Tax challenges deriving from the Metaverse and Web 3.0

Agend a

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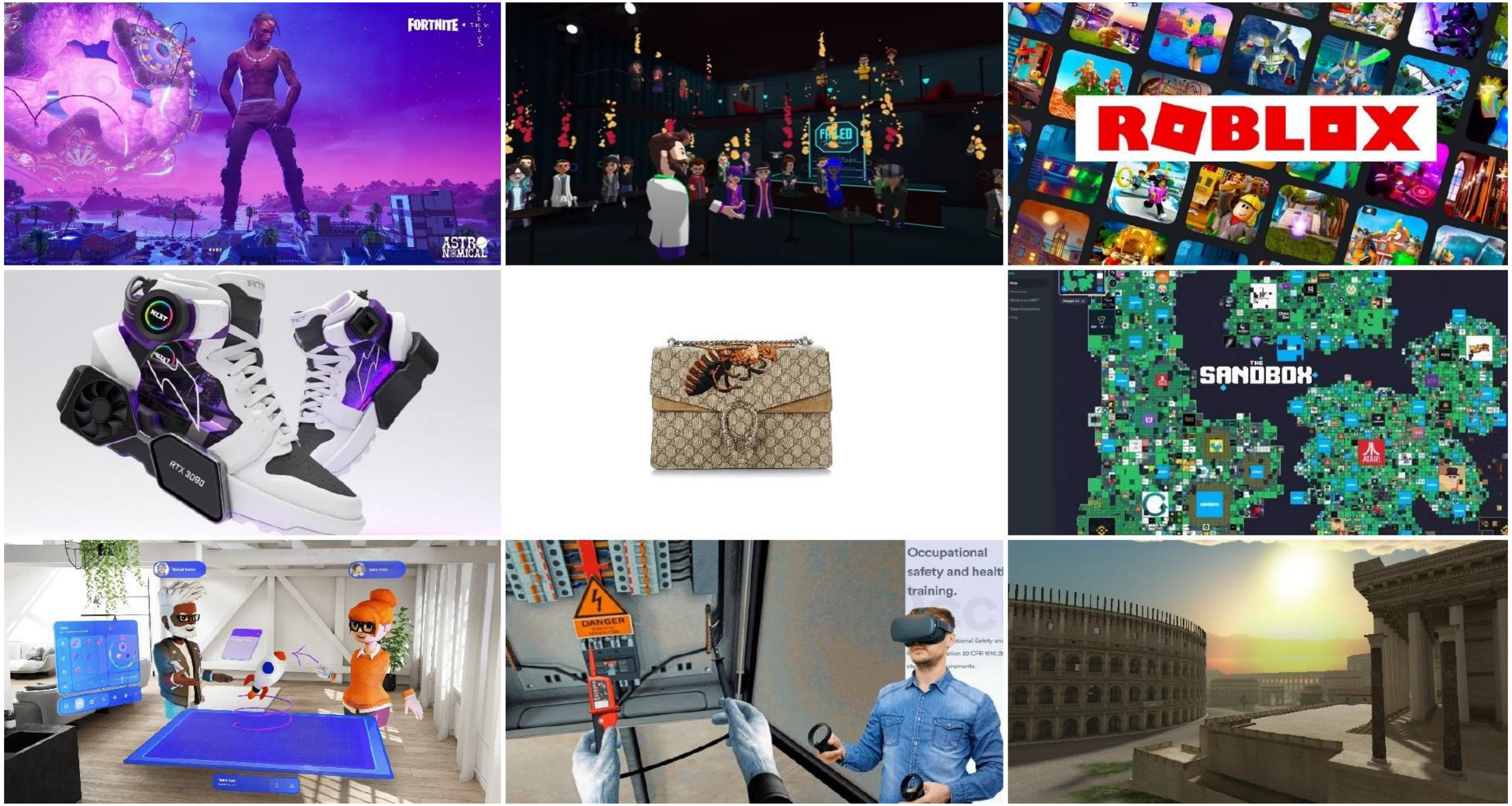
Can you spot the trend?



