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## Insert Another Coin to Continue: How In-Game Benefits in Video Games Should be Addressed By the IRS

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# **Insert Another Coin to Continue: How In-Game Benefits in Video Games Should be Addressed By the IRS**

*Clay Alexander*

## **ABSTRACT**

In 2019, the IRS released a publication announcing Fortnite V-bucks are a taxable source of income, deeming it a virtual currency. After announcing this decision, there was a small uproar in the gaming community, and the publication was retracted and re-released without the mention of V-bucks. The issue raises an interesting question: how should the IRS handle video game benefits that have real-world value?

As it currently stands, the in-game benefits that players earn while playing video games have not been subject to any tax reporting requirements. Previously, there was no need to report the benefits earned since they did not have a real-world value. However, the recent advent of microtransactions in the video game industry has produced a system in which in-game benefits potentially have real-world exchange value. Therefore, players are now realizing a new form of wealth that is potentially subject to taxation.

This article will look at the world of in-game benefits and address the tax implications of various possible classifications. It will also put forward various concerns and possible solutions to the problem posed by this issue.

## I. INTRODUCTION

Video games are a mainstream entertainment medium.<sup>1</sup> Last year, the video game industry generated over \$120 billion in gross revenue.<sup>2</sup> Celebrities have leveraged their love of gaming into various lucrative endorsement deals.<sup>3</sup> There is even an increasing amount of video game stories that are being adapted for both movie and TV audiences.<sup>4</sup> An increased presence in the social sphere, however, comes with increased scrutiny from lawmakers.<sup>5</sup>

Lawmakers targeting the video game industry is not a new phenomenon. In the past, lawmakers have focused on the violent nature of certain video games.<sup>6</sup> While there are ongoing attempts to address this supposed issue,<sup>7</sup> legislative attention has shifted away from trying to regulate violence in video games.<sup>8</sup> Today, the most prevalent issue that lawmakers are addressing in the video game industry is the use of loot boxes and its introduction and promotion of gambling to underage kids.<sup>9</sup> While this article does address loot boxes more generally, the primary purpose is to analyze their impact on tax earnings.<sup>10</sup>

What is virtual currency that you obtain from playing video games? In most instances, it is a reward earned by the player during gameplay. This currency is distributed for a variety of reasons: completing a particular challenge, accumulating enough experience points to “level up,” logging in and playing the game for consecutive days, and being part of the winning team in an online match are notable examples.<sup>11</sup> The issue the Internal Revenue Service (IRS) has identified with this currency is that since it arguably has a real-world monetary value, it should

1. Ci Paul Johnson, Video games: from niche pastime to mainstream entertainment, QUOTED DATA (June 8, 2020), <https://quoteddata.com/2020/06/video-games-niche-pastime-mainstream-entertainment/#:~:text=Video%20games%20have%20gone%20mainstream,%25%20growth%3B%20%2468.2bn>.

2. Dean Takahashi, *SuperData: Games hit \$120.1 billion in 2019, with Fortnite topping \$1.8 billion*, VENTURE BEAT (Jan. 2, 2020), <https://venturebeat.com/2020/01/02/superdata-games-hit-120-1-billion-in-2019-with-fortnite-topping-1-8-billion/>.

3. See Nathan Sharp, *10 Celebrity Gamers (& Their Favorite Game)*, GAMERANT (Nov. 1, 2019), <https://gamerant.com/celebrity-gamers-favorite-games/>; see also Saqib Shah, *10 celebrities you never realized were massive video game nerds*, THE SUN (Mar. 16, 2018, 4:25 PM), <https://www.thesun.co.uk/tech/5827965/celebrities-who-are-gamers/>.

4. Sid Natividad, *Every Video Game Being Adapted Into A Movie Or Netflix Show Right Now*, SCREENRANT (Jul. 9, 2019), <https://screenrant.com/every-video-game-adapted-movie-netflix-show/>.

5. See e.g. Paul Tassi, *Trump, Republican Focus On Video Games and ‘Call Of Duty’ After Mass Shootings Is A Transparent Distraction*, FORBES (Aug. 5, 2019, 01:23 PM) <https://www.forbes.com/sites/paultassi/2019/08/05/trump-republican-focus-on-video-games-and-call-of-duty-after-mass-shootings-is-a-transparent-distraction/#73e57f6b3371>; see also *Brown v. Entm’t Merchants Ass’n*, 564 U.S. 786 (2011).

6. Tassi, *Trump, Republican Focus On Video Games and ‘Call Of Duty’ After Mass Shootings Is A Transparent Distraction* (Aug. 5, 2019).

7. *Id.*

8. This is likely due to the Supreme Court striking down restricting the sale of violent video games. See *Brown v. Entm’t Merchants Ass’n*, 564 U.S. 786, 790 (2011).

9. Julie Muncy, *This Senator Wants to Ban Videogame Loot Boxes Aimed at Kids*, WIRED (May 10, 2019 09:00 AM), <https://www.wired.com/story/videogame-legislation-loot-boxes/>; Ben Gilbert, *The video game industry is facing government scrutiny over loot boxes, and the most powerful leaders in gaming are divided over what to do*, BUSINESS INSIDER (June. 23, 2019, 6:41 AM), <https://www.businessinsider.com/video-game-industry-loot-box-legislation-2019-6>.

