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Note

Virtual World, Real Taxes: A Sales and Use Tax Adventure Through Second Life Starring Dwight Schrute

*J. Robert Schlimgen**

I. INTRODUCTION

In an episode of the sitcom *The Office*, Dwight—a character whose comedic lines are punctuated by his geeky demeanor—describes Second Life,¹ an online virtual community.² Dwight explains that he “signed up for Second Life about a year ago” because “back then, [his] life was so great [he] literally wanted a second one. Absolutely everything [in Dwight’s Second Life] was the same . . . except [in Second Life, Dwight] could fly.”³ Dwight clarifies that, despite its appearance to the untrained eye, “Second Life is not a game. It is a multi-user virtual environment. It doesn’t have points or scores. It doesn’t have winners or losers.”⁴ Jim, who plays the Fonzie-cool foil to Dwight’s socially aloof antics, retorts, “Oh, it has losers.”⁵

Dwight’s description points out a striking feature of Second

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1. See Second Life Official Site, <http://secondlife.com/> (last visited Nov 16, 2009). Second Life will be used throughout this note as a paradigm of a virtual community. There are several other examples available as well; see also World of Warcraft Community Site, <http://www.worldofwarcraft.com/index.xml> (last visited Mar. 17, 2010).

2. *The Office: Local Ad* (NBC television broadcast Oct. 25, 2007). See also Youtube.com, *The Office: Second Life is the Same*, http://www.youtube.com/watch?v=U3d_fqDcN1s (last visited Nov. 17, 2009).

3. *The Office: Local Ad*, *supra* note 2.

4. *Id.*

5. *Id.*

Life. Although many use Second Life for entertainment purposes, Second Life is more than a game.⁶ One of the most notable features of Second Life is the presence of a “a virtual economy, where players can make, find, win, buy, sell, rent, and exchange virtual goods.”⁷ As virtual economies, such as Second Life, have grown, academic speculation has begun as to the tax ramifications.⁸ Although federal income tax consequences have been addressed by academics,⁹ and even caught the attention of Congress¹⁰ and the Internal Revenue Service (IRS),¹¹ state and local taxes have been largely ignored.

Exploring state and local sales and use tax in Second Life is important for several reasons. First, the Internet plays a large and growing role in our national economy.¹² States rely heavily on sales and use taxes for funding.¹³ Forty-five states,¹⁴ and numerous other localities, count sales and use tax as a source of revenue¹⁵ and are losing billions of tax dollars in

6. Adam Chodorow, *Tracing Basis Through Virtual Spaces*, 95 CORNELL L. REV. 283, 288 (2010).

7. *Id.* at 288.

8. See, e.g., Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 HASTINGS L.J. 1, 44 (2007) (arguing that “in-world transactions are not and should not be taxable”); Chodorow, *supra* note 6, at 288; Leandra Lederman, *EBay's Second Life: When Should Virtual Earnings Bear Real Taxes?*, 118 YALE L.J. POCKET PART 136 (2009), <http://yalelawjournal.org/content/view/743/14/> [hereinafter Lederman, *EBay's Second Life*] (arguing that Second Life transactions are like PayPal exchanges when purchases are made on eBay); Leandra Lederman, “*Stranger than Fiction*”: *Taxing Virtual Worlds*, 82 N.Y.U. L. REV. 1620, 1646 (2007) [hereinafter Lederman, *Stranger than Fiction*]; Theodore P. Seto, *When Is a Game Only a Game?: The Taxation of Virtual Worlds*, 77 U. CIN. L. REV. 1027, 1051 (2009) (arguing that amounts earned in such a world should be treated as real in every sense for tax purposes).

9. See, e.g., sources cited *supra* note 8.

10. See Adam Reuters, *US Congress Launches Probe into Virtual Economies*, REUTERS, Oct. 15, 2006, <http://secondlife.reuters.com/stories/2006/10/15/us-congress-launchs-probe-into-virtual-economies/>.

11. NAT'L TAXPAYER ADVOCATE, I.R.S., 2008 ANNUAL REPORT TO CONGRESS 213–23 (2008).

12. See Leslie J. Carter, Comment, *Blowing the Whistle on Avoiding Use Taxes in Online Purchases*, 2008 U. CHI. LEGAL F. 453, 472 (2009).

13. See John A. Swain, *Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?*, 75 S. CAL. L. REV. 419, 419 (2002).

14. See State Sales Tax Rates, <http://www.taxadmin.org/fta/rate/sales.html> (last visited Nov. 4, 2009).

15. See Christina T. Le, *The Honeymoon's Over: States Crack Down on the Virtual World's Tax-Free Love Affair with E-Commerce*, 7 HOUS. BUS. & TAX

uncollected sales and use tax as a result of e-commerce.¹⁶ The problem of lost revenue is amplified because several states are on the brink of insolvency and in need of every cent of tax to which they are entitled.¹⁷

The goal of this Note is to explore the sales and use tax ramifications of virtual goods in Second Life. The background section provides an overview of the Second Life economy and sales and use tax in the context of e-commerce. That section concludes with a description of the Supreme Court cases that have interpreted the Constitution as placing a limit on a state's ability to impose sales and use tax. The analysis section describes the likely challenges states will face if a sales and use tax is implemented in virtual worlds. Since tax concepts are most interesting and understandable by way of example, the analysis section concludes by returning to Dwight and *The Office* to provide a useful illustration. In totality, the analysis section will demonstrate, using Dwight and Dunder Mifflin as its paradigm, that despite potential challenges, states should impose a tax on virtual worlds.

II. BACKGROUND

A. AN OVERVIEW OF SECOND LIFE AND VIRTUAL WORLDS

The dialogue between Dwight and Jim, although written for comedic effect, goes to the heart of Second Life. As the name indicates, users conduct a "Second Life." Users interact in a virtual environment, "with one another through characters they create, often called avatars."¹⁸ The computer animation that facilitates interactions within Second Life makes Second Life feel similar to playing a video game.¹⁹ Where Second Life

L.J. 395, 399 (2007).