Resources: https://www.roblox.com/ | https://www.pcgamer.com/these-shoes-are-an-rtx-3080-powered-pc |
https://www.gucci.com/us/en/ca/campaign/gucci-bee-c-gucci-bee-collection | Sandbox: https://www.sandbox.game/en/

Introduction: Web 3.0

	Web 1.0	Web 2.0	Web 3.0
Premise	Read only	Read-Write	Read-Write-Own
Construct	Decentralized	Centralized	Decentralized
Interaction	Static, one-sided consumption (consumers consume)	Participatory, two-sided consumption, with intermediaries (lines blur between consumer/creator)	Two-sided consumption, without intermediaries, value in hands of the consumer

Web 2.0

Payments & Commerce

- Traditional payments
- Fiat currency

Transaction fees paid to

Ownership

- Formal titles
- Operated by law

Fees paid to central market places/intermediaries

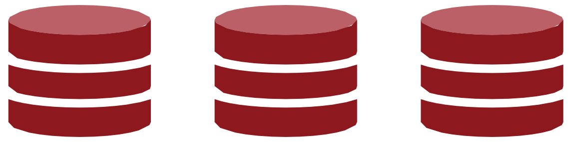
Finance

- Operated by banks/intermediaries
- Strict KYC/AML and verification procedures

Fees (interest) paid to banks/others

Governance

- Centrally owned, legal entities
- Board of directors / shareholders



Web 3.0 (blockchain-based)

- Crypto wallets
- Cryptocurrencies / digital fiat

Transaction fees paid to community (miners)

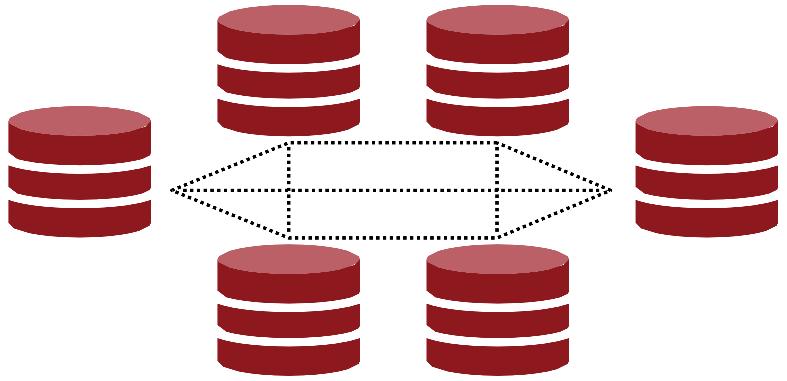
- Non-fungible tokens (NFTs)
- Operated by smart contracts

Fees paid directly to the community/creators

- Decentralized Finance (DeFi)
- Lending/borrowing against virtual assets
- Without the need for a bank account…

Fees (interest) paid to community (liquidity providers)

- Decentralized Autonomous Organizations (DAOs)
- Operated by community consensus
- Voting in native tokens