10. See *infra* Part III.A.ii.

11. Prateek Argawal, *Microtransactions in video games*, INTELLIGENT ECONOMIST (Nov. 19, 2017) <https://www.intelligenteconomist.com/microtransactions/>.

therefore be taxed as income. How can a virtual currency in a video game have any real-world value? In a single word: microtransactions. Game developers and publishers make money from a game beyond the initial purchase by offering additional content that can be obtained with in-game currency.<sup>12</sup> Players can exchange real-world money for the currency used within the video game to obtain various in-game cosmetics or power-ups.<sup>13</sup> When real-world money is able to be exchanged for in-game benefits (excluding the initial purchase of the game), it is called a microtransaction. These microtransactions have been a boon to the video game industry, generating over \$43.4 billion in 2018 alone.<sup>14</sup> With so much money being made from microtransactions, it is fair for the IRS to wonder whether the currency that a player earns through playing a game should be includable in a person's gross income.

This article discusses the practical implications of attempting to tax these in-game benefits and the roadblocks that pose a challenge to decision makers. Part II of this article will give an overview of the various types of in-game benefits and classify them into broad categories to be used throughout the article. Part III will examine which tax code provisions in-game currencies should be examined under. Part IV will analyze the numerous impediments that would make tax collection difficult. Lastly, Part V will look at some possible solutions and their foreseeable ramifications.

## II. IN-GAME BENEFITS

For convenience in determining applicable tax code provisions, we first must determine which kinds of in-game benefits we are addressing. In general, in-game benefits can be broken into three distinct categories: in-game currency, loot boxes, and cosmetic items.<sup>15</sup>

### A. *In-game Currency*

In-game currency is the most straightforward in-game benefit. The game rewards players for playing with virtual currency which can be spent in the game's virtual store.<sup>16</sup> Players can also spend real-world money to obtain additional in-game currency to spend in the store.<sup>17</sup> However, these games do not have a "cash-out" feature that allows the players to exchange their in-game currency for real-world money.<sup>18</sup> Common examples of games that operate using in-game currency are Call of Duty Modern Warfare (COD points) and Fortnite (V-bucks).<sup>19</sup>

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12. Erik Kain, *This is why video game microtransactions aren't going anywhere*, FORBES (Jan. 23, 2019, 12:02 PM), <https://www.forbes.com/sites/erikkain/2019/01/23/video-game-accessories-in-game-purchases-and-subscriptions-drove-industry-growth-in-2018/#47f33a063d24>.

13. *Id.*

14. *Id.*

15. Argawal, *supra* note 11.

16. James Madigan, *The Perils of In-Game Currency*, FORBES (Dec. 19, 2019, 09:55 AM), <https://www.forbes.com/sites/jamiemadigan/2019/12/19/the-perils-of-in-game-currency/#3f7a0b0242da>.

17. *Id.*

18. *Id.*

19. *Id.*

### B. Loot Boxes

Loot boxes are another form of in-game benefit available to players. Loot boxes are virtual crates containing randomized rewards.<sup>20</sup> Loot boxes are guaranteed to reward players with some items, but the value of the reward is determined by an odds system similar to that of a slot machine.<sup>21</sup> Most game companies choose either a straight-up virtual currency or a loot box system for monetization.<sup>22</sup> This means a consumer can spend real-world money to obtain either virtual currency or additional loot boxes.<sup>23</sup> A prime example of a game that uses loot boxes is Overwatch.<sup>24</sup>

### C. Cosmetic Items

Cosmetics items are the most convoluted in-game benefit to assign a real world value due to the rarity of direct purchase cosmetics.<sup>25</sup> Cosmetic items are items within a game that affect the player's virtual character's appearance.<sup>26</sup> There is a large variety in cosmetics that can change anything from the character's outfit, voice lines, emotes, and more.<sup>27</sup> Cosmetic items are a common reward for players who obtain certain in-game achievements but are rarely obtainable through direct purchase.<sup>28</sup> An infamous example of a cosmetic direct purchase (that started the trend of microtransactions in gaming) came from Bethesda Studios landmark game Skyrim and their "horse armor" downloadable content ("DLC").<sup>29</sup>

## III. CLASSIFICATION

With the three categories of in-game rewards established, we will analyze how the IRS tax code could apply to each category.

### A. How is it Currently Viewed?

As it currently stands, the IRS has not set forth a definitive policy governing taxation of in-game benefits. However, a recent publication made by the IRS has

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20. Andrew Freedman, *What Are Loot Boxes? Gaming's Big Controversy Explained*, TOM'S GUIDE (Aug. 9, 2019), <https://www.tomsguide.com/us/what-are-loot-boxes-microtransactions,news-26161.html>.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. The game with arguable the most well known cosmetic market place, Counter Strike Global Offensive, requires players to use third party sites in order to be able to trade rare cosmetic items for some type of currency. See Michael Crider, *How to Make Real Money Playing Video Games*, HOW-TO GEEK (May 16, 2017), <https://www.howtogeek.com/306389/how-to-make-real-money-playing-video-games/>.

26. *How on earth is trading virtual items in videogames a \$50billion industry?*, MEDIUM (Dec. 11, 2017), <https://medium.com/wax-io/how-on-earth-is-trading-virtual-items-in-video-games-a-50-billion-industry-5972c211d621>.

