity surrounds whether or not the in-world accumulation of virtual assets will be subject to taxation. Persons who convert their virtual world assets into real world currency however, are required to treat these gains as taxable. Similarly, Sweden and China also regard the conversion of virtual world assets into real world currency as a taxable event, in terms of each country's respective income tax legislation.

The final chapter will examine the achievement of the goals laid out in the first chapter. In addition it will highlight the potential for tax avoidance schemes through the manipulation of these structured virtual worlds emphasising the need for regulation. Once this has been achieved, suitable recommendations shall be made regarding the treatment of virtual world transactions, taking into account the work completed by Camp (2007) and Lederman (2007) as well as the comments offered by the previously mentioned national tax authorities of the United Kingdom, Australia, Sweden and China since 2006.

CHAPTER 8: FINDINGS

8.1 INTRODUCTION

Chapter 8 will begin by restating the goals of the research and summarizing the findings of each chapter in light of these goals, highlighting how each chapter contributed to achieving the goals set out in the first chapter. Once the achievement of the goals of the research has been assessed, a brief assessment will be made of the potential for tax avoidance in the context of persistent virtual worlds. Following that, recommendations shall be made regarding the treatment of virtual world participation and the transactions that may arise through participation, taking into account the work completed by Camp (2007) and Lederman (2007) as well as the comments offered since 2006 by the national tax authorities of the United Kingdom, Australia, Sweden and China.

8.2 GOALS OF THE RESEARCH

8.2.1 INTRODUCTION

The ultimate goal of the research was to establish the taxability of virtual assets obtained in structured as well as unstructured virtual environments, with the following sub-goals:

- developing an understanding of how structured and unstructured virtual worlds operate;
- establishing the income tax consequences of the trade in virtual assets and in particular the difference between capital and revenue receipts in virtual worlds;
- establishing the deductibility of expenditure incurred in respect of virtual world assets and in particular, distinguishing between expenditure that is of a revenue nature and that which is of a capital nature;
- investigating the application of other taxes to transactions in virtual worlds, including value-added tax, donations tax and the withholding tax on gambling gains, as well as possible tax evasion and avoidance problems;

- illustrating through the use of hypothetical examples, how the transactions within structured and unstructured virtual worlds may be subject to the application of appropriate tax legislation; and
- making suitable recommendations relating to the taxation of virtual world transactions.

8.2.2 ASSESSMENT OF THE ACHIEVEMENT OF THE GOALS

Using hypothetical examples, the thesis was able to illustrate how asset accumulation and transactions stemming from persistent virtual worlds may be subject to South African tax legislation. As an understanding of the nature of the working of virtual worlds is necessary for an understanding of the potential to tax transactions in these worlds, Chapter two described persistent online environments, highlighting the difference between structured and unstructured virtual worlds. The chapter also explained the various methods of asset acquisition and disposal available to virtual world participants.

Chapter three presented a theoretical discussion the "gross income" definition in Section 1 of the South African Income Tax Act, which is the starting point for the inclusion of amounts in a person's taxable income. The elements of the definition were then applied to transactions stemming from virtual worlds. Ignoring the capital or revenue nature of receipts, the chapter was able to show that the accumulation of virtual assets as well as transactions involving their acquisition and disposal raised potential taxation consequences. Chapter four presented a theoretical discussion of the capital or revenue nature of receipts. Based on the various objective as well as subjective tests applied in deciding on the nature of particular receipts and discussed in the chapter, a framework was established enabling one to distinguish between receipts and accruals of a capital and revenue nature. The theoretical framework was applied to the transactions that occur in virtual worlds. Chapter five focused on the general deduction formula, in terms of which most allowable deductions can be claimed in arriving at the taxable income of a person, and it was demonstrated that "expenditure" in virtual world currency as well as real world currency could be deductible in terms of section 11(a) of the

South African Income Tax Act. Chapters three to five therefore achieved the second and third sub-goals of the thesis.

Chapter six addressed the fourth sub-goal of the thesis by discussing the potential VAT and donations tax consequences can arise through participation in virtual worlds. The possible application of the withholding tax on gambling gains was considered to be moot in the context of persistent virtual worlds. Only loot drops could have been argued to constitute gambling, based on the inherent element of luck involved in the procedure. However, loot drops were determined to not meet the definition of a "gambling activity" as present in the National Gambling Act.