16. See *Sales Tax Fairness and Simplification Act: Hearing on H.R. 3396 Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 8 (2007) (statement of Congressman Chris Cannon) (citing two different estimates of how much revenue is lost: \$45 billion and \$4.2 billion).

17. See generally THE PEW CTR. ON THE STATES, BEYOND CALIFORNIA: STATES IN FISCAL PERIL, 1-2 (2009), available at <http://downloads.pewcenteronthestates.org/BeyondCalifornia.pdf> (studying the flagging economies of nine states in addition to California).

18. Chodorow, *supra* note 6, at 284.

19. Michael Risch, Symposium, *Virtual Rule of Law*, 112 W. VA. L. REV. 1, 4 (2009).

departs from a video game is that there are no missions to complete, nor does Second Life “pause or end when a user exits.”²⁰ Moreover, there is no script or storyline to follow in Second Life; rather, Second Life is guided by “the tastes and inclinations of those who participate.”²¹

The unscripted nature of Second Life transforms it from a video game into an economic conduit. By May 2004, “users had created more than one million [virtual] objects” such as virtual clothing and real property.²² The Second Life currency, the Linden Dollar²³—named after Second Life’s parent company, Linden Labs—is further evidence of the economic sophistication of Second Life. The Linden Dollar is accepted throughout Second Life and can be readily converted into US dollars.²⁴ The types of businesses that users engage in, using the Linden Dollar, are creative and numerous. For example,

[a] concert promotion business might pay the virtual land owner for the right to use the space for a concert. A fledgling musician might pay the promotion company for the right to play a show Conversely, the promotion company might pay an established musician to play in the venue, so that the patrons might pay for the right to listen to the music.²⁵

In fact, Second Life boasts its own Dwight Schrute and Dunder Mifflin Paper Company²⁶—the fictional employer of the characters on *The Office*.²⁷ Second Life departs from its

20. Chodorow, *supra* note 6, at 288.

21. *Id.* at 289.

22. See Cory Ondrejka, *Escaping the Gilded Cage: User Created Content and Building the Metaverse*, 49 N.Y.L. SCH. L. REV. 81, 87 (2004).

23. SecondLife.com, Currency Exchange, <http://secondlife.com/whatis/currency.php> (last visited Feb. 2, 2010).

24. *Id.* (“Rates fluctuate based on supply and demand, but over the last few years they have remained fairly stable at approximately 250 Linden Dollars (L\$) to the US Dollar.”).

25. Risch, *supra* note 19, at 6; see also Side-Line Music Magazine, New Redzone Live Album Only Available in Second Life, http://www.side-line.com/news_comments.php?id=30314_0_2_1_C (last visited Feb. 4, 2010) (noting that the band Redzone released music exclusively in Second Life).

26. See SecondLife.com, Group: Dunder Mifflin Paper Company, Inc., <http://world.secondlife.com/group/25333d35-f794-2a01-0783-51dc2a5189b5> (last visited Nov. 17, 2009) (describing Dunder Mifflin Paper Co. in Second Life).

27. SecondLife.com, Resident: Dwight Shelford, <http://world.secondlife.com/resident/b5818515-d7d7-407a-9ffd-b0f7832b6409> (last visited Nov. 18, 2009) (showing the profile of Second Life’s analogue to *The Office* character Dwight Schrute).

portrayal on *The Office* in that Second Life is not only for computer geeks, or in Jim's terms "losers." In contrast to Dunder Mifflin, which has engaged in extensive lay-offs and is rumored to be on the verge of bankruptcy,²⁸ Second Life's economy is thriving. Second Life boasts millions of users, some of whom are amassing real life fortunes.²⁹ In addition to individual users, corporations and government agencies also utilize Second Life to market and conduct business.³⁰ For example, Fortune 500 companies and government agencies such as Coca-Cola, IBM,³¹ and even the IRS³² have established a virtual presence in Second Life. Second Life is looking to capitalize on this emerging market, and further attract traditional businesses by "adding a new dimension to Second Life online world to give businesses private places for virtual meetings."³³

B. CURRENT E-COMMERCE TAX STANDARDS

Before examining sales and use tax in the context of Second Life, a general background on e-commerce and its taxation history is necessary. In general, the taxation of e-commerce, especially on the state and local level, is still developing. In the early stages of e-commerce, transactions were relatively untaxed by state, local, and federal governments.³⁴ The Internet avoided heavy taxation for two

28. See, e.g., *The Office: The Alliance*, (NBC television broadcast Apr. 12, 2005) (Dwight and Jim form an alliance to avoid falling victim to the rumored downsizing); *The Office: Murder*, (NBC television broadcast Nov. 12, 2009) (a Wall Street Journal article reveals economic troubles for Dunder Mifflin).

29. Robert Holden, *Second Life Mints First Millionaire*, THESTREET.COM, Nov. 28, 2006, <http://www.thestreet.com/story/10324675/1/second-life-mints-first-millionaire.html> (profiling Second Life's first millionaire).

30. See, e.g., David J. Mack, Comment, *iTAX: An Analysis of the Laws and Policies behind the Taxation of Property Transactions in a Virtual World*, 60 ADMIN. L. REV. 749, 756 (2008); GamePolitics.com, IRS Claims Big Savings with Second Life Recruitment, <http://www.gamepolitics.com/2009/08/14/irs-claims-big-savings-second-life-recruitment> (last visited Nov. 18, 2009).

31. See Mack, *supra* note 30, at 756 n.37.

32. See GamePolitics.com, *supra* note 30.

33. See Glenn Chapman, *Second Life Creates Virtual World for Business*, Nov. 4, 2009, <http://www.google.com/hostednews/afp/article/ALeqM5iBAvqVdJcnvgOug8rNeH3L8YUjKw>.