27. *See Id.*

28. *Id.*

29. Brendon Sinclair, *Oblivion's Horse Armor was ahead of its time*, GAMESINDUSTRY.BIZ (April 6, 2016), <https://www.gamesindustry.biz/articles/2016-04-06-10-oblivions-horse-armor-was-ahead-of-its-time>.

indicated they intend to treat the in-game benefits as virtual currency.<sup>30</sup> This publication was shocking to many in the gaming community and the IRS retracted any mention of in-game benefits from the publication before re-release.<sup>31</sup> Since the IRS has signaled a potential change, it is wise to evaluate the concept of treating in-game benefits as a virtual currency.

### *i. What is a Virtual Currency?*

The IRS defines a virtual currency as:

a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like “real” currency — i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance— but it does not have legal tender status in any jurisdiction.<sup>32</sup>

By this definition, the currency a player receives in a video game fits within the IRS definition of virtual currency. However, this definition is excessively vague. Several things could be classified as a digital representation of value that is used for exchange or storing value. Social media likes, favorites, views, and retweets arguably have value since they could be exchanged for products or services.<sup>33</sup> The IRS has clarified that they are focused on whether the currency is a “convertible virtual currency.”<sup>34</sup> Convertible virtual currency is a “[v]irtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency[.]”<sup>35</sup> A popular example is Bitcoin. Bitcoin has a known exchange rate.<sup>36</sup> A dollar can be used to purchase some Bitcoin, and Bitcoin can be sold for U.S. dollars. Because of this convertibility between an exclusively digital currency and a physical currency, Bitcoin is known as a convertible virtual currency.<sup>37</sup>

### *ii. Can In-game Benefits be Properly Classified as a Virtual Currency?*

Applying the framework of virtual currency to in-game benefits is where things begin to get complicated. The difficulty is due to problems in applying a virtual currency tax framework to all forms of in-game benefits. For in-game currency, the application is fairly straightforward. The storefront that allows players to spend

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30. Brian Fung, *IRS quietly deletes guideline that Fortnite virtual currency must be reported on tax returns*, CNN (Feb. 14, 2020, 1:59 PM), <https://www.cnn.com/2020/02/13/tech/fortnite-taxes/index.html>.

31. *Id.*

32. I.R.S. Notice 14-16, 2014-21 C.B. 931.

33. Leslie K. John, et al., *What's the Value of a Like?*, HARVARD BUS. REV. (March–April 2017), <https://hbr.org/2017/03/whats-the-value-of-a-like>.

34. I.R.S. Notice 14-16, 2014-21 C.B. 931.

35. I.R.S. Notice 14-16, 2014-21 C.B. 931.

36. *See Bitcoin*, COINDESK, [https://www.coindesk.com/price/bitcoin\\_\(last visited Aug. 19, 2020\)](https://www.coindesk.com/price/bitcoin_(last%20visited%20Aug.%2019,%202020)) (showing the current price for Bitcoin).

37. I.R.S. Notice 14-16, 2014-21 C.B. 931.

money to buy in-game currency sets the fair market value of the currency.<sup>38</sup> One must simply determine the amount of in-game currency the player accumulated over the year and calculate the real-world equivalent of that currency.<sup>39</sup>

If the in-game reward is a cosmetic item, one must determine the value of the cosmetic in either in-game currency or real-world currency. If the cosmetic is tied into the purchase of another item (such as a battle pass) then the concept is muddled. It must be determined whether the individual items within the battle pass or the initial battle pass price itself is being evaluated.<sup>40</sup>

This analysis is even more difficult if the reward is a loot box, because it is unclear what value basis should be used for taxation purposes. For the cosmetics and in-game currency, the basis is simply the fair market value.<sup>41</sup> For loot boxes, there is not a clear value to use as the basis. Using the price of the loot box itself is problematic because the total value of the contents could be less than the value of the loot box, resulting in excessive taxation with no recourse.<sup>42</sup> On the other hand, using items received from loot boxes would force the taxpayer to determine the gain and loss of every loot box transaction, a time consuming endeavor.<sup>43</sup>

The issue with all of these analyses, however, is that they operate under the assumption that these in-game benefits are convertible virtual currencies. There is a reasonable argument that in-game benefits cannot be classified as convertible virtual currency since the conversion is usually one way. The conversion that most in-game benefits applies is one way transaction from real-world currency to in-game virtual currency.<sup>44</sup> This seems to be incompatible with the standard that a currency functions as a medium of exchange since the term “exchange” implies a two way transaction. However, it should also be noted that nowhere in the definitions of virtual currency or convertible virtual currency does it exclude exchanges in one direction.<sup>45</sup> The requirement is only that the exchange has a real-world value.<sup>46</sup>

Treating all in-game benefits as a virtual currency is one way to deal with the issue of video game taxation. However, there could be other ways to address in-game benefits in a more precise manner, which will be explored further.

### B. *Is this Gross Income?*

In looking at alternative ways to classify in-game benefits, the first issue to be determined is whether the various in-game benefits can even be classified as “income.” In the landmark tax case *Glenshaw Glass*, the United States Supreme Court classified “gross income” as any accession to wealth, clearly realized, that the

38. Department of the Treasury Financial Crimes Enforcement Network, *FIN-2013-G001-Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FINCEN GUIDANCE 3 (2013), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf> [hereinafter FinCEN’s Guidance on Virtual Currency].