In each chapter, hypothetical examples were used to illustrate the potential application of various taxes to participation in virtual worlds, thus addressing the fifth sub-goal of the research.

The present chapter will present recommendations for the taxation of virtual world transactions. Virtual worlds also present opportunities for tax avoidance and evasion and this will be briefly referred to in this chapter.

8.3 TAX AVOIDANCE AND TAX EVASION

8.3.1 INTRODUCTION

There exists a very real potential for tax avoidance, tax evasion and money laundering schemes through the manipulation of transactions within and stemming from structured and well as unstructured persistent virtual worlds. This potential for abuse on the part of in-world participants highlights the need for greater regulation of such activities in terms of the appropriate legislation discussed in this thesis.

There is an important distinction between tax avoidance and tax evasion that one needs to understand, before investigating the potential for tax avoidance schemes in a persistent virtual world. De Koker and Williams (2011: par.19.1) explain that tax evasion, characterized by fraud and deceit, “refers to all those activities deliberately undertaken by a taxpayer to free himself from a tax burden". Sections 75 and 76 of the South African Income Tax Act impose penalties in cases where taxpayers undertake to evade tax, whereas no such penalties are in effect to serve as punishment where tax avoidance measures have been implemented. This stems from the fact that tax avoidance refers to a situation where a taxpayer arranges his or her tax affairs in a perfectly legal manner but which has the effect of avoiding or reducing a tax liability and no obligation rests upon a taxpayer to pay a greater amount of tax than is legally due under the taxing Act (*Duke of Westminister v IRC 51 TLR 467, 19 TC 490*). While a taxpayer may attempt to arrange his or her tax affairs in a manner so as to minimize the tax liability he or she will incur, sections 80A to 80L of the South African Income Tax Act deal with certain tax avoidance arrangements which are impermissible in terms of these sections. Furthermore, taxation is based on the substance rather than the form of a transaction and if the two differ, taxed will be based on the true intention of the underlying agreement (*Zanberg v Van Zyl (1910) AD 302*), (*ITC 1625 (1996), 59 SATC 383*).

8.3.2 GENERAL ANTI-AVOIDANCE RULES

The provisions of sections 80A to 80L of the South African Income Tax Act apply to arrangements entered into on or after 2 November 2006, replacing section 103(1) which applied before this date. Section 80A is entitled "Impermissible tax avoidance arrangements" and as such implies that tax avoidance arrangements do not ab *initio* constitute impermissible activities. Instead, only certain types of tax avoidance arrangements are regarded as impermissible in terms of the general anti-avoidance rules. An arrangement will be regarded by the Commissioner as impermissible if the sole or main purpose of the arrangement was to obtain a tax benefit and one of the following is applicable:

- in the context of a business, it represented a non-*bona fide* business transaction that would not normally have been entered into other than to obtain a tax benefit, it lacked commercial substance in terms of section 80C of the Income Tax Act, the arrangement created rights or obligations that would not usually arise from persons

transacting at arm's length or it would result in the misuse or abuse of the provisions of this act;

- in a context other than business, it represented a non-*bona fide* transaction that would not normally have been entered into other than to obtain a tax benefit, the arrangement created rights or obligations that would not usually arise from persons transacting at arm's length or it would result in the misuse or abuse of the provisions of the Income Tax Act.

Therefore, according to De Koker and Williams (2011: par.19.4), in order for an arrangement to be regarded as an impermissible tax avoidance one, the purpose of the arrangement must be to avoid tax and the means or manner, or rights or obligations must be abnormal. If a transaction appears to be abnormal, then one must investigate the reasons for which the transaction was entered into. If it is evident that the sole or main reason for the existence of the transaction was to acquire a tax benefit, then it is likely that the general anti-avoidance rules will apply. If the arrangement is not abnormal, but instead misuses or abuses the provisions of the South African Income Tax Act, then once again, it is likely that it will be considered to be an impermissible tax avoidance arrangement. Where it has been found that an impermissible tax avoidance arrangement exists, section 80B of the South African Income Tax Act determines the consequences available to the Commissioner, which generally involve the arrangement being disregarded and tax being applied as if the transaction had taken place under normal circumstances.

