The metaverse: how to tax virtual goods in the real world

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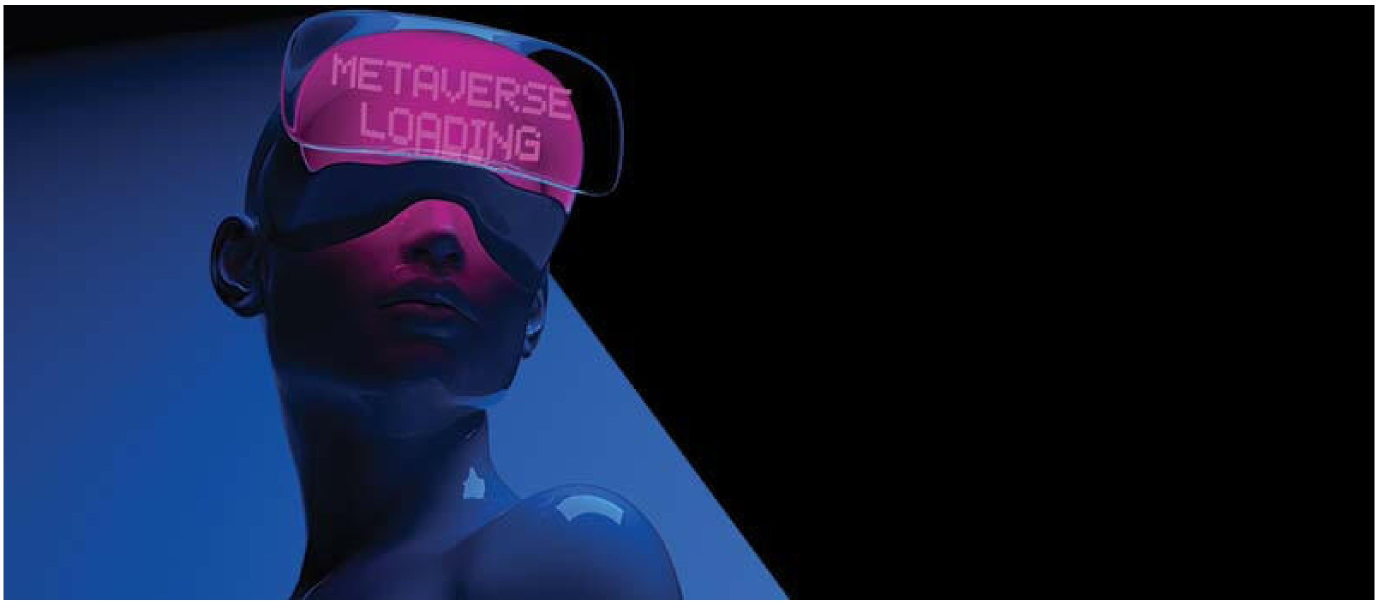

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It once sounded like science fiction but the metaverse will soon be part of our reality. So, as virtual goods are bought and sold, or as real world goods are purchased virtually, how will they be taxed?

If one thing is certain, it's that we're going to live an increasing amount of our lives in the digital world. By 2026, research firm Gartner predicts that 25% of people will spend an hour a day in a virtual world or the 'metaverse' and they won't just be playing games or interacting with friends (see bit.ly/3oci4si).

The metaverse, which is essentially the internet in 3D, will increasingly mirror the real world and this means people will be using it to go to virtual doctors' appointments, business meetings and even house viewings. There will also be increasing commercial activity involving the buying and selling of virtual goods and services – as well as real world items that are purchased virtually but arrive at your door.

An early example of the commercial metaverse is Decentraland. A window into the future, this virtual marketplace allows avatars to buy and sell land, estates and wearables. And regardless of whether the transaction is in cryptocurrency, non-fungible tokens (NFTs) or through a credit card, when money is changing hands, a transaction is taking place. So what does this mean for indirect tax?

Taxing a virtual world?

As it stands, the metaverse is currently a tax haven as transactions aren't subject to any controls, and the reason for this is simple – imposing tax on the metaverse is hugely complex.

There's just no precedent when it comes to taxing a virtual world as our tax legislation has developed based on geography, with physical location generally determining the tax jurisdiction you fall within. This longstanding approach can't be unpicked overnight, and as transactions in the metaverse can't easily be attached to any particular tax jurisdiction, reporting on and paying taxes in the virtual world is highly complicated.

The EU introduced destination-based VAT for certain digital transactions, which has been followed by other countries (and retained by the UK). However, the approach doesn't extend to the metaverse.

It's time to take a fresh look at taxes, and this means creating a global set of indirect tax rules for the metaverse. Perhaps it's a case of taxing an avatar based upon the user's real-world location. Imposing tax on the location of the server powering the avatar is unlikely as servers aren't tied to certain data centres so the tax jurisdiction could move. Another idea is to base tax on the location of the metaverse application owner. In other words, where each metaverse company is registered in the real world. But are these the best solutions? A global challenge requires worldwide collaboration – tax and virtual reality minds from across the world coming together to advise governments on indirect tax in the metaverse. And of course, governments would need to agree on it!

A crypto tax framework

These experts must ensure that the metaverse rather than tax takes centre stage when creating a crypto tax framework. Understanding how the metaverse operates and the different aspects of a virtual world are crucial here – from the legal status of avatars and which digital currencies are used, through to all the different ways the virtual world connects to the real world. Is the virtual world a game, potentially with winnings? Is it an investment or a trading business, with potential profits and losses? Is it a different way of carrying out a commercial transaction?

The tax complexities then need ironing out. Are all types of digital currency taxable, for example? We know that Bitcoin is taxable; however, what is the status of Decentraland's MANA tokens and Fortnite's V-Bucks currency? And can blockchain transactions be managed and reported on by using tax engines?

Importantly, tax must be approached from the perspective of the customer experience, making any transaction totally frictionless. As it stands, today's customer demands a seamless digital checkout experience, and the stakes will be even higher in a living digital world in which users want the ability to make impulsive purchases with no interruption to their virtual reality experience. By taking a meta-first approach, this will most effectively shape tax regulation and help to future-proof indirect tax, regardless of how the digital world evolves in 10, 20 or even 100 years' time.

The start of a new journey

It's time for indirect tax legislation to catch up. We've seen how the internet has totally transformed digital sales, with online sales tax proving highly complex and continuing to be an ever-changing landscape. The impact on tax departments has been significant with many investing in tax technologies to keep pace with change.

Could we be at the start of this same tax journey with metaverse transactions? We shouldn't be naïve about what could be in store for tax in the metaverse, which is why clear global rules must be put in place, and organisations must gear-up for change with the right tax technologies.

Although the 'metaverse' is still a new concept, we shouldn't be fooled into thinking it will take many years for it to become embedded into our everyday culture. Virtual reality is not new – virtual world 'Second Life' was launched way back in 2003, and recent advances in technology mean that opportunities to transact virtually will only gain pace. In fact, Microsoft plans to roll out Mesh in 2022 – a metaverse collaboration tool that will be an extension to Teams. It's therefore the responsibility of global governments to ensure that the digital world doesn't remain unregulated and tax free, or we’ll soon be dealing with the fallout on an unprecedented scale.