39. I.R.S. Notice 14-16, 2014-21 C.B. 931.

40. Erno Kiiski, *What’s the big deal with Battle Pass*, GAME REFINERY (Aug. 14, 2018), <https://www.gamerefinery.com/whats-the-big-deal-with-battle-pass/>.

41. FinCEN’s Guidance on Virtual Currency, *supra* note 37.

42. *See infra* Part II.,B.ii.

43. *See infra* Part II.,B.ii.

44. Allyson Versprille, *Gamers Rich in Virtual Cash Freed From IRS Reporting Worry (1)*, BLOOMBERG TAX (Feb. 12, 2020), <https://news.bloombergtax.com/daily-tax-report/irs-pulls-wording-subjecting-gamers-to-virtual-currency-question?context=search&index=0>.

45. *See* I.R.S. Notice 14-16, 2014-21 C.B. 931.

46. *See* I.R.S. Notice 14-16, 2014-21 C.B. 931.

taxpayer has dominion over.<sup>47</sup> In applying this standard to the in-game benefits that players achieve while playing a video game, the benefits seem to pass the test to be able to classify as a type of income.

First, because these in-game benefits have a real-world dollar amount that can be determined, obtaining any of these benefits without having to purchase them is an accession to wealth.

To determine realization, courts have looked at whether the taxpayer has received an economic gain.<sup>48</sup> Under that analysis, these items become “clearly realized” when they are deposited within the players’ account because they obtain a gain that has real-world value.

Lastly, to determine dominion and control, courts have looked at whether the individual can dispose of the property at will.<sup>49</sup> The player has the choice of what to spend their virtual currency on, and the choice of whether to open the loot box or not. The player also has the ability to choose and equip earned cosmetics to their in-game character. It is for these reasons that any in-game benefits players earn should be considered gross income. The next issue to determine is whether there is a more specific category in which to classify this income.

### *i. Classification as a gift*

Alternatively, in-game benefits can be treated for tax purposes as gifts. For most gamers, this would be the ideal way to treat the in-game benefits received. This is because, as a general rule, the IRS has found that “[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance.”<sup>50</sup> This would mean that gamers would be allowed to withhold these earnings from gross income. While this would be ideal for gamers, it is another matter on how the IRS interprets the meaning of a “gift.” For tax purposes, the IRS has generally defined a gift as “something given with detached and disinterested generosity.”<sup>51</sup> How the game developer or player define the transaction is irrelevant; there must be an objective inquiry as to whether what may be called a “gift” amounts to one in reality.<sup>52</sup>

Looking at how it applies to various in-game benefits, the applicability of gift status seems to vary depending on the type of in-game benefit received.

#### *1. In-game Currencies*

The argument that virtual currency is a gift is not entirely convincing. Game developers argue that they derive no benefit from rewarding players with in-game currency to spend in their store.<sup>53</sup> The players already spent some money to acquire the game, so the developer is rewarding the player for purchasing and playing their game with virtual currency. In addition, it is more profitable for developers to make currency acquisition possible only through real money exchanges.<sup>54</sup> In essence, they

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47. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 429, 431 (1955).

48. *Diedrich v. Comm’r*, 457 U.S. 191, 196-97 (1982).

49. *Pauley v. United States*, 459 F.2d 624, 627 (9th Cir. 1972).

50. I.R.C. § 62.

51. *See Comm’r v. Duberstein* 363 U.S. 278, 285 (1960).

52. *Id.* at 286.

53. Argawal, *supra* note 11.

54. *Id.*



are giving away “free” money to players to spend in their in-game store.<sup>55</sup> The counter to this argument is that the game developer is giving out currency to entice the player to visit the in-game store, and spend extra money to supplement their earned currency to acquire cosmetic items.<sup>56</sup> This would make the distribution of currency to players not a gesture of “detached and disinterested generosity,” but an enticement to spend money in their store.<sup>57</sup> Further, there is evidence that developers are intentionally giving currency at low rates and pricing their cosmetics at a high prices to push consumers to spend real-world money to supplement their currency to obtain these cosmetics.<sup>58</sup> Given the totality of the circumstances, it is difficult to classify currency rewards are given with “detached and disinterested generosity” by game developer. Virtual currency rewards are therefore a poor fit for gift classification.

### 2. *Loot boxes*

In the case of receiving loot boxes, the gift argument is even less availing. This argument is that the developers are giving the players guaranteed cosmetic rewards.<sup>59</sup> The developers could restrict cosmetics to direct purchases, but are instead passing them out in a completely random process.<sup>60</sup> The argument against this categorization is the same as the argument lawmakers are currently using against loot boxes in general: they promote gambling behavior. Because the rewards are handed out randomly in loot boxes, and the odds of obtaining the most valuable items are astronomically low, it promotes consumers to spend real-world money to acquire more loot boxes to acquire desired items.<sup>61</sup> There is also a psychological stimulant derived from slot machine mechanics that promotes an addiction to this type of gambling.<sup>62</sup> It is clear that creating a player base with an addiction to playing your version of a slot machine is not “disinterested and detached generosity.” Therefore, loot boxes should not be considered gifts.

