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VAT and Virtual Worlds – A German Precedent?

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About a year ago, a Regional Fiscal Court in Cologne (Germany) ruled virtual renting of virtual land to be a VATable transaction.[1] In the case, a German taxpayer generated revenue by renting out virtual land. The taxpayer – or rather his avatar – received virtual currency in exchange for the virtual land.

The taxpayer then had this virtual currency exchanged for real fiat money.

In short, the Regional Court applied the relevant VAT norms to the virtual world (we accepted this view, see our blog contribution). The Regional Court left the categorization of the service open in its judgment. Hence, we expected more clarification on this end from the higher court in the appeal decision if one of the parties decided to appeal the verdict. The taxpayer did appeal.

On the appeal, the Federal Finance Court of Germany (*Bundesfinanzhof*, BFH) deviated quite fundamentally from the Regional Court's decision. In this context, it addressed several legal questions for the first time. However, it should be noted that the German legal system does not recognize precedents as the Anglo-American case law system. According to German fiscal court procedural law, a judgment is only binding for the participants of the respective court proceeding. However, the German Federal Ministry of Finance can make the case binding for all tax offices in Germany by publishing it in the German Federal Tax Gazette. Alternatively, it may issue an administrative guideline addressing how the German tax authorities should treat comparable cases. Finally, German Regional Fiscal Courts will use the Federal Fiscal Court's decision as a factual precedent if the facts are sufficiently comparable. The Federal Fiscal Court also usually bases its decision on previous decisions – albeit it sometimes changes its legal opinion. Against this background, the recent decision of the Federal Fiscal Court has some present-like effect and might even (in one form or the other) become binding for the German tax authorities.

In this second blog contribution on the matter, we will focus on the novelties brought by the BFH. If the issue interests you, feel free to take another look at our first contribution to the judgment of the Regional Finance Court. Here, we will consider possible implications that might or might not be drawn from the case.

The Federal Finance Court's judgment

As indicated above, we expected the BFH to be a little more precise on the classification of the actual services provided. Remember, the service classification determines which place of supply rules apply. However, the BFH's decision went in a different direction.[2] Instead of applying the

VAT provisions to the virtual world, the court went down the road of saying that anything in a game is outside the real world and then also out of the economic sphere where VAT applies.

In its judgment, the BFH pointed out that the service recipient must receive an advantage that results in consumption within the meaning of the common EU VAT law. For this to be the case, an identifiable consumer must be provided with an advantage that could constitute a cost factor in the activity of another participant in economic life. From this, the court concluded that the mere participation in a game and the related sales regularly do not constitute a service within the meaning of VAT law. According to the learned judges, such sales lack the provision of an advantage that leads to consumption within the meaning of the common EU VAT law.

In-game "sales" between persons, which are limited to mere participation in a game and thus shaping the gaming experience in interaction with other game participants, do not generally constitute participation in real economic life. In this context, the BFH considers it essential that a game indeed represents a departure from the real world, that is, a sub-world with its own rules, roles and goals. In the court's view, game benefits in such a sub-world cannot represent consumption within an EU VAT law's meaning. In contrast to the first instance, the BFH thus did not see any real legally relevant action. As a result, the court did not consider the plaintiff's activity in the game itself to be a VATable service (i.e., the renting of virtual land). However, it was assumed that there was a VATable service at a later stage, namely when the plaintiff exchanged the in-game currency received for the rental against real fiat money.

According to the BFH, by changing the in-game currency to legal tender, or vice versa, the plaintiff had rendered a service subject to VAT. Specifically, the court viewed the exchange of the gaming currency into legal tender via the gaming operator as a service commission. According to the court, the gaming currency represented a contractual right that is transferred to a contractual partner by way of assignment. This is in the scope of both German and EU VAT. This transfer of in-game currency took place on a real market. With the in-game currency, the plaintiff provided the respective recipient with a virtual game object for later use in the game and thus a consumable benefit.

