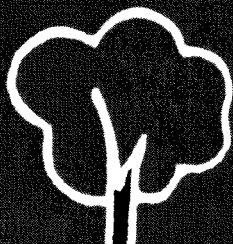


e-commerce law & policy

FEATURED ARTICLE
11/08



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Virtual currency: regulation and taxation issues

China's State Administration of Taxation recently announced a tax levy on individual income made through virtual currency transactions, despite a February 2007 ban on the trading of virtual currency. Ping Chu, an Attorney at Sheppard Mullin Richter & Hampton, discusses the use of virtual currency in China, the State concerns that led to the 2007 ban and issues that the September tax has raised.

Is the trading of virtual currency legal or illegal in China? The government issued a ban in February 2007 and answered 'no'. However, a new tax rule issued by the State Administration of Taxation, in September, seems to answer 'yes'.

● The official reply of the State Administration of Taxation concerning the levy of individual income tax on income obtained through network virtual currency transaction' reads as follows:

Beijing Local Taxation Bureau

'Your Request for instructions regarding the issues concerning the levy of individual income tax on the income obtained through network virtual currency transaction (No. 114 [2008] of Beijing Local Taxation Bureau) has been received. We hereby reply to your request as follows:

1. The income obtained by individuals through selling the virtual currency at added price after purchasing it from players by network are taxable incomes for individual income tax, and shall be levied individual income tax as income from transfer of property.
2. The original property value of the virtual currency sold by individuals should be the price for purchasing network virtual currency and the related taxes payment.
3. The original property value shall be verified by the competent administration of taxation in case that the individual fails to furnish the certificate of the original property value.'

*State Administration of Taxation
28 September 2008*

Virtual currency trading in China

Today, virtual currency trading is widely accepted in China. Billions of Chinese yuan (RMB) in virtual

currency is being traded online, and this amount increases by 20% every year. There are two major types of virtual currency. The first type of virtual currency is offered by instant messaging and portal-based issuers. Examples of such currency include Q Coins from Tencent, U Coins from Sina, POPO Gold Coins from NetEase, and Baidu Coins from Baidu. Q Coins is the most popular virtual currency in China because Tencent's instant messaging software, QQ, dominates 90% of the market in China and has four times the users of Microsoft MSN. Starting in May 2002, users could purchase Q Coins with RMB at the exchange rate of 1:1. Tencent has always prohibited users from selling back or exchanging Q Coins for real money. Tencent's original intention was for users to spend Q Coins on Tencent operated websites. However, the popularity of Q Coins has projected Q Coins beyond Tencent's control and Q Coins are now being traded for real money and used as an online payment system.

The second type of virtual currency is offered by online game-based issuers. Examples of games that offer virtual currency include World of Warcraft from Blizzard Entertainment/The 9, Fantasy Westward Journey from NetEase and Legend of Mir II from Shanda. In these massively multi-player online role-playing games, online game currency can be purchased with RMB or earned by killing monsters and completing designated missions in the online game.

Gold farmers

The concept of earning virtual currency has created the phenomenon of 'gold farmers', which are Chinese workers employed to play online games day and night in order to earn virtual

currency and equipment. The 'farm owner' then sells the earnings for real money. Trading virtual currency and equipment can be a lucrative business as it accounts for about \$600 million dollars in business for IGE - a service provider operating a network of buying and selling sites for massively multiplayer online game (MMOG) virtual currency and assets on the internet.

Efficient online payment systems

The popularity of virtual currency stems from the economical need to have an efficient online payment system. China traditionally has heavy restrictions on PayPal-like online payment platforms, and little credit card usage among China's online population. These pitfalls allowed virtual currencies to quickly become an online payment system. Online giants such as Shanda, Tencent, Sina and Soho all have their own virtual currencies to facilitate online payment transactions. For example, in April, Tencent reached an agreement with Beijing Rising International Software Co., Ltd., a popular anti-virus software company, to allow the purchase of the company's anti-virus software with Q Coins. Such companies expressly forbid users to trade their virtual currency as real money or for real money.

However, as with Q Coins, virtual currency in China is being traded for real money. Virtual currency is traded on auction sites such as Taobao, 5173.com, IGE and eBay China. Virtual currency in China has matured enough to have the basic essence of real money: valuation, liquidity, methods of saving and methods of payment.