### 3. *Cosmetic Rewards*

There is a decent argument that the last type of in-game benefit, direct cosmetic rewards, could fairly be considered gifts. The argument is that by handing out the item directly, the game developers avoid all monetization efforts.<sup>63</sup> The player’s efforts are rewarded with the cosmetic.<sup>64</sup> There is no enticement to visit any store, take chances with loot box rewards, or even spend any real-world money.<sup>65</sup> The opposing argument is that, depending on the difficulty of obtaining the cosmetic organically, the player might be incentivized to purchase in-game power-ups in order to obtain the item.<sup>66</sup> This point will likely turn into an analysis on how realistic is it for the average gamer to achieve this reward, and what kind of commitment the average gamer must make in order to obtain it. However, as long as the cosmetic

55. *Id.*

56. *Id.*

57. *Comm’r v. Duberstein* 363 U.S. 278, 285 (1960).

58. Argawal, *supra* note 11.

59. *Id.*

60. *Id.*

61. *Id.*

62. Wendy Patrick, *the Real Reason Some People Get Hooked on Slot Machines*, PSYCHOLOGY TODAY (Jul. 13, 2019), <https://www.psychologytoday.com/us/blog/why-bad-looks-good/201907/the-real-reason-some-people-get-hooked-slot-machines>.

63. Argawal, *supra* note 11.

64. *Id.*

65. *Id.*

66. *Id.*

would not encourage the average gamer to spend money to achieve it, it likely will be viewed as a gift. If the cosmetic would encourage the average player to spend money in order to obtain it, then it likely will not be viewed as a gift because it was not given out of disinterested generosity.

## ii. *Classification as a prize*

Prizes are generally included in gross income.<sup>67</sup> While there is no strict definition, prizes are generally classified as anything given as an award that has monetary value.<sup>68</sup> Under this type of classification, in-game benefits would squarely fall within the definition of a prize. In-game benefits have a monetary value, and are given as a reward to players for playing the game.<sup>69</sup> However, there are exceptions that allow prizes to be excluded from gross income.<sup>70</sup> In general, there are three requirements.<sup>71</sup>

First, the recipient must be selected without any action on their part to enter the contest or proceeding.<sup>72</sup> One could argue that the purchase of the game represents entry into an opportunity to obtain in-game benefits. This, however, is likely a losing argument. In *Isenbergh*, the tax court held that the participant must have the purpose of entering the contest to violate §74.<sup>73</sup> Filling out an application to join the contest is enough to justify intent.<sup>74</sup> However, if the participant was already engaging in an event, and they were later awarded a prize for participating, then that prize would be deductible.<sup>75</sup> For this case, the player's purpose is to play the game, and the rewards are a side bonus. In other words, players play video games to experience the games, not to just obtain cosmetics. Since the purpose of the player is to play the video game, they are likely not going to be viewed as intentionally trying to obtain cosmetics, and therefore can proceed to the other elements of a §74 claim.

Second, the player must not be required to render future or additional work to receive the prize.<sup>76</sup> Since the in-game benefits are typically given on account of past work done by the player, and not for future consideration, this requirement is satisfied.

Lastly, the prize must be donated to a certain class of people.<sup>77</sup> This is where the argument for exception from income falls apart, since gamers are not considered by the government to be a charitable organization.<sup>78</sup> Ultimately, because the in-game benefits are given as an award, it is completely fair for them to be classified as taxable prizes.

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67. I.R.C. § 74.

68. *Id.*

69. Argawal, *supra* note 11.

70. I.R.C. § 74.

71. *Id.*

72. *Id.*

73. *Isenbergh v. Comm'r*, 31 T.C. 1046 (1959).

74. *Id.*

75. *Id.* at 1053 (citing Rev. Rul. 57-67, 1957-1 C.B. 33)

76. I.R.C. § 74.

77. *Id.*

78. *Id.*

### *iii. Classification as gambling proceeds*

Loot boxes, as the only in-game benefit with a gambling aspect, could be seen as gambling proceeds. As identified earlier, gross income includes accessions to wealth, and this includes gambling proceeds.<sup>79</sup> A taxpayer is only able to deduct wagering losses from their gross income to the extent of gambling gains. This means the taxpayer either has gains or no tax liability from gambling.<sup>80</sup>

If the proceeds from loot boxes are classified as gambling proceeds, the determination of gains and losses is complicated. The first step in determining gains and losses is the determination of the basis of the wager.<sup>81</sup> Since a loot box is an in-game reward, it arguably has three possible bases. The first is the price of the full game at the time of purchase.<sup>82</sup> This is because the player's initial investment into the gambling transaction is the game itself. However, this is the least likely option. When people go to gamble, they cannot include the cost of gas to the betting location or the cost of admission into their gambling basis, even though these are necessary investment costs.<sup>83</sup>

The next possible basis amount is zero. Since the loot box is given to the player, they do not have to pay any money for the ability to gamble.<sup>84</sup> The only result would be gambling proceeds, because loot boxes give guaranteed rewards every play. There is likely no slot machine in existence that intentionally pays out rewards on every turn. Guaranteed wins also defeat the purpose of gambling, so this option does not feel like a fair determination of basis.

The last option is using the fair market value of loot boxes as the basis.<sup>85</sup> Usually, the developer determines the fair market value by setting the price of loot boxes.<sup>86</sup> If this is used as the basis, then there could actually be wagering gains and losses. By subtracting the value of the cosmetic items received from the cost of the loot box, there is either a loss (most cases) or a gain. The issue is that games that use loot boxes as the sole in-game benefit and monetization method do not place a value on the cosmetics earned. While this an inconvenience, it would put the onus on developers to put a dollar value on their cosmetics, allowing for gains and losses to be calculated. While it is a bit unwieldy to classify loot boxes that give out guaranteed rewards as a sort of gambling, it is a feasible way to determine gains and losses.