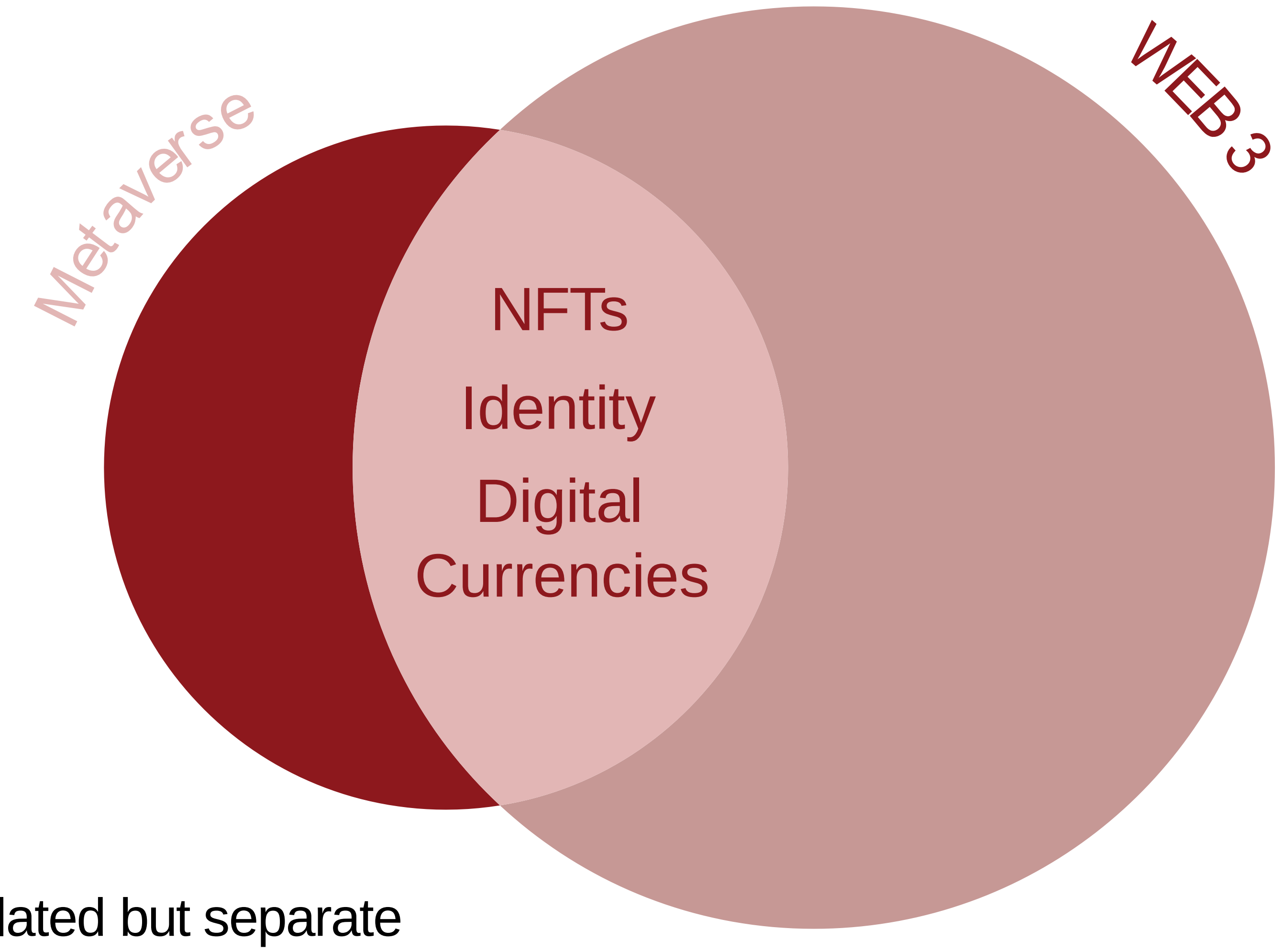


Is it about Web 3.0 or the Metaverse?

The metaverse is the future state of how humans will experience the Internet

Web3 is the next generation of decentralized infrastructure enabling the new Internet paradigm

3D
Virtual/physical Immersive
Persistent
Creative



Blockchain
Decentralized web Apps
DeFi
DAOs
Creator economy
Personal data ownership

Interrelated but separate

Agend
a

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What is a Metaverse?

- **A virtual world in which one can buy land, erect buildings on it and then sell the land that has been developed in this way, manufacture and sell objects, move by way of an avatar, meet other people, communicate with them, visit shops and museums and attend parties, concerts and other events.**
  - A mixture of Virtual Reality (VR), Minecraft and Second Life
  - Still very much in its infancy

Which Metaverse projects exist?

- **Decentralized projects (assets are represented as blockchain-based tokens, in which a user has full ownership)**
  - Decentraland (https://decentraland.org/)
  - The Sandbox (https://www.sandbox.game/en/)
  - Cryptovoxels (https://www.voxels.com/)
  - Somnium Space (https://somniumspace.com/)
  - Otherside (https://otherside.xyz/)
- **Centralized projects (assets are represented as entries in a database maintained by a "Big Tech" corporation)**
  - Meta (https://www.facebook.com/business/metaverse)
- **Interoperability between Metaverses?**

What business scenarios exist in the Metaverse?