Section 80A of the South African Income Tax Act refers to section 80C which provides that an arrangement will be regarded as an impermissible tax avoidance arrangement if it lacks commercial substance. In terms of section 80C(a) an arrangement lacks commercial substance if it results in a significant tax benefit for a party but has no effect upon the business risks or the net cash flow of the party (apart from any effect attributable to the tax benefit). Section 80C(2) states that an arrangement will be considered to lack commercial substance if either the legal substance is inconsistent with the legal form of the arrangement or the arrangement includes the presence of round trip financing (80D), an accommodating or tax indifferent party (80E) or elements that have the effect of offsetting or cancelling each other out. Section 80F of the South African Income Tax Act states that where a tax

arrangement has made use of either connected persons or a tax indifferent party, it is necessary to treat the connected persons as the same person or disregard the tax indifferent party and any accommodating or tax indifferent party and the other party to the arrangement are treated as the same person.

8.2.3 ANTI-AVOIDANCE IN THE VAT ACT

The South African VAT Act contains its own anti-avoidance provisions as well as several specific anti-avoidance provisions targeted at eliminating arrangements or schemes carried out for the express purposes of providing a taxpayer with a tax benefit. The general anti-avoidance rules of the South African VAT Act are found in section 73. The section states that where the Commissioner is satisfied that a scheme has been carried out for the sole or main purpose of obtaining a tax benefit, and the scheme was carried out in an abnormal manner (one that would not normally be employed for *bona fide* business reasons) or created abnormal rights or obligations, then the Commissioner is entitled to levy VAT as if the transaction had been entered into in an appropriate manner. A tax benefit for purposes of the South African VAT Act includes a reduction of output tax, an increase in input tax, a reduction in the consideration paid for the supply of goods or services or any other avoidance or postponement of a tax, levy or duty liability. With regard to the specific anti-avoidance rules, the provisions governing connected persons, the time and value of a supply were discussed in chapter six.

8.3.4 PERSISTENT VIRTUAL WORLDS

Structured and unstructured persistent virtual worlds have the potential to create new situations for the manipulation of transactions in an attempt to avoid a tax liability. Where such transactions are arranged in such a manner as to constitute an impermissible tax avoidance arrangement, the general anti-avoidance rules in the Income Tax Act and the VAT Act will apply. One likely scenario when considering tax avoidance and virtual environments is that these persistent online worlds afford connected persons the opportunity, if unchecked by the Commissioner, to arrange their affairs in a manner aimed solely or primarily at the generation of a tax benefit for one or both parties. If the Commissioner takes an active

interest in the dealings that take place within structured and unstructured virtual worlds, it can be assumed that any arrangements involving accommodating, tax indifferent or connect persons will be treated as impermissible tax avoidance arrangements and the transaction/s in question will be disregarded and tax will be imposed on the substance rather than the form of an arrangement. Another potential use of transactions in virtual worlds is to effect round trip financing (which may even be connected with money laundering schemes). Through careful monitoring of a taxpayer's transactions within virtual worlds, the Commissioner may be able to assess the likelihood of tax avoidance schemes and respond appropriately in accordance with the anti-avoidances rules laid out in the South African Income Tax Act and the South African VAT Act. In addition to the tax avoidance schemes that may arise through virtual world participation, money-laundering, which is beyond the scope of this thesis, poses another potential problem to authorities the world over. According to Symantec (2007), while it is not impossible, it is "difficult to trace the true source of the funds when they are withdrawn" and as virtual world interactions "can be conducted worldwide without the oversight that typically accompanies international bank remittances", Greene (2007) explains that it affords opportunities to the "criminal element to launder their ill-gotten gains" and provides further incentive for taxation regulators to pay greater heed to these thriving online economies.