34. See Brian Fagan, Note, *Taxation of Electronic Commerce: Avoiding an Inroad upon Federalism*, 49 DRAKE L. REV. 465, 466 (2001) (describing The Internet Tax Freedom Act, which placed a moratorium on the taxation of

primary reasons. First, the federal government was wary that taxation would prevent the Internet, at the time a nascent technology, from reaching its full economic potential.³⁵ As a result, the federal government pressured states to refrain from taxing internet transactions.³⁶ In recent years, as the Internet has matured and proved itself a sustainable mode of commerce, many have lost sympathy for this argument, especially state and local governments that feel they are being deprived of an important source of revenue—sales and use tax on purchases made by residents within their states.³⁷

Second, even where tax laws have been imposed, the anonymous nature of the Internet has made enforcement difficult. While state, local, and federal tax law has remained stagnant, the Internet, in contrast, has proved to be a dynamic mode of commerce with the underlying transactions becoming more complex. This added complexity has made it even more difficult to apply tax law to internet transactions. Famed University of Chicago economist Milton Friedman noted in 2000 that “cyberspace is going to make it . . . much more difficult for government to collect taxes”³⁸ His statement has proved prescient.

A decade later, as Friedman’s statement portended, states and localities are struggling to capitalize on e-commerce as a source of revenue by bringing internet transactions under their taxation bases. Taxing internet commerce is difficult because, in addition to tangible goods, the Internet abounds with intangibles such as “[m]usic, video games, software, pornography, gambling, banking . . . travel services,”³⁹ and

internet transactions).

35. See, e.g., Statement on Senate Action on Internet Tax Freedom Legislation, 2 PUB. PAPERS 1768 (Oct. 8, 1998) (“[W]e cannot allow 30,000 State and local tax jurisdictions to stifle the Internet”); Le, *supra* note 15, at 411.

36. See Le, *supra* note 15, at 417.

37. *Id.* at 397–98.

38. See *Commanding Heights: The Battle for the World Economy: Milton Friedman* [hereinafter *Commanding Heights*] (PBS television broadcast Oct. 1, 2000) transcript available at http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int_miltonfriedman.html.

39. See Aldo Forgiione, *Weaving the Continental Web: Exploring Free Trade, Taxation, and the Internet*, 9 L. & BUS. REV. AMS. 513, 561 (2003).

religious services.⁴⁰ The intangible nature of goods sold on the Internet represents a challenge to tax authorities because the whole process of marketing, distribution, payment, and delivery of an intangible good or service can be completed electronically without the need for physical delivery of the product or human contact between the consumer and the e-commerce vendor.⁴¹

In addition to the nature of the goods, the purchaser is cloaked in anonymity, making it difficult for authorities to track and collect applicable taxes.⁴² Second Life embodies the complex nature of the goods being purchased and the anonymous nature of the purchaser.

C. SALES AND USE TAX AND THE CURRENT TAX REGIME

As the Internet has matured and proved its economic prowess, states have argued that e-commerce is depriving them of their primary source of revenue—sales and use tax on purchases made by residents within their states.⁴³ As a preliminary matter, the definitions of, and effective differences between, a sales tax and a use tax need to be discerned. To begin with, both taxes are consumption taxes that are “triggered . . . by the final sales of goods and services.”⁴⁴ Although rates vary by locality,⁴⁵ the consumer typically will pay an additional six or seven percent of the purchase price as a result of the tax.⁴⁶

Although both are consumption taxes, the taxes differ in who is responsible for collecting them.⁴⁷ A sales tax is “applie[d]

40. See Anne Hammock, *Online Churches Draw Believers, Critics*, CNN, Nov. 15, 2009, <http://www.cnn.com/2009/TECH/11/13/online.church.services/>.

41. See Forgione, *supra* note 39, at 513.

42. *Id.*

43. See Le, *supra* note 15, at 417–19. See also JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES* 14 (4th ed. 2008) (noting that in 2005 retail sales taxes constituted 33% of state and local tax revenue, more than any other source).

44. See SLEMROD & BAKIJA, *supra* note 43, at 195 (“A consumption tax...means that the ‘tax base’ (what triggers tax liability) is consumption, as opposed to income, wealth, or some other concept.”).

45. See Posting of Joseph Henchman to Tax Policy Blog, <http://www.taxfoundation.org/blog/show/25399.html> (last visited Feb. 26, 2010) (providing a map of the sales tax rates of the fifty states).

46. *Id.*

47. See BRUCE M. NELSON ET AL., *SALES AND USE TAX ANSWER BOOK*, 5–19 (2009).

at the time a purchase . . . is made; the seller of the item is responsible for collecting, reporting, and remitting the tax” to the appropriate state or local agency.⁴⁸ In contrast, a use tax is remitted “after the purchase is made and no sales tax was charged.”⁴⁹ Most importantly, it is the buyer of the good, in contrast to the seller, who is responsible for remittance.⁵⁰ The use tax serves to complement a sales tax. Its general purpose is to “capture lost sales tax revenue when transactions occur in a different jurisdiction than that of the collecting agency.”⁵¹

As will be discussed in detail below, goods purchased from on-line retailers that do not have a “substantial nexus” with the state the purchaser resides in are exempt from a sales tax, but are still subject to a use tax.⁵² A use tax is inherently difficult to enforce since states would have to track the goods being purchased by its residents.⁵³ An example can be particularly illustrative. If a consumer who resides in a state that charges a sales and use tax goes to the local bookstore to purchase a book, the store would add on a sales tax to the price of the book, collect the tax from the consumer, and then remit that amount to the state. In contrast, if that same consumer logs on to her computer and purchases the book from Amazon.com,⁵⁴ no amount of tax would be added to the book. Instead, the consumer would be responsible for calculating the appropriate tax owed under the state statute, and remitting that amount to the state. Therefore, as can be inferred from the example, a use tax depends on self-reporting.⁵⁵ As one would likely intuit, a large amount of individuals do not self-report.⁵⁶

48. See South Dakota Department of Revenue and Regulation, Use Tax, <http://www.state.sd.us/drr2/businessstax/st/usetax.htm#Whatisthedifferencebetweensalestaxandusetax> (last visited Nov. 4, 2009).