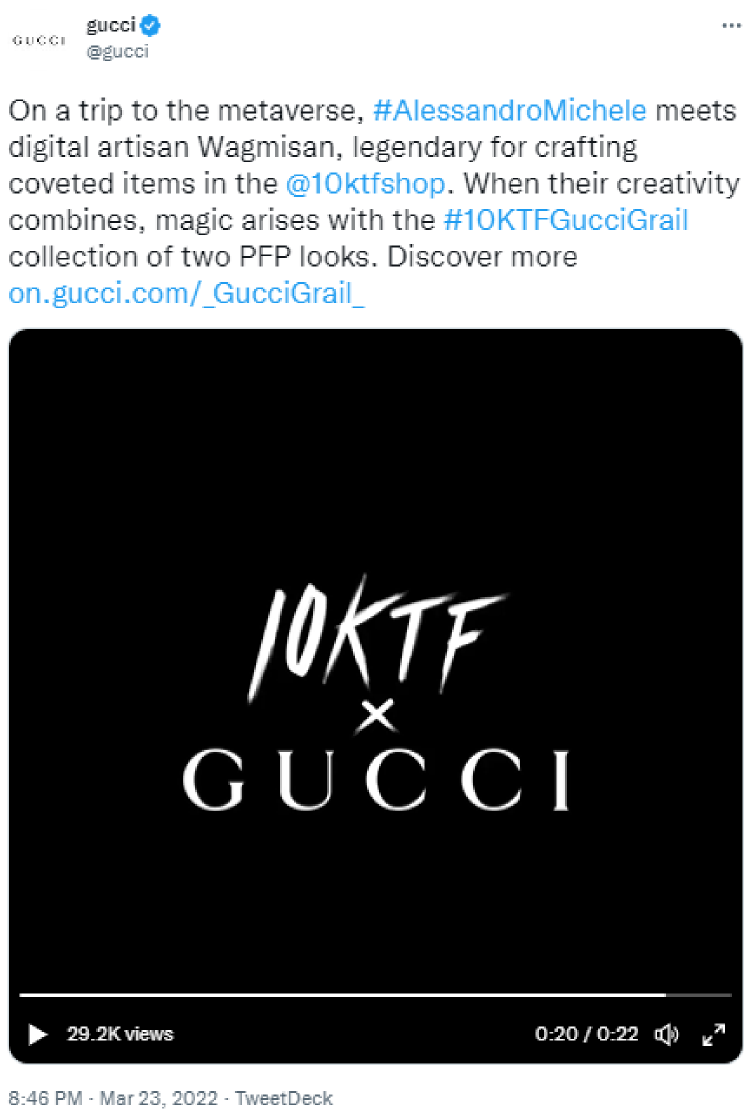
- **Entertainment**
  - “Virtual reality platform Decentraland has kicked off Metaverse Festival featuring a star-studded lineup of acts from all over the world. The four-day virtual festival begins on 21 October at 4 PM EST […] and is free for all to stream on the Decentraland website. More than 80 artists will have their own set at the festival, including EDM artist Deadmau5, media personality and DJ Paris Hilton, indie rock outfit The Wombats, and producer RAC. What makes the festival stand out from the rest is that these artists will be performing in the form of virtual avatars.”

What business scenarios exist in the Metaverse?

- **Real estate development**
  - “Metajuku is a 16,000 sf (256 m2) project built with a pedestrian-friendly open space at its center. Retail stores line both sides of the open center atrium. […] The development was designed by Austin-based architect Martin Guerra and developed by Everyrealm’s global team of 3D real estate and game developers. […] Tenants include digital fashion brands Genial Investimentos, Majid Al Futtaim, Dress-X and Tribute Brand, as well as JPMorgan, the first bank in the metaverse. In Metajuku, NFT wearables can be purchased at both Dress-X and Tribute Brand stores […].”

What business scenarios exist in the Metaverse?

- **Sale of fashion items (“metaverse wearables”)**
  - “Digital fashion is gaining momentum. Designers can use NFTs that are deployed on blockchains to ensure uniqueness, authenticity and ownership of garments and accessories. Adidas, Nike, Gucci, Louis Vuitton and Burberry are just a few of many brands that are competing to be fashion icons in the metaverse. […] Virtual fashion is not a new concept. Online gamers have been able to customize their avatars with wearables for the past two decades.“



What business scenarios exist in the Metaverse?

- **Legal and financial services**
  - “Gleiss Lutz has become the first leading German business law firm to open an office in the metaverse. With our established Digital Economy industry group and award-winning legal tech skills, we are ideally placed to provide clients with comprehensive advice on the wide range of new legal issues arising in the digital space. […] Select ‘Play as guest’ on the start page and follow the instructions to design your avatar, then confirm with ‘Done’. Choose your nickname, click ‘Next’ and then accept the terms & conditions.”

