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Virtual worlds, real money: Tax issues in the metaverse

Vincent OOI
Singapore Management University, vincentooi@smu.edu.sg

Daryl LOY

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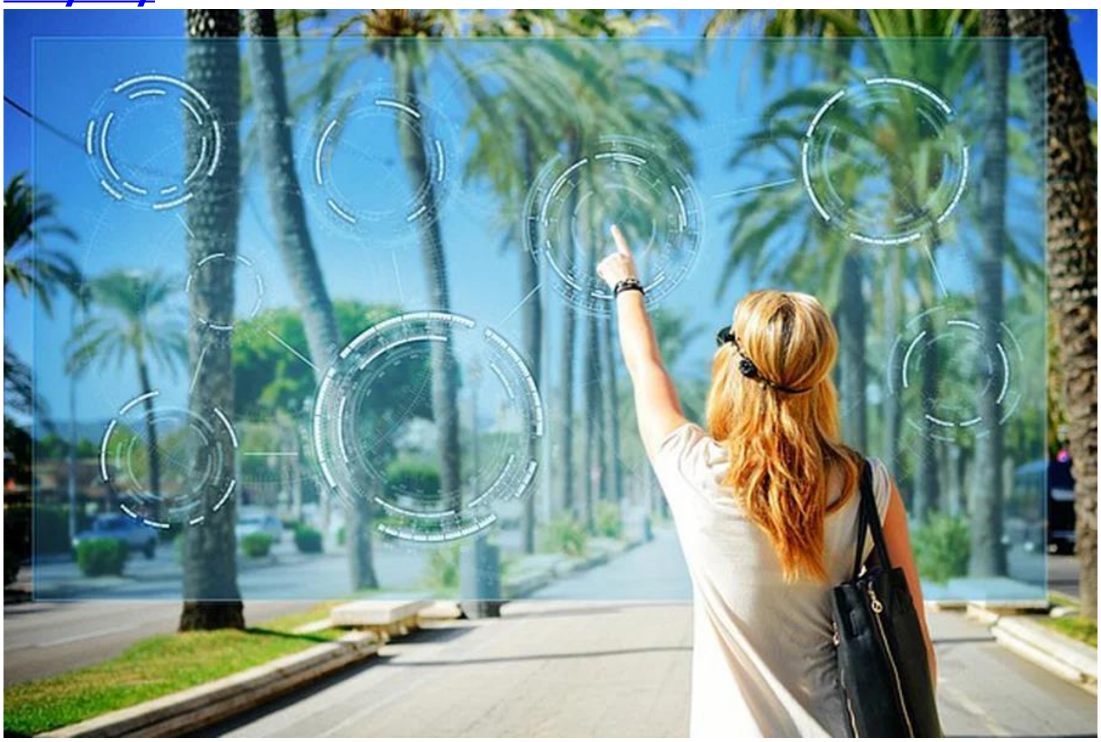
Vincent Ooi

Daryl Loy



As the digital and metaverse economies grow, the tax issues of the day will evolve around the business models adopted.

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THE term “metaverse” is thought to have been coined by Neal Stephenson in his 1992 science fiction novel *Snow Crash*. Some 30 years later, with major leaps in technology raising the possibility of this becoming a reality, the tech and business world is abuzz with talk of the metaverse and its potential commercial applications. This has led to debates about whether new legal rules are required to regulate the metaverse (see, for instance, *Regulating avatars in the metaverse*, BT, Aug 26, 2022).

While participants may feel that they are situated in a different plane of existence, given the immersive capabilities of the metaverse, their physical self remains firmly rooted in the same spot. More importantly, the user remains in the same tax jurisdiction in the eyes of the law. Regardless of how real the experience may be, domestic and international tax law does not currently give any special status to a meta realm as a distinct jurisdiction.

However, what we are likely to see is a change in business models and behavioural patterns, leading to different kinds of taxable events becoming either more or less prominent. Tax law may not change but the tax issues of the day will.

As the digital and metaverse economies grow, it is likely that they will make up an ever-increasing proportion of international trade. Bloomberg estimates that the metaverse would constitute a US$800 billion market by 2024. Uses of the metaverse for commercial purposes can take many forms. A different set of tax issues arises depending on one's business model adopted in the metaverse. Broadly, there are three main models.

Platform operators

First, platform operators provide the hardware and/or software required for participants to use the metaverse. Typically, a two-sided "infrastructure-as-a-service" model is adopted. One side caters to users while the other side caters to advertisers. Past experience with online social media platforms suggests that users will expect access to the platform to be free, creating a model where revenue is likely to come mostly from advertisers. That said, revenue generation need not be limited to advertisement revenue, but can also come in the form of transaction fees (for example, Amazon, eBay).

At the present moment, advertisement and transaction fees are likely to be taxable as business profits in the jurisdiction where the platform operators are resident (the "residence state") and not where the users are based (the "source state"). However, a range of new initiatives such as digital services taxes, the Pillar 1 proposal by the Organisation for Economic Co-operation and Development (OECD) and the new Article 12B in the United Nations Model Tax Convention may provide source states with some taxing rights too. Aside from direct taxes, there is also the possibility of goods and services tax (GST) being charged and collected by the platform operators on behalf of the source states.

Businesses

Second, once there are enough users on a metaverse platform, significant network effects would attract businesses to expand their operations there. Businesses can operate on the metaverse purely digitally with no provision of physical goods (for example, the purchase of a customised skin for a metaverse avatar, or the perusal of audio-visual content or virtual reality experiences). Their income from such operations is likely to be taxed in the residence state and, under the new initiatives, in the source state as well. Source states may also charge GST on the sale of digital goods and services.

Businesses could also adopt an omni-channel marketing strategy to use the metaverse as a means to sell physical goods and services (for example, product placement in the metaverse for goods later delivered in the physical realm). This would largely attract the same tax treatment as for offline businesses, with income tax and GST likely to be payable to the source state. Businesses could also adopt a hybrid model where both a digital and physical good or service is provided. Companies such as Adidas, for instance, have adopted such a model by selling physical athleisure merchandise in their “Into the Metaverse” range of products, coupling them with a Non-Fungible Token (NFT). The tax treatment of income from such a model will be apportioned based on whether the income is from digital or non-digital activities.

Individuals

Last, individuals will play a large role in shaping the metaverse. The metaverse is a part of the Web 3.0 movement, where its advocates are developing an Internet characterised by decentralised and mass user participation. Individuals could participate in the metaverse as consumers, where it is likely that they would have to pay GST on their purchases. On the other hand, if individuals provide goods and services on the metaverse as part of the wider “gig economy” and derive income from it, then the income may be subject to income tax by the tax jurisdiction which they are physically in.

Looking to the future

In Action 1 of the Base Erosion and Profits Shifting (BEPS) plans, the OECD stated that it is not possible to ring-fence the digital economy from the rest of the economy for tax purposes as the digital economy is rapidly becoming the actual economy itself. While we may be still quite a while away from being able to say the same about the metaverse, we should start looking at how domestic and international tax systems can be adapted to better deal with the economy of the future. This should start with a good understanding of how business models and behavioural patterns are likely to change due to the metaverse.

Vincent Ooi is a lecturer of law at the Yong Pung How School of Law, Singapore Management University (SMU) and specialist counsel at Legal Ink. Daryl Loy is a former research assistant from the same school. The views are the authors’ own and do not represent those of SMU or Legal Ink.