The gaming operator is deemed to be the recipient of the other performance because it was involved as a commission agent in the transfer of the gaming currency by the plaintiff. The gaming operator then provided the same service to the in-game recipients. In essence, the gaming operator acted like a financial services provider that sells securities for its customers. By way of a VAT legal fiction, the plaintiff has rendered a service to the gaming operator. Pursuant to Sec. 3a (2) Sentence 1 of the German VAT Act, the place of performance of such transactions is abroad; hence, not subject to German VAT – as the gaming operator was based abroad, in the United States. If the gaming operator were based in Germany, the transaction would have been taxable in Germany.

In contrast to the Regional Finance Court, the BFH considered the acquisition of the virtual currency to be taxable consumption; hence, a transaction even before the actual renting transaction. This actual renting transaction, in turn, was not taxable. In contrast, the Regional Court did not regard the transaction of transferring legal tender into in-game currency as a taxable transaction. It solely regarded the rental in the virtual world as a taxable transaction.

Electronically Supplied Services

Probably most relevant for real tax life is the qualification that the transfer of the in-game currency constitutes the transfer of a right. In practice, such transactions are likely to be regarded as electronically supplied services, even if this cannot be derived directly from the relevant statutory examples.

Taxable persons who previously considered such transactions to be electronically supplied services will have to correct their VAT returns or assessments. According to the German rules, the place of supply of an electronically supplied service to non-taxable persons is where the recipient of the service is located. In contrast, the place of supply for the transfer of rights to non-taxable persons is generally where the supplier is established, pursuant to Article 45 of the VAT Directive. Only in the case of services to non-taxable persons resident in a third country does the place of performance shift to the place where the recipient has its (residential) domicile, pursuant to Article 59 of the VAT Directive. Thus, if the sale of in-game currencies were previously considered an electronically supplied service, the respective seller would have been taxed on the sale where the customer is resident. Therefore, a taxable person from abroad would have paid VAT in Germany for sales to German end customers, possibly via the so-called mini-one-stop store procedure. According to the court's decision, he would now have to pay tax on the sales in his home country. The taxpayer could therefore have the tax paid in Germany refunded.

This inevitably raises the question as to which virtual transactions are transfers of rights within the meaning of Article 59(a) of the VAT Directive, and which are electronically supplied services within the meaning of Article 58(1) subparagraph 1(c) of the VAT Directive? Unfortunately, the judgment does not help in this determination. It does not explain why the sale of virtual currencies in dispute cannot constitute an electronically supplied service. However, it can be safely assumed that the transfer of virtual products can be an electronically supplied service. This follows from the wording of Article 7(2)(a) of the VAT Implementing Regulation.

According to this provision, the "transfer of digital products in general" is an electronically supplied service. A strong indication of the distinction between general transfer of rights and electronically supplied service could be provided by Art. 7(2)(c) of the VAT Implementing Regulation. According to this, "services automatically generated by a computer" are also electronically supplied services. In the case of virtual rental, the plaintiff manually initiated the transfer of virtual currency via the gaming operator's exchange. It is conceivable that the BFH would have considered the same transaction to be an electronically supplied service if the sales transaction had been initiated automatically by a program. Thus, the amount of human intervention (or the lack thereof) might have resulted in a different decision. Unfortunately, the BFH did not address this specific question in its decision. Therefore, the implications of the decision for this question remain somewhat shrouded in mystery.

Virtual Worlds and Crypto-Currency

The BFH's judgment may lead to the conclusion that everything that happens in a game world is not subject to VAT. However, sales between the game world and the real world should be subject to VAT. This raises a series of delimitation questions: when is there a game world? When is the boundary of the game world crossed? What is the situation with barter-like sales? What is the interaction with alternative means of payment?