Agenda

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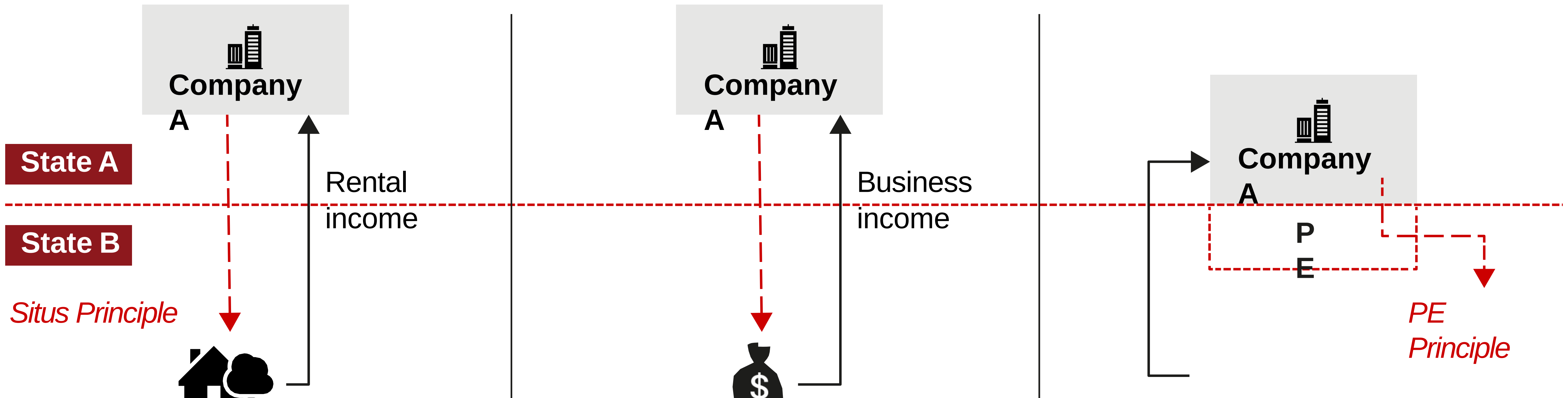
Possible options of source state in the Metaverse

- The taxation of the Metaverse could raise many issues, among these:
  - A. **Territoriality: Where and who will be subject to tax?**

1. **Where payer/purchaser/user is located**
2. **Where the seller/vendor/NFT creator is located**
3. **Where the Metaverse owner is located**
4. **Where the technical infrastructures are located**

Sourcing rules according to the OECD M.C.



Income derived by a Resident of a Contracting State from immovable property situated in the other Contracting State ***may*** be taxed in the other contracting state

Profits of an enterprise of a Contracting State ***shall*** be taxable only in that state

Business income
Unless the enterprise carries on business in the Other Contracting State through a Permanent Establishment situated therein

The connecting factor between the income and the territory generally differs depending on the item of income concerned

Taxation principles evolution along digitalization and impacts on sourcing rules

Because the digital economy is increasingly ***becoming the economy itself****, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes (OECD BEPS Action 1 2015)*

Tax principles

1925-1928 League of Nations
Physical presence main principles: the source and residence state, and introduction of permanent establishment

1995 TP Guidelines & 1998 OECD Ottawa report
Globalization evolution of business models due to web and e-commerce no introduction of innovative taxation principles, update of the OECD Model Tax Convention, introduction of the arm's length principle (transfer pricing)

2015 EPS Action 1
Focus on (i) **nexus**, (ii) gather and use of **data**, (iii) c**haracterization** of digital products/services international tax rules became outdated & new business models had developed new options to address new tax challenges: (i) new Nexus for significant economic presence (Digital PE) (iii) WHT on certain digital transactions (iv) equalization levy

2020 OECD Pillar I & II blueprint
Pillar I introduces new nexus and profit allocation rules *(***Amount A***)* related only to the following categories of activities: Automated Digital Services (ADS) and Consumer-Facing Businesses (CFB); Pillar II introduces a "top-up" tax up to the minimum tax rate *(***15%***)*

Future
Will the metaverse taxation request the development of new principles? **currently potential double taxation/no taxation due to no global consensus on crypto and metaverse taxation**