### *iv. Classification as a “fringe benefit”?*

Fringe benefits represent the last major category under which in-game benefits could be classified. The IRS defines fringe benefits, or more specifically “de minimis fringe” as “any property or service the value of which is . . . so small as to make

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79. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955).

80. I.R.C. §165.

81. *Id.*

82. Argawal, *supra* note 11.

83. Gambling deductions only apply to losses from wagers. See *Topic No. 419 Gambling Income and Losses*, IRS, <https://www.irs.gov/taxtopics/tc419> (last visited Dec. 6, 2020).

84. Argawal *supra* note 11.

85. Gambling Income and Losses *supra* note 92.

86. FinCEN's Guidance on Virtual Currency, *supra* note 37.

accounting for it unreasonable or administratively impracticable.”<sup>87</sup> At face value, this seems like a sensible way to classify video game benefits. For an overwhelming majority of the gaming population, benefits earned in-game are likely to translate to a small actual dollar value (easily less than \$100).<sup>88</sup> However, the §132(d) exception only applies in respect to employment benefits.<sup>89</sup> It is difficult to imagine a scenario where those who buy video games are “employees” of the game company. Therefore, for the public at large, in-game benefits cannot be categorized as de minimis fringe.

#### IV. MAJOR ROADBLOCKS

Even with an ideal tax scenario put in place to properly identify in-game benefits, there are several roadblocks to implementing taxes on in-game benefits. Specifically, there are six major questions that need to be addressed before any type of tax structure can be implemented.

##### *A. Who are these gamers?*

The first problem is identifying who these gamers are. As it currently stands, there is a high degree of player anonymity in the videogame universe.<sup>90</sup> This is apparent through the use of a player’s gamer tag instead of their actual name.<sup>91</sup> Furthermore, there is currently no system in place to verify the names of these players. The most extensive work done to verify a player’s real-world identity is a requirement to provide some credit card information in order to create an account to play certain games.<sup>92</sup> However, this is done primarily to allow the purchase of in-game benefits, rather than to provide an identity verification tool.<sup>93</sup> Additionally, large game publishers will likely point to their terms of service which require that the individuals paying for items on an account verify that they are also the account holder.<sup>94</sup> Since there is not a system in place to verify the identity of players, it is nearly impossible for game developers or the IRS to accurately provide a tax statement to these individuals.

##### *B. When were the benefits earned?*

Since the IRS wants individuals to report their income that they have earned only in the past year,<sup>95</sup> there should be a way for players to identify which in-game

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87. I.R.C. § 132(d).

88. Takahashi, *supra* note 2.

89. I.R.C. § 132(d).

90. Will Wheaton, *Anonymous trolls are destroying online games, Here’s how to stop them*, WASHINGTON POST (Nov. 11, 2014, 6:00 AM), <https://www.washingtonpost.com/posteverything/wp/2014/11/11/anonymous-trolls-are-destroying-online-games-heres-how-to-stop-them/>.

91. *See Id.*

92. *Id.*

93. *Id.*

94. *See* Terms of Service, EPIC GAMES, <https://www.epicgames.com/site/en-US/tos> (last visited Dec. 6, 2020); Terms of Use, ACTIVISION, <https://www.activision.com/legal/terms-of-use> (last visited Dec. 6, 2020).

95. *Tax Years*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/tax-years> (last visited Dec. 6, 2020).

benefits they have earned in that time. Currently, the only information available to the players to track their gains is a general overview of all in-game benefits that they have earned since playing the game.<sup>96</sup> There is no distinction provided as to when these in-game benefits were earned, because it is largely irrelevant to the player when they earned the benefit. To help make it easier for players to identify on their tax forms how much they've earned through in-game benefits, there should be a system that clearly shows when the benefits were earned.

### C. *What is the value of those benefits?*

Another issue that must be addressed is determining the value of in-game benefits. If the game rewards players with in-game currency, and that in-game currency can also be purchased using real-world money, then it is a fairly straightforward calculation.<sup>97</sup>

For example, Fortnite rewards players with in-game currency known as V-bucks.<sup>98</sup> The player also has the option to purchase V-bucks directly with real-world money. Therefore, there is a direct conversion rate between the earned currency and its real-world value.<sup>99</sup> This could be used to determine the value of any cosmetic reward if the game has a direct purchase option.<sup>100</sup> Most video games assign a rarity system to cosmetics.<sup>101</sup> For example, Fortnite places each cosmetic into a rarity category: common, uncommon, rare, legendary, or exotic.<sup>102</sup> With the direct purchase option, one would only need to determine how much the specific cosmetic item costs with in-game currency, then convert it to a real-world value.<sup>103</sup> This would allow the taxpayer to determine the value of all cosmetics in the game. Cosmetic items that were directly rewarded to the player, rather than purchased, could also have their bases accurately determined under this system.

What happens if there is not a direct purchase option for the reward? There is not a clear way to determine the value on in-game benefits in that circumstance, and that would require inquiries into the difficulty to obtain the item and whether the item remains obtainable.

### D. *What about the impact to the industry?*

Tax law is one the most influential factors on business decisions.<sup>104</sup> With that in mind, how would addressing in-game benefits in tax law affect the video game industry? Microtransactions (the element of video games benefits that tie in-game

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96. See Wheaton *supra* note 99.