Government action

The government worries that virtual currency may cause

The new tax regulation amounts to a tacit recognition that trading of virtual currency for real money is legal

inflation and may be used for money laundering. Gambling is also a concern. Numerous online games offer winnings in virtual currency. If such winnings are exchanged for real money on auction websites, then, in essence, online players can engage in gambling by playing such online games. However, Chinese gambling regulations are silent when it comes to virtual currency. Thus, although the government wants to prosecute online gambling, there has not been an actual case because the government has no legal basis for prosecution. Due to these concerns, at the March 2006 Conference of the National People's Congress, a representative proposed a bill entitled 'Ban on Trading of Virtual Currency for Real Money, Establish Regulations on Online Games'. Supporters for this bill advocate a complete separation between virtual currency and real money, and urge the Chinese government to ban the 'printing of fake (virtual) money'.

Protection of virtual property

Conversely, others advocated the protection of virtual property. Several cases in China recognised the protection of virtual property. In 2006, Chen Xiao Fan ('Chen') was prosecuted for the theft of virtual property in Guangzhou Tianhe District Court. Chen was an employee of Guangzhou Net Ease Interactive Entertainment, Inc. and worked on the game Westward Journey Online II. Chen accessed several Net Ease accounts and stole virtual equipment. He sold the stolen equipment to other players and made a profit of 3,750 RMB. The court held that because the stolen virtual equipment was paid for by players and negotiable between players, it has value just as intangible property. Thus, the court convicted Chen on the crime of theft. Supporters of virtual

property urge the Chinese government to issue regulations protecting virtual property such as virtual equipment and virtual money.

Impact of prohibition

In February 2007, 14 government agencies, including the Ministry of Culture and the Administration of Industry and Commerce, jointly issued a statement banning the use of virtual currency to buy real-world products and the trading of virtual currency. At the same time, the government also halted the setting up of new internet cafes and enhanced regulation of online games. The world watched and waited for the outcome of the Chinese government's earnest attempt at improving online regulation. However, little impact resulted from the ban on trading virtual currency. Users continued to conduct trading openly on Chinese auction websites. Possible reasons for the lacklustre response to the ban are:

- the unbeatable popularity of virtual currency such as Q Coins creates underground markets where users can buy virtual currency at an exchange rate lower than the official exchange rate; and
- farming for virtual currency sustains the livelihood of small towns in China and workers are not willing to stop unless they are offered an alternative source of income.

Taxation of virtual currency

Contrary to the 2007 ban, the State Administration of Taxation recently announced the levy of individual income tax on income obtained through network virtual currency transactions. The income from the sale of virtual currency with increased value is taxable at 20%. This new regulation raises several concerns.

First, the new tax regulation

amounts to a tacit recognition that trading of virtual currency for real money is legal. However, the National People's Congress has yet to declare the legality of such trading and, as discussed, there is a 2007 regulation banning such trading. Although one could presume that the Chinese government is leaning toward officially legalising virtual currency trading, there is the possibility of the National People's Congress taking another u-turn in 2009.

Second, tracking online transactions poses a significant problem for authorities. Using Google, a search for the Chinese words 'virtual currency trading' results in 561,000 hits. This number signifies the immense volume of online trading. Also, online trading has no boundaries and it is often difficult to find the actual location of the participants.

Third, levying tax is another hurdle. According to China's Individual Income Tax Law, income paying entities shall be responsible for withholding individual income tax on the taxable income. In the absence of a legal withholding entity, individuals who obtain the income shall make a tax payment declaration to the taxation administration. In the case of virtual currency, there is usually no legal withholding entity, because most trading of virtual currency occurs between individuals. Getting individuals to voluntarily declare taxation is also difficult to implement.

Lastly, the vaguely worded regulation provides local tax bureaus with little guidance on how to implement the new tax. Chinese media reports the following responses from various provinces:

- Shanghai Local Taxation Bureau will start implementing this tax in the coming weeks, but did not

specify the methods for implementation.

- Chongqing Local Taxation Bureau will temporarily not implement this tax.

- Zhejiang Local Taxation Bureau is currently analysing how to implement this tax, and does not project a date for implementation.

- On 11 November, the Beijing Local Taxation Bureau announced the following implementation rules for this tax: (1) for transactions with verifiable income, the income will be taxed at 20%; and (2) for transactions with unverifiable income, the entire transaction amount will be taxed at 3%.

- Beijing Local Taxation Bureau requests individuals to make tax payment declarations to the Bureau after transactions involving virtual currency.

Conclusion

Analysts and game players are not optimistic about the success of implementing this new tax. With the fast growing economy of virtual currency trading, the Chinese government has a heavy incentive to make this taxation work. We can only wait to see the results.

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1. No. 818 [2008] of the State Administration of Taxation.