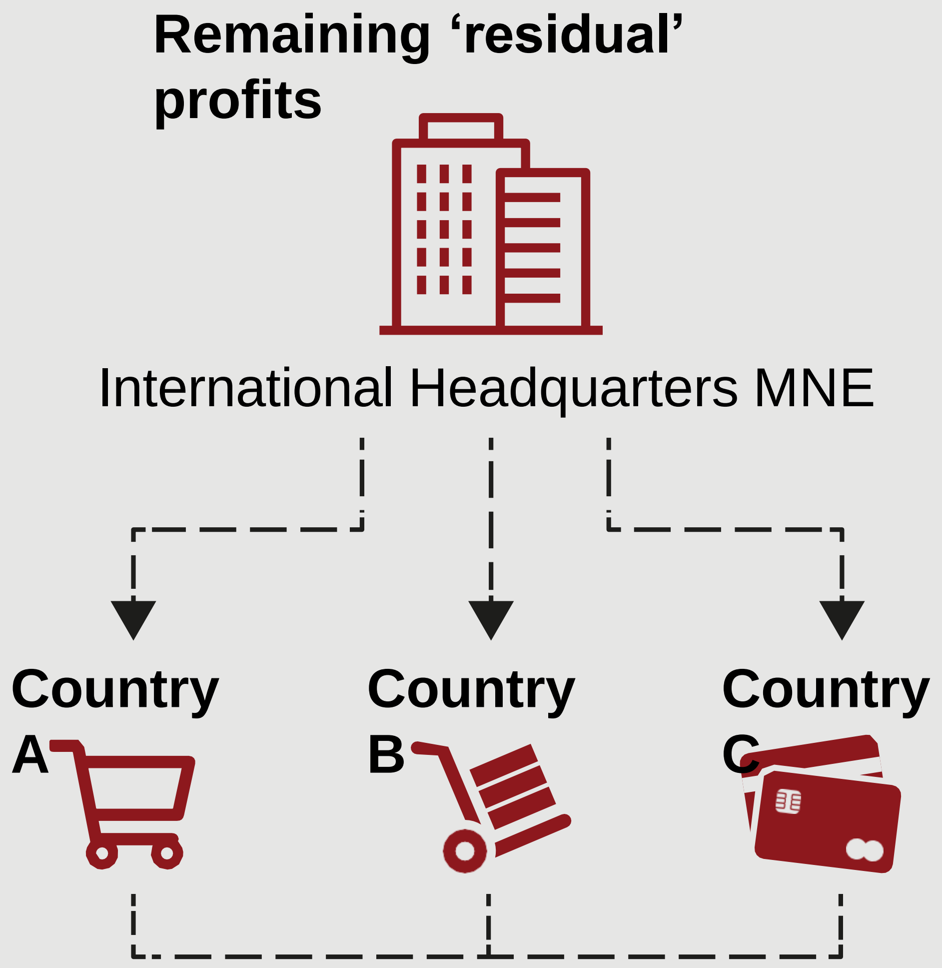
OECD Pillar One – New sourcing rules

Pillar I deals with new nexus and profit allocation rules to shift taxing rights on certain business models to market jurisdictions

Amount A
new taxing rights for market jurisdictions over a share of residual profit calculated at an MNE group

Amount B
fixed return for certain baseline marketing and distribution activities taking place physically in a market jurisdiction

Tax Certainty
effective dispute prevention and resolution mechanisms



25% of residual profits fits re-allocated to the countries where MNE's users and customers are located

What is the end-market of the metaverse?

OECD Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, Brochure October 2021

Agenda

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General issues and fundamental tax queries

Fundamental Tax Questions

- New (DAOs organizational models)
- Infrastructure investment in new technologies
- Decentralization: Who and how to tax?
- New digital assets: Which tax is applicable?
- Uncertainty in application of existing tax rules to metaverse activities: Characterization?
- Implications for digital government: Increased transparency

General issues

- Decentralized/(pseudo-)anonymous digital environment
- Emerging tax / tech policy and regulatory layer
- Tokenization using blockchain technology

What is a non-fungible token (NFT)?

The acronym "NFT" stands for "non-fungible tokens" and these are digital assets with unique identification codes and metadata recorded in a blockchain ledger representing the ownership and authenticity of an associated unique tangible or intangible asset

As the name suggests, NFTs are characterized by their non-fungible nature which means they are, by definition, not interchangeable, irreplaceable and unique

The non-manipulative nature of NFTs enables both real and virtual assets to have verifiable scarcity and original ownership

As any other token, NFTs represent specific claims or rights, given out by the issuer.

Identifying NFT substance? – What is the transferred right?

Underlying most NFTs is some kind of Transferred Right which accompanies the exchange.
Identifying the substance of the NFT requires an deep understanding of the (i) Transferred Right(s) conferred to the NFT, as well as (ii) the local laws that apply to NFTs.

Services	Tangible Assets	Intangible Assets	Nothing	TBD
Right to an hour of legal services Right to SaaS like in game feature	Right to a t-shirt Right to land	Right to original artwork Right to in game feature		

Note: It is important to consider the specific laws for ALL the jurisdictions of market participants. The same NFT and transferred rights could trigger a different tax and legal treatment in creator, market, and purchaser jurisdictions, based on their respective laws.

Tax considerations of non-fungible tokens (NFTs): Snapshot

Digital Asset Minted as NFT

Creator

Tax considerations:

- Revenue model alternatives
- Categorization of digital assets and transaction types
- Direct and indirect taxability
- Impact GLTI and FDII calculations (USA)
- Integration of NFT strategy into supply chain models
- Royalty vs Business Income

NFT Sold (for ETH) on Marketplace

Marketplace

Tax considerations:

- Primary seller of record and intermediaries in transactions
- Characterization of seller (e.g., dealer, trader, collector)
- Qualification of the marketplace for direct and indirect tax requirements?
- Access to geo information participants
- Place of transaction
- Information reporting (CARF/ DAC8) and withholding requirements?