49. *Id.* See also Wisconsin Department of Revenue, Difference between Wisconsin Sales Tax and Use Tax, <http://www.revenue.wi.gov/faqs/pcs/diff.html> (last visited Nov. 4, 2009); Utah State Tax Commission, Frequently Asked Questions about Utah Sales and Use Taxes, <http://tax.utah.gov/sales/faq.html#6> (last visited Nov. 4, 2009).

50. S.D. Dept. of Revenue & Regulation, *supra* note 48.

51. See Mack, *supra* note 30, at 764.

52. See Le, *supra* note 15, at 401.

53. *Id.*

54. Amazon.com, <http://www.amazon.com> (last visited Feb. 4, 2010).

55. See Le, *supra* note 15, at 400.

56. Ashlea Ebeling, *States to Consumers: Pay Up*, FORBES, Feb. 27, 2008, http://www.forbes.com/2008/02/26/tax-consumer-state-biz-belt-cx_ae_0227beltway.html (noting that the Minnesota House of Representatives

D. THE SUBSTANTIAL NEXUS TEST: QUILL AND BELLAS HESS

Since a sales tax, in comparison to a use tax, is easier to enforce,⁵⁷ states generally prefer to impose a sales tax, but the reach of the sales tax has been limited by the courts. According to the Supreme Court, a state can only force a company to collect a sales tax on its behalf if the company has a “substantial nexus” with the respective state.⁵⁸

Quill Corp. v. North Dakota is often cited as the seminal sales and use tax case, but the Supreme Court heard several cases that guided it in articulating the *Quill* standard,⁵⁹ the most important of which is *National Bellas Hess, Inc. v. Department of Revenue of Illinois*.⁶⁰ *Bellas Hess* represents the first time the Court addressed the “duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail”⁶¹—the very situation facing many of today’s internet retailers. The Court concluded that “the many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [the appellants] interstate business in a virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose ‘a fair share of the cost of the local government.’”⁶² The Court reasoned that the “very purpose of the Commerce Clause was to ensure a national economy free from such unjustifiable local entanglements. Under the Constitution, this is a domain where Congress alone has the power of regulation and control.”⁶³

In *Quill*, North Dakota attempted to require an out-of-state

conducted a survey of nineteen states that asked whether citizens self-reported use taxes on their income tax return. The survey found that only 1.6% of taxpayers reported use tax liability. This number is “suspiciously low, considering that sales taxes are collected on only about 50% of online purchases”).

57. *Id.*

58. *Quill Corp. v. North Dakota*, 504 U.S. 298, 311–13 (1992).

59. See Marjorie Gell, *Broken Silence: Congressional Inaction, Judicial Reaction, and the Need for a Federally Mandated Physical Presence Standard for State Business Activity Taxes*, 6 PITT. TAX REV. 99, 110–12 (2009).

60. *Nat’l Bellas Hess, Inc., v. Dep’t of Revenue of Ill.* 386 U.S. 753 (1967), *overruled in part by Quill Corp.*, 504 U.S. 298.

61. *Id.* at 758.

62. *Id.* at 759–60.

63. *Id.* at 760.

retailer that sold to North Dakota residents to collect sales tax on North Dakota's behalf.⁶⁴ The petitioner, Quill, was "a Delaware corporation with offices and warehouses in Illinois, California, and Georgia. None of its employees work[ed] or reside[d] in North Dakota, and its ownership of tangible property in that State [was] either insignificant or nonexistent."⁶⁵

Once again, the Court found that requiring Quill and like sellers to collect a sales tax would be in violation of the Commerce Clause.⁶⁶ The Court held that the Commerce Clause "and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy."⁶⁷ The Court explained in a footnote how upholding the North Dakota law could unduly burden interstate commerce:

On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent the *Bellas Hess* rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions.⁶⁸

Therefore, the court concluded that in order for a state to require a company to collect and remit a tax on its behalf, the company must have a substantial nexus with the state.⁶⁹ The substantial nexus test amounts to a physical presence within the state.⁷⁰

E. STATES PUSH BACK

The Court did note in the *Quill* decision—after it expressed its own reluctance on the subject—that allowing states to force retailers to collect a tax on the states' behalf would be within

64. *Quill Corp.*, 504 U.S. at 301.

65. *Id.* at 302.

66. *Id.* at 318–19.

67. *Id.* at 312.

68. *Id.* at 313 n.6.

69. *Id.* at 312.

70. *Id.* at 301.

the power of Congress.⁷¹ At the behest of the states, federal legislation that would force companies to collect a sales tax on behalf of the states has been proposed several times in the House and Senate but no version has ever garnered much legislative steam.⁷²

Since the *Quill* standard appears here to stay for the time being, many states are attempting to pressure large companies to collect sales tax on their behalf, not all of which have acquiesced.⁷³ Amazon has become the poster child in the debate, causing some to dub the taxation of internet transactions the “Amazon tax.”⁷⁴ A recent case making its way through the court system is *Amazon.com v. New York State Department of Taxation and Finance*.⁷⁵ The facts of the case are relatively straightforward. Amazon instituted a commission program that “allow[ed] participants . . . to maintain links to Amazon.com on their own websites and compensates them by paying ‘a percentage of the proceeds of the sale.’”⁷⁶ Thousands of New Yorkers registered for the program.⁷⁷ In 2008, New York amended its tax law to require “collection of New York taxes from New Yorkers by out-of-state sellers that contractually agree to pay commissions to New York residents for referring potential customers to them, provided that more than \$10,000 was generated from such.”⁷⁸ As the New York legislature intended, Amazon fell squarely within the confines of the statute. Amazon subsequently brought an action alleging

71. *Id.* at 318 (“This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.”).

72. See Stephanie Condon, *States May Tax iTunes, Other Digital Downloads*, CNET, Aug. 12, 2008, http://news.cnet.com/8301-13578_3-10013327-38.html.