8.4 RECOMMENDATIONS

This thesis has served to inform readers not only exactly what persistent virtual worlds are, but also that there are potential tax consequences that may arise from structured as well as unstructured persistent virtual worlds and the transactions that stem from participation in these online environments. As a result of these potential taxation consequences, as well as the potential for tax avoidance schemes to be operated through these online environments, there is a need for SARS to proactively address emerging issues from virtual environments. The present thesis may focus greater attention on virtual world participation and proposes recommendations as to how best deal with the tax consequences that arise out of virtual world transactions. The recommendations offered are based on the author's own understanding of the difficulties posed by income generated through persistent online

environments, taking into consideration the findings of Camp (2007), Lederman (2007) and the stances of selected tax authorities, as discussed in chapter seven of the thesis.

In chapter three, "gross income" as defined in section 1 of the South African Income Tax Act was applied to situations stemming from the participation in structured as well as unstructured virtual worlds. The chapter ignored the capital or revenue nature of receipts and concluded that the acquisition of any virtual asset has the potential to attract taxes within the Republic of South Africa as a result of the ascertainable market value attributable to all in-world items. Chapter four went a step further, introducing and applying the tests used to distinguish receipts of capital and revenue nature to receipts stemming from virtual world transactions. Objective as well as subjective tests have been established by South African courts as a means of determining the difference between a capital receipt and one that is revenue in nature. Structured worlds, from an objective viewpoint, have as their primary purpose the entertainment of players. Unstructured virtual worlds, on the other hand, provide a platform for both socialization and commercial gain, creating the potential for dual intentions on the part of participants. While objective factors create a basic classification for the potential nature of a receipt, the subjective factors relating to the intention of a taxpayer play a significant role in the determination of the nature of a receipt. Ultimately, a combination of these factors helps determine the nature of a receipt

While, based purely on the definition of "gross income" it is possible to include the value of virtual assets and transactions in the taxable income of a participant, either as a revenue or capital receipt, it is submitted that in view of the difficulty in identifying and taxing in-world transactions, the legislation should only be implemented to the extent that real-world transactions are entered into. Furthermore, based on the number of transactions a single person could undertake involving loot drops, quest rewards, item crafting, item creation and in-world trade transactions, it would be unlikely that a participant taxpayer would be able to calculate the total value of these transactions and it would not be feasible for the Commissioner to discover or assign a value to the "taxable" activities that take place in these online worlds. Consequently, as a result of the problems discussed by Camp (2007: 24) relating to the "measurement, payment and compliance" posed by these transactions, it is

submitted that a tax liability should only exist if and when a virtual world participant "cashes out".

Real money trade and the conversion of virtual currency to real world currency should constitute a taxable event and failure to disclose these transactions could amount to tax evasion. Rather than focusing on the hypothetical real world value of entirely virtual assets, SARS could direct their attention to situations where virtual wealth manifests itself in the real world. When assessing the nature of a receipt, the real world currency a virtual world participant is able to derive from in-world participation, the objective as well as subjective tests discussed in chapter four could play an important role. Players treating virtual worlds as a form of entertainment, a hobby, are entitled to realize their virtual assets to their best advantage provided there is no change in their intention. Where there is evidence of a systematic scheme of profit making, real money trade or the conversion of virtual world currency to real world currency will result in a revenue receipt in the hands of the recipient taxpayer.

It then follows that, if a participant taxpayer may only be taxed when virtual assets manifest themselves as real world currency through either real money trade or the conversion of virtual world currency to real world currency, then a participant taxpayer may only claim real world currency expenditure as deductible in terms of the "general deduction formula". Therefore, in order for expenditure of a non-capital nature to be deductible in terms of the general deduction formula, the expenditure must be incurred in real world currency and comply with the requirements of the preamble to section 11, section 11(a) and section 23(g) of the South African Income Tax Act. Similarly, for capital allowances to be permitted, the expenditure should be incurred in real world as opposed to virtual world currency.

As far as the possible VAT implications of virtual world asset transactions are concerned, it appears that real world currency exchange is perhaps not necessary for the application of the South African VAT Act. Value-added tax is payable by or refundable to a registered VAT vendor based on the difference between that vendor's output tax and input tax and in order for

a transaction to attract VAT, the transaction must constitute the supply of goods or services by a vendor in the course or furtherance of an enterprise carried on by the vendor. Therefore, because virtual assets were found to constitute a supply of services, transactions involving the disposal of virtual items and currency by a vendor registered for VAT purposes will attract VAT even if no real world currency is involved in the transaction.