Purchaser Collects/Exploits NFT

Purchaser

Tax considerations:

- Transactional or value-based tax considerations for digital assets
- Taxable barter transactions when paid in crypto
- Relevance of intent of purchases (collector, investment)
- Tax consequences of subsequent transactions

Agend
a

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What is the tax relevance of the Metaverse and Web 3.0?

- **Activities not generating income**
  - Dressing up, wandering around, meeting friends, chatting to strangers, going shopping, listening to a band, visiting a museum, etc.
- **Activities generating income**
  - Selling services against consideration
  - Selling goods (as a manufacturer or as a trader) against consideration

What types of taxes can be relevant in the Metaverse and Web 3.0?

- **Personal and corporate income taxes**
- **Withholding taxes**
- **Value added taxes**
- **Real estate transfer taxes**

Agenda

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Permanent establishment

General definition

- Fixed place of business through which the non-resident company carries out, in whole or in part, its activity in a State
- The attribution of profits is based on the OECD report of 2010

!

Based on physical presence

Digital presence

- The development of digital economy has requested an update of the concept of Permanent Establishment due to the new digital business models
- The "Digital PE" based on digital presence was introduced in Italy "*A significant and continuous economic presence in the territory of the state built in such a way [as] not to result in any physical presence in the same territory*"

Main key indicators/criteria:

- total **revenues** derived from the provision of the digital services to users located in the same jurisdiction
- number of **users** of one or more such digital services located in the same jurisdiction
- number of commercial **contracts** for the provision of digital services from users located in the same jurisdiction

The majority of international tax landmark cases are based on PE challenges!! **!**

Tax challenges of the Metaverse – The role of data centers and infrastructure

- **MNEs operating in the field of digital economy (e.g., digital advertising, social networks) have been heavily impacted by Digital Services Tax (DST) and OECD Pillar I, which mainly focuses on where users are located**
- In recent years, MNEs have increased investment on technical infrastructure (e.g. data centers, servers, cloud infrastructures) all over the world in order to strength the provision of digital services and to facilitate the access for users <u>Metaverse will benefit from such infrastructures!</u>

- These infrastructures could increase the presence of an MNE in a jurisdiction and lead to PE disputes (with particular reference to cases where there is no other legal entity of the MNE in the jurisdiction)
- For example, in Italy, a “fixed place of business” (PE) was challenged based on an innovative interpretation of the Italian infrastructure usage (servers, computers, cables, algorithms and optical fibers are considered equivalent to offices, plants and equipment in a digital economy business)

Simplified example on Metaverse tax implications

M-owner

- M-owner when sells NFT receives crypto and is subject to US taxation
- According to OECD Model, the transaction may be subject to tax in USA (art. 7, 12 or 13)

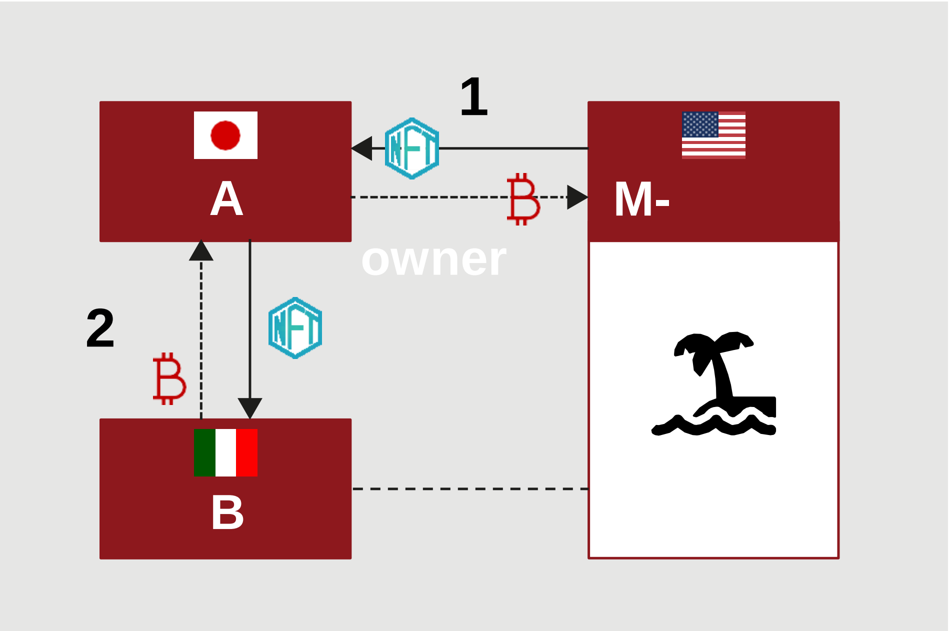
Potential double taxation

Selling of NFT from A to B. For A is qualified as business income (art. 7) while for B is qualified as royalty and WHT applies (art. 12)