73. See NYTimes.com, Bits Blog, *Amazon Plays Dumb in Internet Sales Tax Debate*, <http://bits.blogs.nytimes.com/2008/02/13/amazon-plays-dumb-in-internet-sales-tax-debate/> (last visited Nov. 4, 2009) (noting that some companies, such as Netflix, voluntarily collect and remit sales tax on behalf of all states).

74. See The Tax Foundation, “Amazon Tax” Unconstitutional and Unwise, <http://www.taxfoundation.org/news/show/25120.html> (last visited Nov. 4, 2009).

75. *Amazon.com LLC v. N.Y. State Dep’t of Taxation and Fin.*, 877 N.Y.S.2d 842 (2009).

76. *Id.* at 845.

77. *Id.*

78. *Id.* at 847.

that requiring Amazon to collect and remit tax on behalf of the State of New York violated the Commerce Clause and Due Process Clause of the Constitution.⁷⁹ Ultimately, the court rejected Amazon's arguments and dismissed its complaints, finding that Amazon met the substantial nexus requirements of *Quill*.⁸⁰

Amazon, however, has not left its fate in the hands of the judiciary. This past summer Amazon eliminated its affiliate program in two states: North Carolina and Rhode Island.⁸¹ Amazon has been upfront with its motives; after it discontinued the affiliate programs, a company spokesperson was quoted as saying that it found state legislation in the area to be "inappropriate."⁸² When similar legislation was introduced in California, Amazon wrote a letter to Governor Schwarzenegger informing him that "[i]f . . . enacted, Amazon would have little choice but to end its advertising relationships with California-based participants in the Amazon 'Associates Program,'" and "[t]hus, [the legislation] would provide no new tax revenue collected by Amazon or others who sever their relationships with California-based advertisers."⁸³ Other large internet retailers, such as Overstock.com, have followed Amazon's lead and also cut affiliate ties with states that have passed similar legislation.⁸⁴

F. TAXING DIGITAL PROPERTY

In addition to taxing tangible goods purchased over the Internet, a recent trend among states, as digital consumption has become more commonplace, is the inclusion of digital goods in the sales and use tax base. For example, South Dakota, which has "taken the broadest approach to taxing digital products," has passed legislation that "all sales, leases and rentals of any product transferred electronically" are to be

79. *Id.* at 846.

80. *Id.* at 851.

81. Andrea Chang, *Amazon.com Fights Sales-Tax Plans*, L.A. TIMES, June 30, 3009, available at <http://articles.latimes.com/2009/jun/30/business/fi-amazon30>.

82. *Id.*

83. *Id.*

84. See Affiliate Tip Blog, *Overstock.com Drops New York Affiliates*, <http://blog.affiliatetip.com/archives/overstockcom-drops-new-york-affiliates/> (last visited Mar. 24, 2010).

subjected to state sales and use tax.⁸⁵ New Jersey has also brought digital property under the scope of its sales and use tax.⁸⁶ Internationally, Europe has a consumption tax similar to the sales tax on Second Life transactions.⁸⁷

Although digital taxes are becoming more commonplace, there is a concerted effort by technology industry groups to oppose the attempts to enact them.⁸⁸ The groups proffer three main arguments against digital taxes.⁸⁹ The first argument echoes the previously mentioned arguments about taxing e-commerce in general: it's too soon.⁹⁰ Second, the groups maintain that given the recession, all governments should refrain from imposing more taxes on their citizens.⁹¹ Third, the groups argue that a digital product is more environmentally friendly than its tangible counterparts, and therefore, "the last thing governments should do is add taxes on something that uses no oil and produces no carbon."⁹²

III. ANALYSIS

A. STATES SHOULD PURSUE A SALES AND USE TAX ON SECOND LIFE

As can be gathered from above, if state and local governments attempt to impose and enforce a sales and use tax on Second Life transactions there will be roadblocks. First, since state and local governments have traditionally only imposed a sales and use tax on "tangible personal property"⁹³ it is likely that the governments would face a general policy argument against taxing digital goods. Second, as mentioned

85. HARLEY DUNCAN & MICHELLE ANDRE, KPMG, WHAT'S NEWS IN TAX: SALES AND USE TAXATION OF DIGITAL PRODUCTS 5 (2009), *available at* http://us.kpmg.com/microsite/taxnewsflash/2009/Aug/SALT_Digital_Prod.pdf. *See also* H.R. 1010, 83d Leg. Assem., Reg. Sess. (S.D. 2008).

86. *See* N.J. STAT. ANN. § 54:32B-2(vv).

87. *See* [Secondlife.com, Value Added Tax](http://secondlife.com/corporate/vat.php), <http://secondlife.com/corporate/vat.php>, (last visited Nov. 18, 2009). *See also* SLEMROD & BAKIJA, *supra* note 43, at 233 (describing the European value-added tax as a "close relative to the sales tax").

88. *See* Condon, *supra* note 72.

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *See* NELSON ET AL., *supra* note 47, at 5–19.

above, Second Life embodies the free flow of goods and services that Friedman predicted would threaten governments' abilities to collect taxes;⁹⁴ therefore, states would face an enforcement problem. Third, given the *Quill*⁹⁵ substantial nexus standard, state and local governments may have to weigh the benefits of additional government revenue against the possibility of companies pulling Second Life employment opportunities from their citizens in order to avoid creating a substantial nexus. Despite these potential problems, states and localities need to begin exploring tax options to digital e-commerce, including Second Life, if they hope to address their budgetary problems and create a tax base that is reflective of the changes in consumer behavior that have resulted from technological advancements.

B. STATES SHOULD CONTINUE TO ELIMINATE THE DISTINCTION BETWEEN TANGIBLE AND INTANGIBLE GOODS

The current sales and use tax distinction between tangible and intangible goods retained by many states covers a much broader base than Second Life transactions. Some digital goods are exact analogues to their tangible counterparts; for example, music downloaded from iTunes is indistinguishable from that same music on a compact disc. The fact that Second Life operates in an entirely virtual forum,⁹⁶ and therefore, cannot quickly be analogized to traditional tangible goods may explain why it has to this point been left out of the debate. More cynically, it could just be another example of state and local tax policy lagging behind technology. Either way, the mere fact that Second Life and other virtual worlds operate in non-traditional fora should not preclude it from being encompassed in the movement to tax digital goods. Indeed, Second Life abounds in many of the goods, such as music,⁹⁷ that have spearheaded the movement toward taxing intangibles.