From a donations tax point of view, once more, real world gains should play a more significant role than in-game rewards. Most in-world disposals, either in the form of a "donation" as defined or a deemed donation, are clearly insignificant and once more it becomes an issue of practicality. Virtual world participants disposing of and receiving virtual assets in manner regarded as either a "donation" or deemed donation, are unlikely to recognise such disposals as being donations and are therefore unlikely to report them. Furthermore, it would not be feasible for the Commissioner to investigate every single virtual world disposal transaction to which a participant taxpayer is party. Where the value of a disposal is clearly not insignificant, it is the duty of the disposing taxpayer to report the disposal of the virtual asset/s to the Commissioner, where such disposals amount to either a "donation" or a deemed donation.

8.5 SUMMARY

This final chapter restated the goals of the research and then addressed these goals in the light of the findings in the various chapters. Following that, the chapter briefly referred to the possibility that there may be a potential for virtual world participants to use these online environments as a mechanism through which to conduct tax avoidance schemes. The difference between tax avoidance and tax evasion was briefly highlighted, identifying the difference between illegal and legal schemes. Without going into any detail, the chapter also mentioned the potential use of virtual worlds for money laundering activities. As a result of potential illegal as well as tax avoidance schemes that may present themselves, the thesis made recommendations as to how best deal with the issue of persistent online environments and the potential tax implications that may arise through transactions stemming from these worlds.

It was recommended that a taxable event should only be regarded as having taken place when converting virtual world currency to real world currency or selling virtual assets for real world currency, practices known as "cashing out". Similarly, only real world currency expenditure incurred in the pursuance of a "trade" within a persistent online environment should be treated as deductible in terms of the "general deduction formula". VAT differs, in that no real world currency exchange is necessary for a transaction to have VAT levied upon it. Provided the disposal of virtual items or currency constitutes a supply of services by a vendor in the course or furtherance of an enterprise carried on by the vendor, the transaction will attract VAT, regardless of whether or not real world currency exchange took place. For donations tax purposes, real world currency gains rather than virtual asset gains should result in the levying of donations tax on disposals regarded as "donations" or deemed donations.

It would appear that the present tax legislation can be applied to transactions in a virtual world, without the need for any amendment to the Acts. Ultimately, as it would be difficult for the Commissioner to investigate the plethora of virtual transactions South African taxpayers may conduct in persistent online environments, SARS should issue guidelines addressing how taxpayers will be required to report on economic activities in virtual worlds, to improve voluntary tax compliance.

AFTERWORD

Strolling at a leisurely pace through the Evensong Woods, Aethas pays little mind to the beasts of the region. The Blood Elf thinks back to his training and how far he has come. Once a timid Blood Elf, lacking the confidence to stay beside his brethren in battle, he now strikes fear and awe, in equal amounts, into Horde and Alliance members across Azeroth. Many moons have passed since his last encounter with Magistrix Erona, and although he is now known for being tactically astute and ruthless in the heat of battle, the temperament of his old master sends shivers down his own spine. On his right hip, within its scabberd, rests the legendary Kingsbane. Of immense financial and historical value, the Kingsbane is believed to be the dagger wielded by Garona Halforcen to assassinate Llane Wrynn during the First Great War. On his opposite hip, Aethas still carries one of the original two daggers forged for him by his father before his journey began. While hardly a true representation of his physical prowess or his monetary wealth, the blade serves to remind Aethas Dawnblade of who he is, where he came from and why he fights.

Approaching the very same Sunspire he bid farewell to many years ago, Aethas can't help but feel emotional over fallen comrades and family lost. He longs for the chance to see his parents one last time, to thank them for all that they had done for him while he was growing up, and to perhaps regale them with tales of his adventures. Drawing nearer, he notices the familiar silhouette of his first master, Magistrix Erona. Although years have passed since her final teachings, she appears not have aged a day. The two greet one another as if their master-apprentice relationship had never ended and Aethas feels at home. The two talk for hours on a wide range of topics from Erona's current crop of apprentices to the delicate wine served with their dinner, from the re-emergence of Deathwing the Destroyer to the exceedingly vast value of Aethas' estate. Dwelling on his finances for a moment, Aethas wonders what adventures still await him.

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