The case concerned an online environment operated by a single operator according to fixed rules. Meanwhile, more decentral operated virtual worlds are emerging. Here, however, there is no central operator. Instead, the world is created, maintained, and developed through the voluntary efforts of its users. On the other hand, in-game currencies are not always limited to one game. For example, game developers now often create an in-game currency that users can use in several of the developer's game titles. The currency cannot then be used outside the game cosmos of the respective developer. On the other hand, it is also not limited to a single game world but can be used in several game locations. In the case, the plaintiff exchanged the in-game currency for real money. However, it is also conceivable that he would have exchanged it for other in-game assets or alternative forms of payment, such as cryptocurrencies.

The correct taxation of cryptocurrencies has not yet been the subject of a judgment by the CJEU. Only in the famous *Hedqvist* decision[3], the CJEU has dealt with the taxation of cryptocurrencies. Specifically, it dealt with the question of whether the trading margin of fiat-crypto currency exchange is subject to VAT. What was not decided was whether the exchange of a legal currency into a virtual currency is subject to VAT.

Whether the principles of the BFH judgment are transferable to cryptocurrencies is questionable. In the judgment at comment, the virtual currency was usable in a delimited space, in a virtual world. Cryptocurrencies are sometimes or often universally usable and are not a virtual game object for later use in the game and thus represent a consumable benefit. The game currency assessed here had to be used to pay for certain other services in the virtual world. This can be reconciled with the opinion of Advocate General *Kokott* in *Hedqvist* to the effect that the virtual currency in the case under review had a practical use other than as a means of payment. It cannot therefore be only a means of payment. Consequently, it is rather doubtful whether its function is limited to the exchange of goods in a (virtual) economy. The virtual world provider is ultimately responsible for issuing the currency and its framework conditions, and he will not do this entirely altruistically. Indirectly, he is also promoting his economic activity. However, such economic activity can certainly not be attributed across the board to every blockchain with every associated cryptocurrency. At the very least, it should be noted that in the case of the judgment at comment, a gaming operator is behind the currency. However, this fundamentally contradicts the idea of Web3.0 – i.e., a decentralized system where precisely not one person stands behind a cryptocurrency.

Accordingly, no conclusions should be drawn from the judgment as to whether every purchase of a virtual currency is a transaction subject to VAT. It remains conceivable that such currency exchange is not subject to VAT since it is merely an exchange of means of payment. Conventional cryptocurrencies are characterized by versatility, while in-game currencies are less versatile. However, the full implications for the crypto world are left to further research.

Conclusion?

A conclusion is hard to draw. As indicated above, the BFH's judgment as a German "precedent" is not that easy to handle. Nevertheless, three points can be concluded from the decision:

1. Transactions in virtual worlds are generally out of the scope of VAT – in the interpretation of the BFH, unless virtual items are exchanged for legal tender.
2. Transactions "into" virtual worlds constitute transfers of rights, not electronically supplied services. The same applies to the transactions "out of" virtual worlds.

3. Taxable transactions via virtual exchanges or marketplaces usually lead to a service commission whereby the virtual exchange or marketplace operator becomes part of the supply chain (i.e. seller à operator à buyer).

It is worth noting that a similar case was decided almost simultaneously in the Netherlands by the Rechtbank Noord-Holland.[4] In that case, a taxpayer traded gold coins in a virtual world against a legal tender. The Dutch court ruled the taxpayer's activity to be within the scope of VAT. Furthermore, it was determined not to be exempted according to Article 135(1) of the VAT Directive. This outcome seems to be in line with the BFH judgment. As a similarity, one must find that both the German and Dutch courts do not see a virtual in-game currency as a currency according to the VAT understanding of "currencies".

Though, a cumbersome task to find the correct tax treatment through national court judgments. It seems pressing that the EU VAT legislator actively finds answers to upcoming questions.

[1] ECLI:DE:FGK:2019:0813.8K1565.18.00.

[2] ECLI:DE:BFH:2021:U.181121.VR38.19.0.

[3] ECLI:EU:C:2015:718.

[4] ECLI:NL:RBNHO:2021:2091.

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