As referred to above, state tax law has historically been slow to account for technological developments. By way of example, states just recently have begun to bring online sales

94. See *Commanding Heights*, *supra* note 38.

95. *Quill Corp. v. North Dakota*, 504 U.S. 298, 311–13 (1992).

96. Chodorow, *supra* note 6, at 288.

97. See Risch, *supra* note 19, at 4–5.

under the umbrella of their sales and use statutes.⁹⁸ With the increased use of the Internet to purchase electronic books, movies, and music, it seems likely that cash strapped states will continue to pass legislation to bring online sales under their tax base,⁹⁹ as they should. That many states do not tax digital goods might be attributed to the enactment of most state and local tax laws before the Internet was invented,¹⁰⁰ not a calculated policy decision. As states revise their sales and use tax statutes, they need to be aware of slightly less mainstream electronic consumption, such as Second Life, so they can legislate accordingly.

Some might argue that even if more commonly used digital goods, such as digital music and books, should be subject to sales and use tax, virtual worlds are still being developed and should be exempted until they prove themselves to be a sustainable mode of commerce. Yet recently developed tangible goods cannot avail themselves of such a tax preference; and moreover, the sheer size and money being poured into virtual worlds calls into question the premise that they are fragile. Virtual worlds, of which Second Life is one, are composed of some 30 million users¹⁰¹ and estimated to have a gross domestic product between \$7 and \$12 billion dollars.¹⁰² Moreover, a consumption tax on digital goods, such as those in Second Life has been successfully implemented in other countries,¹⁰³ leaving little basis for the argument that states could not be successful in the same endeavor or that that Second Life could not withstand the added tax burden.

Most importantly, expansion of the tax base to include digital goods could bring in more revenue for cash strapped states, and would also create a more equitable tax system. Currently many states, possibly out of ignorance,¹⁰⁴ are providing consumers of digital products a tax preference by

98. See Le, *supra* note 15, at 417–18.

99. *Id.* at 420–21 (evinced cooperation among many states to collect taxes from online sales by creating “interstate taxation uniformity,” the simplicity of which is designed to encourage online retailers to collect taxes from sales).

100. See Condon, *supra* note 72.

101. Camp, *supra* note 8, at 2.

102. Chodorow, *supra* note 6, at 285.

103. See SecondLife.com, Value Added Tax, *supra* note 87.

104. See Condon, *supra* note 72 (noting that the reason why digital downloads are not widely taxed is most likely caused by most state laws being written before the Internet existed).

exempting such goods from sales and use tax while requiring those who purchase the exact same goods in a traditional, tangible format to pay sales or use tax. Opponents of taxing digital goods make a creative argument that such a preference is justified because it encourages environmentally friendly consumption.¹⁰⁵ Even if this is taken as true, a preferential rate, rather than complete exemption, seems the more appropriate route, given the cash strapped position of many states and localities.¹⁰⁶

C. ENFORCEMENT AT EXCHANGE: THE ADVANTAGE OF THE EXTERNAL VIEW OF SECOND LIFE

If it is taken as given that intangible goods, such as those that compose the Second Life economy should be subject to sales and use tax, there still remains the problem of enforcement. Since transactions in Second Life occur in virtual space using a virtual currency,¹⁰⁷ sales would be particularly difficult to track. Therefore, even if states choose to tax Second Life, if the tax is not constructed properly, the tax runs the risk of being unenforceable.¹⁰⁸ As will be demonstrated below, constructing a system where Second Life users are taxed when they exchange U.S. dollars for virtual dollars would avert many of the potential enforcement problems.

The way in which state and local governments choose to enforce sales and use tax on Second Life is inextricably related to the way in which they view virtual worlds. There are two potential ways to view Second Life transactions: an external viewpoint¹⁰⁹ and internal viewpoint.¹¹⁰ These two alternatives will be referred to by the name of the professor that proposed each respective standard: Professor Bryan Camp proposed the external viewpoint, (Camp) and Professor Leandra Lederman proposed the internal viewpoint (Lederman).

Although Camp and Lederman's scholarship is limited to federal income tax,¹¹¹ the theoretical framework they provide

105. *See id.*

106. *See* THE PEW CTR. ON THE STATES, *supra* note 17, at 1–7.

107. *See* SecondLife.com, Currency Exchange, *supra* note 23.

108. *See Commanding Heights*, *supra* note 38.

109. *See* Camp, *supra* note 8, at 44.

110. *See* Lederman, *Ebay's Second Life*, *supra* note 8.

111. *Id.*

can be readily used in the context of the sales and use tax. Professor Camp proposes that transactions undertaken within the confines of Second Life are not taxable events.¹¹² Rather, a tax would only be imposed when an individual exchanges his or her virtual wealth for a traditional currency. In contrast, Lederman's internal view is based on the notion that the Linden Dollar serves as a cash equivalent, and therefore each transaction within Second Life gives rise to potential tax liability.¹¹³

1. Professor Camp

As mentioned above, Camp's standard is predicated on an "external" view of virtual worlds.¹¹⁴ The underlying premise is that goods accumulated within Second Life only increase one's ability to participate in the virtual world and; therefore, the goods have no real world value until they are exchanged for a traditional currency, such as a US dollar.¹¹⁵ Based on this external viewpoint, Camp argues that all income earned within Second Life should be immune from federal income taxation until it is converted into US dollars.