97. I.R.S. Notice 14-16, 2014-21 C.B. 931.

98. See generally Ryan Gilliam, *Fortnite V-Bucks are getting Cheaper*, POLYGON (AUG. 13, 2020, 11:10 AM), <https://www.polygon.com/fortnite/2020/8/13/21366332/fortnite-v-bucks-pricing-epic-games-google-apple-store-ios-android> (explaining How V-Bucks have been recently discounted).

99. I.R.S. Notice 14-16, 2014-21 C.B. 931.

100. I.R.S. Notice 14-16, 2014-21 C.B. 931.

101. See Madigan, *supra* note 16.

102. Ed Thorn, *Fortnite Weapons – New Tier List Ranking for Chapter 2*, METABOMB (Oct. 16, 2019), <https://www.metabomb.net/fortnite-battle-royale/gameplay-guides/fortnite-battle-royale-all-weapons-tier-list-with-stats-15>.

103. See I.R.S. Notice 14-16, 2014-21 C.B. 931.

104. See Heather M. Field, *Aggressive Tax Planning & The Ethical Lawyer*, 36 VA. TAX. REV. 261, 307-308 (2017).

benefits to real-world currency) are a significant component of video game revenue.<sup>105</sup> By 2023, it is estimated that the video game industry will grow to a value exceeding \$200 billion, based in no small part to microtransactions.<sup>106</sup> It is not a far stretch of the imagination to suggest that if players are taxed on their in-game benefits, those same players will have less money to spend on microtransactions, thereby hurting the video game industry.<sup>107</sup>

For games that charge a traditional, up-front price to play their game, this would be an inconvenience to post-purchase monetization, but the model will likely still remain economically viable.<sup>108</sup> For free-to-play games that rely on microtransactions for revenue, such as Fortnite, this would be a cataclysmic event. These types of games do not have other forms of monetization.<sup>109</sup> This would likely force game developers to abandon these games in favor of the traditional sales model, harming games that have become cultural landmarks in our society.<sup>110</sup> Therefore, any decision on taxing in-game benefits needs to keep in mind the impact that it could have on the various type of video game developers.

### *E. What about those who did not choose to earn in-game benefits?*

Implicit in the tax code is the idea that it is fair to tax any monetary benefit the taxpayer receives because the taxpayer agreed to accept it.<sup>111</sup> Taxpayers have the right to refuse gifts and not be taxed on them.<sup>112</sup> Taxpayers similarly have the right to refuse various inheritances for tax purposes.<sup>113</sup> Acceptance of the inheritance or gift is done willingly, and therefore it is fair to tax the individual for obtaining this gain.<sup>114</sup> It would seem unfair to tax an individual for a gift they have refused. In the case of in-game benefits, players often do not have the ability to refuse. If these gains were subject to taxation, the IRS would be taxing players for accessions to wealth the player did not choose to accept. If players are not given the option to deny the in-game benefit, it seems unfair to tax a player for an item that they may not have wanted or intended to accept.

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105. See Christina Gough, *Gaming monetization – Statistics & Facts*, STATISTA (July 30, 2020), [https://www.statista.com/topics/3436/gaming-monetization/#dossierSummary\\_\\_chapter4](https://www.statista.com/topics/3436/gaming-monetization/#dossierSummary__chapter4).

106. See Matt Gardner, *Report: Gaming Industry Value to Rise 30% - With Thanks to Microtransactions*, FORBES (Sep. 19, 2020, 09:48 AM), <https://www.forbes.com/sites/mattgardner1/2020/09/19/gaming-industry-value-200-billion-fortnite-microtransactions/#19ad02fa2bb4>.

107. See generally Dave Thier, *New Microtransaction/Loot Box Bill Could Devastate Video Game Publishers If It Passes*, FORBES (May 8, 2019), <https://www.forbes.com/sites/davidthier/2019/05/08/new-microtransaction-loot-box-bill-could-devastate-video-game-publishers-if-it-passes/#6030598c676f> (showing how dependent the video game industry is on microtransactions).

108. See generally *Id.* (indicating that some parts of the gaming industry have found other methods to increase revenue, including battle passes and straightforward premium shops.)

109. *Id.*

110. See *Id.*; see also Kevin Webb, *'Fortnite' Was the Most Important Video Game of This Decade, and It Will Be for the Next One Too*, BUSINESS INSIDER (Dec. 29, 2019, 9:05 AM), <https://www.businessinsider.com/fortnite-most-influential-video-game-decade-2019-12>.

111. This is best exemplified through the “realization” requirement for gross income. If the taxpayer doesn’t do anything with the gift/inheritance, then they have not realized it. See *Comm’r v. Duberstein*, 363 U.S. 278, 291-292 (1960).

112. See *Id.*

113. See *Id.*

114. See *Id.*

*F. Do in-game benefits get their own tax rule or does it fit inside some other rule?*

As demonstrated throughout this article, in-game benefits do not fit neatly inside any current tax rule. While analyzing video game benefits under one framework produces straightforward results for certain types of in-game benefits, applying it to other in-game benefits devolves into chaos. Since the in-game benefits do not fit neatly into any single tax category, there is a reasonable argument that lawmakers should create a rule specifically tailored to in-game benefits for tax purposes.<sup>115</sup>

The benefit of creating unique tax law for video game benefits is that the policy could cater to all of the nuances tied to the video game industry. The drawback to crafting such a policy is the expenditure of time and resources that could be used elsewhere. The alternative, in this case, would be placing the various in-game benefits into existing tax categories, which would require fewer up-front resources since those tax structures do not need to be created from scratch.

