

US iGaming: the taxation models being considered

2013 appears to be the year the first real-money wager will be accepted on a state licensed and regulated internet gambling website in the United States. To date, the States of Delaware, Nevada, and New Jersey have passed legislation authorising some form of online gambling. These states are carefully taking steps to establish industry standards, while other states strongly consider following their lead. Brad Polizzano, a tax and gaming attorney in New York, discusses the taxation models being considered by US States, the accompanying federal obligations and the tax issues that could encourage federal legislation.

As the US intrastate iGaming market begins to take shape, there is no shortage of critical tax considerations. States must decide how to generate tax revenues through iGaming activity, both through mere intrastate operations and interstate compacts with other states or countries. Once a state's regulatory regime is established and licenses are issued, operators will face the task of ensuring compliance with all federal and state laws applicable to iGaming, including the Internal Revenue Code and Bank Secrecy Act. These considerations are discussed in turn.

State gaming taxation models

It is no secret that the chief aim for most - if not all - states to legalise iGaming is to generate tax revenues. The two basic gaming taxation models are: (1) the gross gaming revenue ('GGR') tax and (2) the deposit tax. GGR is a profit-based model, generally taxing total wagers made by

customers less winnings paid back to its customers. The deposit tax is imposed on a percentage of funds a player deposits with an operator.

Delaware, Nevada, and New Jersey have all adopted their respective GGR models that are applied to already existing gaming operations in their states. Interestingly, a bill currently pending in the Nevada Senate would subject revenue from online poker tournaments to the state's 6.75 percent GGR tax; brick and mortar poker tournaments in Nevada are not included in GGR.

To date, no state has sought to utilise a deposit tax model for iGaming. Arguably, the deposit tax is far easier for operators to implement than GGR. Unlike GGR, the deposit tax does not depend on the type of game played. One issue regarding the deposit tax is that the tax could apply even if a player withdraws a deposit before placing any wagers. To mitigate the issue, states could permit operators to charge customers early withdrawal fees or allow operators to claim tax credits for funds withdrawn by customers.

Interstate compacts and revenue sharing

Less populous iGaming states, such as Nevada and Delaware, will undoubtedly look to partner with other states in order to expand their iGaming reach beyond customers physically present within their borders. How would states share tax revenue generated by interstate iGaming operations?

A realistic scenario is for operators licensed in more than one state to pool their online poker liquidity among those states pursuant to an interstate compact. Here are a few possible approaches for determining which states are entitled to tax rake collected on each online poker hand played:

2. Location of the winning player; or

3. On a pro rata basis by proportion of wagers placed by players in the state to total wagers made.

States looking to outsource operations to a state with an established licensing regime, such as Nevada, would obviously oppose Approach 1. Approach 2 is simple to implement but raises bias concerns, as states would inherently prefer their residents to win all hands over nonresidents. Enter Approach 3, which removes the outcome bias and forms a tax base proportional to the amounts contributed by each state's players for any given hand.

Federal reporting and withholding tax obligations

Unless federal oversight legislation is passed, iGaming operators will have to comply with the current federal withholding and reporting obligations under the Internal Revenue Code. Under these rules, winnings of US residents from the substantial majority - if not all - of online poker cash games would not be reported by operators to the Internal Revenue Service.

In general, gambling winnings of US residents are reportable on IRS Form W-2G if the amount paid with respect to a wager is \$600 or more and the proceeds are at least 300 times the wager; withholding is required if the amount paid is \$5,000 or more and at least 300 times the wager. On a table of ten playing No Limit Texas Hold'em, for example, the most one can win on a single hand is ten times the amount wagered. As a result, the reporting and withholding thresholds for US residents in most cases would not be triggered for operators of online poker cash games.

Perhaps Congress will take action to expand the scope of reportable

iGaming winnings. H.R. 2230, the Internet Gambling Regulation and Tax Enforcement Act of 2011, a federal bill never enacted, sought to require 'Internet gambling licensees' to report to the IRS the 'net internet gambling winnings' for the calendar year of each person placing a wager with the licensee. Would it be prohibitively costly for iGaming operators to report these net winnings of all persons placing wagers, including more nominal amounts (e.g. less than \$100)?

iGaming operators must also consider how to handle claims of treaty benefits made by nonresidents. In general, gambling winnings of nonresident aliens are subject to thirty percent withholding and the payee is issued IRS Form 1042-S. An applicable tax treaty between the US and a treaty partner, however, may reduce the withholding rate or eliminate it altogether. Claimants must provide the operator IRS Form W-8BEN or Form W-ECI to obtain treaty benefits.

Federal wagering tax

The excise tax under section 4401 of the Internal Revenue Code may apply to bets accepted on US iGaming sites. For accepted wagers authorised under state law, the excise tax is 0.25 percent of the wager amount. For all other wagers, the tax jumps to two percent. Taxable wagers include those placed (i) on a sports event or contest with a person engaged in the business of accepting such wagers; (ii) in a wagering pool on a sport event or contest conducted for profit; or (iii) in a lottery conducted for profit.

It is an open question whether poker is considered a lottery conducted for a profit under the Treasury regulations. Even if poker falls within the definition of a lottery conducted for profit, it may

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nevertheless be exempt from the tax, as the Internal Revenue Code provides that the term lottery does not include any game of a type in which usually the wagers are placed, the winners are determined, and the distribution of prizes or other property is made in the presence of all persons placing wagers in such game.

Although it is clear according to a Treasury regulation that in-person poker games and tournaments (as well as all other card games) are exempt, it is far from clear whether online poker wagers are also exempt. Does 'in the presence for all persons' require physical presence, or does virtual presence on the same online poker table also suffice?

The Bank Secrecy Act

Under the Bank Secrecy Act ('BSA'), casinos considered a 'financial institution' are required to report certain financial transactions to the federal government. The BSA is aimed at preventing and detecting money laundering and other financial crimes. A casino or 'gaming establishment' (including, for example, a card room) is considered a financial institution if its gross annual gambling revenue exceeds \$1 million and it is a licensed casino or gaming establishment under federal or state law.

A casino must file FinCEN Form 103, Currency Transaction Report by Casinos, for each transaction involving either currency received or currency disbursed of more than \$10,000. A casino must file FinCEN Form 102, Suspicious Activity Reports by Casinos and Card Clubs, if a transaction aggregates at least \$5,000 in funds and the casino suspects that the transaction has no business or apparent lawful purpose.

Will the BSA cause severe

limitations on iGaming players transferring funds in their accounts to other players' accounts? Possibly. Nevada, in fact, expressly prohibits player-to-player transfers under its interactive gaming regulations. If a jurisdiction does not expressly prohibit them, operators may have to monitor whether transfer requests are suspicious, or not allow them at all.

Conclusion

As states proceed to offer and regulate iGaming, federal legislation that could address some of the tax issues presented remains possible. At some point, Congress may be compelled to enact legislation establishing uniform iGaming standards. In the meantime, the piecemeal state-by-state approach remains at the forefront of US iGaming regulation efforts.

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