In tax lexicon, Camp believes that income earned within Second Life is analogous to imputed income.¹¹⁶ Imputed income is essentially self-provided services.¹¹⁷ The archetypical example of imputed income is the services provided by a homemaker such as cleaning, cooking, and child rearing.¹¹⁸ Although these services undoubtedly have economic value since they free financial resources that otherwise would have been expended for such services, they are not taxable events.¹¹⁹ Professor Camp proffers the following analogy in defense of his position:

Think casino chips. They have measurable fair market value and while courts recognize them as a "medium of exchange," they are not viewed as cash equivalents in tax law. Instead, they are "merely representative of whatever had been given to acquire them" and that

112. See Camp, *supra* note 8, at 59–60.

113. See Lederman, *Ebay's Second Life*, *supra* note 8.

114. Camp, *supra* note 8, at 44.

115. *Id.* at 66.

116. *Id.* at 61.

117. See MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 23–25 (9th ed. 2002).

118. *Id.*

119. *Id.*

will be either cash or play (a successful bet). To the extent that a player wins chips over and above purchased chips, they represent the stored value of the taxpayer's play, a self-provided service The self-provided service is the length of play. A less skilled (or lucky) taxpayer might lose the entire [amount]. A more skilled player might cash out when up by [a given amount and have to report income].¹²⁰

As the example implies, Second Life earnings would not remain entirely exempt from taxation. Rather, when an individual chooses to cash out his Second Life creations in exchange for U.S. dollars, income would have to be recognized.¹²¹

In the context of sales and use tax—if Camp's viewpoint were to be adopted—it is likely that sales tax would be due when a user initially “buys into” Second Life, or more specifically, when the user converts U.S. dollars for Linden dollars. This tax structure is nearly identical to the structure used with tangible goods. For example, assume an individual wants to build a birdhouse. She would go to the local hardware store and buy the requisite materials—wood, nails, a hammer, etc.—and pay a state and local sales tax on all such materials. If, after constructing the birdhouse, she sold it for more than she paid for the individual materials, she would be required to report income. Camp's theory turns on the idea that all user activities in Second Life are working towards building the same item, or metaphorically, the same birdhouse.

2. Professor Lederman

Lederman rejects Camp's imputed income theory,¹²² arguing that Linden Dollars should be treated as cash equivalents and each transaction viewed separately.¹²³ Lederman notes that Second Life has been designed to promote and facilitate commerce,¹²⁴ and therefore, should be taxed in the same manner as its traditional counterparts. Moreover, since Second Life is designed to promote and facilitate commerce, Lederman fears that allowing transactions to take place within the game without being subjected to tax could lead

120. Camp, *supra* note 8, at 64.

121. *Id.* at 66.

122. See Lederman, *Stranger than Fiction*, *supra* note 8, at 1646.

123. See Lederman, *Ebay's Second Life*, *supra* note 8.

124. See Lederman, *Stranger than Fiction*, *supra* note 8, at 1666.

to large scale tax evasion and involuntary non-compliance.¹²⁵

Lederman proposes that transactions that take place in Second Life are analogous to a purchase made on eBay.¹²⁶ Just like Linden dollars, many eBay users allow their PayPal account¹²⁷ to accumulate funds before transferring them to a traditional bank account.¹²⁸ Yet, even if an individual allows the funds to accumulate, they would not be exempt from income tax or sales and use taxes.¹²⁹ Lederman acknowledges that PayPal and Second Life are distinguishable in the sense that PayPal transmits a traditional currency, whereas Second Life uses its own currency, the Linden Dollar.¹³⁰ But Lederman believes that from an economic standpoint, their commonality—that “both serve as electronic means of conducting commerce online”—is dispositive.¹³¹

If transactions are viewed independently for income tax purposes, it is likely they would also be viewed independently for sales and use tax purposes; therefore, if Lederman’s standard were adopted, there could potentially be sales tax ramifications for all in-world transactions.

Lederman’s view does have its strengths. As Lederman notes, allowing income in Second Life to go untaxed until a user “cashes out” would create an unfair income tax preference for Second Life users.¹³² From a revenue standpoint, such a system could have certain advantages. Sales and use tax would be due each time a transaction takes place in Second Life. As a result, not only would sales and use tax be collected when one enters Second Life, but sales and use tax would also be accumulated during the intermediate exchanges.

The problem with such a schema, in the context of state and local sales taxes, is the sheer abundance of rates imposed

125. *Id.* at 1670.

126. Lederman, *Ebay’s Second Life*, *supra* note 8.

127. *Id.* (noting that PayPal is a widely used electronic payment system). See also PayPal, <https://www.paypal.com> (last visited Feb. 3, 2010).

128. Lederman, *Ebay’s Second Life*, *supra* note 8.

129. *Id.*

130. *Id.* (noting that they differ because “PayPal provides a means of sending and receiving various currencies electronically, while Lindens are their own currency—they must be exchanged in order to become U.S. dollars.”).

131. *Id.*

132. Lederman, *Ebay’s Second Life*, *supra* note 8.

by different jurisdictions.¹³³ From an enforcement standpoint, when goods are moving freely in a virtual world between avatars, it would be difficult, if not impossible, to attribute the exchange to an actual individual in a specific taxing jurisdiction and calculate the requisite tax.

As demonstrated by Camp's example, the strength of the external viewpoint is that it can easily be enforced and applied in the context of sales and use tax. First, the only companies that would be responsible for collecting a sales tax would be companies or individuals that exchange Linden Dollars for U.S. currency, which is primarily accomplished through the LindeX Exchange¹³⁴ on Second Life. If the external view becomes accepted, or alternatively, if states phrase their sales and use tax statutes to encompass Camp's viewpoint, it is likely that Linden Labs would have a substantial nexus under *Quill*, and states could require Linden Labs to collect a sales tax on their behalf.

In essence, Second Life users would be viewed as independent contractors under the external view. By purchasing Second Life currency, they are buying the right to enter Second Life and a chance to make a profit. Similar to *Amazon*, Second Life currency transactions create a substantial nexus with the taxing state.¹³⁵ Unlike *Amazon*, however, Second Life would have no choice but to acquiesce since it has so many users throughout the states. Moreover, even if Second Life were not required to collect sales tax under *Quill*,¹³⁶ given the European Union already imposes a tax analogous to the sales tax on Second Life,¹³⁷ it seems unlikely that Second Life would refuse to collect a sales tax.