A

- A pays in crypto, receives the NFT and then re-sells NFT to B and receives crypto
- According to OECD Model, the transaction may be subject to tax in JP (art. 7, 12 or 13)

Potential double taxation



B

- B pays crypto and receives NFT from A
- If B re-sells the NFT, according to OECD Model, the transaction is subject to tax in Italy
- (art. 7, 12 or 13)

If B rents (or makes business profits with) the LAND in the metaverse, according to OECD Model, the transaction may be subject to tax in:

- Italy under art. 6 if we assume the LAND is situated in Italy
- USA under art. 6 if we assume the LAND is situated in USA
- In Italy, under article 7 or 12
- USA and Italy under art. 12

Indian Tax Implication

- **In the Indian context, the adoption of cryptocurrency and other virtual digital assets (VDAs) is increasing across different sectors.**

- **In the past, the Reserve Bank of India (RBI) has taken actions to deter financial institutions and users from using virtual currencies and issued a circular to deter such use.**

- **However, in the case of the Internet and Mobile Association of India v. RBI (IMAI Judgment), the Supreme Court removed the restrictions on dealing in cryptocurrencies by quashing the RBI's circular.**

- **A new mechanism for the taxation of VDAs was brought into the tax regime in Finance Bill 2022, effective from 1 April 2022. The definition of VDAs included in the ITA is broad and includes non-fungible tokens, currency like bitcoins, and any other coins which are traded digitally.**

Virtual digital asset under IT Act, 1962

- **Sec. 2(47A) ITA defines virtual digital assets as under:**

- **‘virtual digital asset’ means–**

- **any information or code or number or token (not being Indian currency or foreign currency), generated through cryptographic means or otherwise, by whatever name called, providing a digital representation of value exchanged with or without consideration, with the promise or representation of having inherent value, or functions as a store of value or a unit of account including its use in any financial transaction or investment, but not limited to investment scheme; and can be transferred, stored or traded electronically;**

- **a non-fungible token or any other token of similar nature, by whatever name called;**
- **any other digital asset, as the Central Government, may, by notification in the Official Gazette specify:**

Provided that the Central Government may, by notification in the Official Gazette, exclude any digital asset from the definition of the virtual digital asset subject to such conditions as may be specified therein.

Tax deducted at source

From 1 July 2022 onwards, any person who is responsible for paying any consideration to an Indian resident for the transfer of a VDA is required to deduct TDS at the rate of 1% if the payment exceeds the relevant threshold limit indicated in the table.

Liability for deduction	Threshold (INR)
All individuals and Hindu undivided families (HUF) less than INR 10 million crore approx. annual turnover in business or less than INR 50 lacs (in the case of professionals)	50,000 (approx. EUR 610)[*]
Other individuals, HUFs, companies, LLPs, firms	10,000

Indirect tax implication

- **Currently, there are no separate rules in the Indian Goods and Services Tax Act (GST Act) concerning the taxation of VDAs. To determine whether goods and services tax (GST) can be levied on VDAs, it is first necessary to determine whether transactions in VDAs are covered by the definition of supply in the GST Act.**

- **Can cryptocurrency be treated as goods?**

Goods mean any kind of movable property, including actionable claims, but does not include money and securities.

- **Can cryptocurrency be treated as a service?**

Services mean anything other than goods, money, and securities. Since cryptocurrency may be regarded as movable property; it may fall within the definition of goods and may be out of the definition of services.

Other Challenges

- **Valuation issues:** What should be the cost basis for cryptoassets – should the such as first-in, first-out (FIFO) method be followed to determine the cost of acquisition?

- **Determination of cost of acquisition in case of gifts:** Where someone receives VDAs as a gift, what should be the cost of acquisition?.

- **The TDS deduction for VDAs** is prescribed in section 194S of the ITA, while TDS deductions for non-residents are covered in section 195. It is not clear whether there is an obligation to operate TDS deduction where VDAs are sold to non-residents.

- **Differentiating between money and VDA:** Situations where cryptocurrencies are recognized as legal tender in other countries: Currently, bitcoins are treated as legal tender in Central African Republic, El Salvador and Panama. It is not clear whether in situations where crypto currencies recognized as legal tender in other countries would be excluded from the definition of VDA.

Thank you for your attention!