## V. POSSIBLE SOLUTIONS

Of the substantial number of questions to address before a tax scheme can be put into place, there are some considerations that can be immediately taken into account to expedite a final conclusion of the issue. There will need to be extensive talks between the IRS and representatives of the video game industry to come up with sustainable solutions.

*A. Require developers to implement a system to track cosmetics during a tax year*

Requiring developers to implement a system to track cosmetics seems to be one of the easier fixes to the in-game benefit tax problem. A system tracking the in-game benefits earned by the player during the year and later sending them a tax form would give that player an accurate their earned cosmetics.. This form could even include the real-world value of the in-game benefits to make it easier for the player base to calculate their tax liability. This would be a similar approach to companies sending out W-2 forms to their employees during tax season.<sup>116</sup> Those forms are sent directly to the employees and lay out how much money they made during the year, with no guesswork required.<sup>117</sup> That same information is sent to the IRS so they can verify the tax returns they receive.<sup>118</sup> This proposal would be similar to existing W-2 practice, so it should not be too cumbersome to implement.

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115. *See supra* Part III.

116. IRS, W-2 FORM, (Sep. 20, 2020) <https://www.irs.gov/forms-pubs/about-form-w-2>.

117. *Id.*

118. *Id.*

*B. Include an opt-out system for in-game benefits if there are microtransactions*

If the game includes microtransactions, there should be an option for the player to accept in-game benefits. This would function as the player opting-in to taxation for anything they eventually earn, and would promote a sense of fairness in that it gives the player a choice in receiving the benefit, which they do not have now. Such a change would align the taxation of in-game benefits with other forms of received property.

*C. Develop a system to identify the real-world identity of players so that any information can be delivered to the right person*

This solution is by far the most complex and controversial.<sup>119</sup> However, in order to impose a tax burden, there needs to be a system to determine who is being taxed and for what. Determining the real-life identity of the taxpayer is imperative to collection, and simple email verification would be insufficient to ascertain this information.<sup>120</sup> Credit card information is a better verification method in that credit card approval usually encompasses involves a credit check.<sup>121</sup> This would involve the game developers and credit card companies reaching an agreement about obtaining customer identification data. Since credit card companies already sell customer identification data, this should be a feasible option.<sup>122</sup> However, since a large amount of the player base is underage, players often do not have access to credit cards.<sup>123</sup> Therefore, they would likely have to borrow their parents credit card for verification, but that is where problems start arising.

An issue arises if the tax bill for the in-game benefits is assessed to the parents due to their credit card information being linked to their child's account. The issue is that parents are being taxed for income obtained by their children that would otherwise be exempt from taxation.<sup>124</sup> For starters, if the child were to file taxes individually, then they likely would not be required to file at all since the value of the in-game benefits they earned is too low.<sup>125</sup> However, if the child's gains from in-game benefits are added to their parent's tax bill, then that gain will probably be taxed.<sup>126</sup> This is due to the fact that the parents likely earn enough income to be

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119. See generally Wheaton, *supra* note 90 (indicating a need for some anonymity to do things such as speak out against the government without fear of reprisal.)

120. See generally *Id.* (showing how unhindered anonymity in gaming is dangerous to the hobby.)

121. See Ben Luthi & Gregory Karp, *How to Apply for a Credit Card So You'll Get Approved*, NERDWALLET (Aug. 7, 2019), <https://www.nerdwallet.com/article/credit-cards/apply-for-a-credit-card>.

122. Jay Stanley, *Why Don't We Have More Privacy When We Use A Credit Card?*, ACLU (Aug. 13, 2019), <https://www.aclu.org/blog/privacy-technology/consumer-privacy/why-dont-we-have-more-privacy-when-we-use-credit-card#:~:text=Under%20GLB%2C%20companies%20can%20sell,when%20they%20fill%20out%20applications>.

123. See Christina Gough, *Age breakdown of video game players in the United States in 2020*, STATISTA (July 24, 2020), <https://www.statista.com/statistics/189582/age-of-us-video-game-players-since-2010/>.

124. IRS, 2020 INSTRUCTIONS FOR FORM 8615, s://www.irs.gov/pub/irs-pdf/i8615.pdf (2020).

125. *Id.*

126. *Id.*



required to pay taxes, and adding their child's income to their income will only increase their tax bill.

Additionally, parents usually would not pay taxes on the income obtained by their children within the small amounts that their children would likely earn through in-game benefits.<sup>127</sup> But, if the system in place that assesses the in-game benefits earned defaults to the credit card holder connected to the account (parent) and not the account user (child), then the parents get a tax bill that they should not be liable for.

## VI. CONCLUSION

In-game video game benefits are difficult to effectively tax. The three main categories of in-game benefits do not fit neatly into any single existing tax framework. While individual types of in-game benefits can fit into existing rules, there is a lack of an overarching policy for video games in general. However, with a little bit of work by lawmakers, video game developers, and the IRS, an effective tax scheme can be implemented that captures the real-world value gained by individuals playing video games.

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127. *Id.*