D. DWIGHT'S JOURNEY THROUGH SECOND LIFE

The complexity of the substantial nexus problem is best distilled by way of example, so let us return to Dwight and *The Office*. Dwight has decided to undertake selling music to other avatars made by Dunder Mifflin's own *Subtle Sexuality*.¹³⁸

133. See Posting of Joseph Henchman, *supra* note 45.

134. See SecondLife.com, Currency Exchange, *supra* note 23.

135. *Amazon.com LLC v. N.Y. State Dep't of Taxation and Fin.*, 877 N.Y.S.2d 842, 848 (2009).

136. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

137. See SecondLife.com, Value Added Tax, *supra* note 87.

138. NBC.com, NBC Video Rewind,

Dwight intends to sell the music primarily for promotional purposes, but also believes he can make a profit. Indeed, in a short matter of time, Dwight would love to employ avatars, with end users controlled in other states, to help Dunder Mifflin, and Dwight, expand its presence in Second Life, but Dwight is concerned that doing so may expose Dunder Mifflin to more tax liability.

From his prior research, Dwight knows that states and localities have varying sales and use tax laws.¹³⁹ He also knows that if he meets the *Quill* standard for minimum contacts¹⁴⁰ he could potentially be liable for knowing each respective state for which he has minimum contacts and the applicable sales and use tax law. Currently, the only state that Dunder Mifflin would have the minimum contacts with is Pennsylvania, the state in which he works.¹⁴¹ From his research into Pennsylvania law, it appears that the music within Second Life would be classified as intangibles. Under Pennsylvania law intangibles are not subject to either sales or use tax.¹⁴² Although this bodes well for Dunder Mifflin, the state of Pennsylvania will not collect revenue from the transactions. This example highlights the arbitrary nature of the tangible and intangible distinction. Dwight is relieved; the fact that he does not have to worry about sales and use tax allows him to continue to grow Dunder Mifflin in Second Life. As Dunder Mifflin continues to grow in Second Life, he is approached by avatars in almost every state—many of which have lost their jobs due to the recent economic downturn—looking for employment. Dwight realizes that if he employs Second Life avatars with end users in New York, and if Lederman's PayPal

http://www.nbc.com/The_Office/video/webisodes/subtle-sexuality/#vid=1170202 (last visited Feb. 1, 2010).

139. See State Sales Tax Rates, *supra* note 14. See also NELSON ET AL., *supra* note 47

140. See *Quill*, 504 U.S. at 302.

141. Although on *The Office* Dunder Mifflin does have Corporate Headquarters in New York and branch locations in Ohio, New Jersey, and New Hampshire, for simplicity's sake it will be assumed that Dunder Mifflin only has contacts within Pennsylvania. See DunderMifflin.com, Dunder Mifflin, About Us, <http://www.dundermifflin.com/about/> (last visited Nov. 19, 2009).

142. See NELSON ET AL., *supra* note 47, at 5–19. See also Pennsylvania Department of Revenue, Sales, Use & Hotel Occupancy Tax, http://www.portal.state.pa.us/portal/server.pt/community/sales%2C_use_hotel_occupancy_tax/14487 (last visited Nov. 19, 2009).

analogy is accepted, then he will establish the minimum contacts necessary under *Quill* and will likely have to collect sales tax on behalf of the State of New York.

Dwight does not mind having to pay taxes but this strikes him as odd, and moreover, unfair for several reasons. First, although Dunder Mifflin has been doing well in Second Life, Dwight is unsure whether or not the added income would be enough to offset the added expense of collecting the tax. Second, Dwight is confused because it appears that the law is discouraging him from creating much needed jobs. Third, as a volunteer member of his local police department,¹⁴³ Dwight knows that states and localities rely heavily on sales and use tax revenue.¹⁴⁴

As demonstrated by Dwight's dilemma, from a sales and use tax standpoint, the main issue with Lederman's internal viewpoint is that a Second Life user could potentially create a "substantial nexus" under *Quill* for each individual company that engages in Second Life activity.¹⁴⁵ As demonstrated by *Amazon*,¹⁴⁶ under the substantial nexus test, companies are potentially dissuaded from employing individuals in multiple states. One of the great advantages of commerce in Second Life is that it is not bound by space. As Dwight points out, virtually every other component can be replicated, but avatars can "fly."

As Second Life moves into its next phase of development and gives businesses a way to meet virtually,¹⁴⁷ we could be on our way to true labor market mobility. The external view allows state and local governments to assert a substantial nexus with Linden Labs rather than each individual business. As a result, states and localities would be able to collect sales and use tax without inhibiting the free flow of labor. In short, it allows states and localities to have their virtual cake and eat it too.

143. See TheOfficetv.Info, Dwight Schrute Bio, <http://www.theofficetv.info/dwight-schrute.php> (last visited Nov. 19, 2009).

144. See Le, *supra* note 15, at 399.

145. See Streamlined Sales Tax Governing Board, Inc., Frequently Asked Questions, <http://www.streamlinedsalestax.org/index.php?page=faqs> (last visited, Jan. 29, 2010).

146. See *Amazon.com LLC v. N.Y. State Dep't of Taxation and Fin.*, 877 N.Y.S.2d 842 (2009).

147. See Chapman, *supra* note 33.

IV. CONCLUSION

Admittedly, states and localities will face many challenges in attempting to collect sales and use tax on virtual goods. Similar problems likely face the federal government as it attempts to impose a federal income tax on the virtual worlds, but the federal government has at least begun to explore potential solutions. Unfortunately, states and local governments have once again lagged behind the technological curve. Given the growing budget problems of many state and local governments, it is time for such governments to start looking at options to expand the tax base. Digital consumption is only going to increase in the coming years, and it presents the perfect opportunity for state and local governments to expand their tax base in a fair and equitable manner. Although there may be roadblocks, as shown above, a framework can be constructed to make such a tax enforceable without discouraging a mobile work force.