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Online Poker Should be Taxed, But How?

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Federal and State Taxation of Internet Gambling
Deposit Tax vs. GGR Tax

There are currently two models proposed for federal and state taxation of legalized and regulated Internet Gambling in the U.S. One model would use the traditional approach relied on by land-based casinos for gambling at their physical locations, which taxes Gross Gaming Revenues. The second model would adopt a different approach to online, in light of the fact that gamblers establish “accounts,” rather than purchase chips solely for immediate play. The approaches discussed below are designed to be applied regardless of whether enabling legislation is adopted under federal (interstate) legislation or state (intrastate) legislation.

I. The Models

Under the Gross Gaming Revenue Model (“GGR”), licensed operators are required to pay a percentage of their revenues to the federal government and to participating states, calculated on the basis of the amount wagered by all of the customers minus the winnings returned to the players, or net sales. In the US, state revenues from land-based casinos have been based on a GGR model, supplemented by admissions taxes, device taxes, and other fees.

Under a Deposit Tax Model, licensed operators are required to pay a fixed percentage of the amounts deposited by players to the federal government and to states wishing to participate in such a federal regime, such as 5% federal and 5% state of total deposits.

While there are advocates for both models for regulated U.S. Internet Gambling, there are important consequences for the federal and state governments and for licensed operators depending upon which approach is undertaken.

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II. GGR Tax

In the context of a land-based casino operation, a GGR tax is easily administered, as it represents the funds left to the operator after the gamblers cash in their chips or otherwise receive payment at the end of their gambling activities on a particular day, or in a particular tournament, or at the end of a particular event, such as a sporting contest.

As applied to online, GGR tax, can create complex revenue recognition questions, which could have a negative impact on federal and state revenue. It would require operators to develop unprecedented procedures, which today do not exist, to determine how to allocate funds to different states relating to games in which players from different states played one another, such as poker. On a strict intrastate system there is no allocation among states, unless and until multi-state compacts are negotiated and implemented.

Casino operators are accustomed to GGR taxes which for them provide a predictable formula for paying taxes in light of their experience with taxation at the state level. GGRs have been set at low, affordable levels in states such as New Jersey and Nevada, at 7.9% and
7.5% respectively, although GGRs have been set much higher in most other states, typically at 20% or more and as high as 50% for large operators in Illinois.

In land-based casinos, where customers buy and then cash chips in at the end of a game or tournament at a single location, a GGR tax is easy to calculate, representing the difference between the funds that have been given by the customers to the operator, and the amount that the customers have collectively been given back by the operator.

Benefits of a GGR Tax

• Land-based casinos are accustomed to paying GGRs and understand its economics.
By contrast, they have not previously paid deposit taxes.

• Operators are never in a position where they are paying taxes on anything other than actual gross revenues to them, limiting their risks.

• No GGR tax is due until a casino pays out winnings to its customers. Payment is deferred until that amount is calculated. The business risk is therefore shifted to the licensing authority to determine compliance accuracy and timely payment.

Concerns About a GGR Tax for Online Gambling

• More Complex Accounting Questions About What Constitutes “Winnings” and What Constitutes Taxable “GGR.” GGR is difficult to calculate in an individual account- based system. Calculating winnings would be based on decisions in each individual account, rather than total amount in and amount out for the operator, as is done for land-based casinos. It is not clear what would happen if the player left funds in the account and did not withdraw them. Do these funds escheat to the licensing authorities and if so when?

• Uncertainty over Timing in Collecting Taxes. While a player is engaged in wagering, there is no tax due under a GGR until winnings can be calculated. Depending on how regulations regarding GGR are defined, this could be deferred for an extended period with an “account,” as a customer could win one day, lose another and not withdraw funds for an extended period, with no taxes being due until the conclusion of that period.

• Substantial Issues in Allocating Funds for Individual States. Under a GGR, it is not clear how an operator would allocate which revenues should go to which state in any case in which there are players from multiple states competing with one another. Accounting rules could be complex.

• Opportunities for Operators and Players to “Game” the System to Defer Taxes Could Be Extensive. With a GGR, operators and players could create incentives for funds not to be cashed out as “winnings,” thereby deferring payment to the federal and state governments for extended periods. Promotional credits and other forms of non-cash payment could be used by casinos to encourage players to maintain accounts and not to cash-out as a means of deferring recognition of GGR. Players could choose to maintain funds in an Internet account in order to reduce the size of bank accounts and other assets that might be more visible to creditors.

III. Deposit Tax

Players would deposit funds into an account maintained by the operator, or on the operator’s behalf. The operator would be required at the end of each 30 day period to remit fixed percentages of the amount deposited to the federal government and to the state in which the player resides (or alternatively, depending on the legislation, the state in which the player is located at the time of the deposit).

In cases in which a player chooses to withdraw funds without using them to play, the operator could impose an “early withdrawal” fee, similar to the fees imposed on consumers withdrawing from a contract with a wire telephone company, or making a change to an airline reservation. This would have no impact on the amount paid to the federal or state governments. Similarly, any “free play” bonuses, or other promotional funds would not change the amount of the deposit tax, which would be a fixed percentage of deposits regardless of incentives.

In an alternative version of deposit tax, a licensed operator would be provided a credit on the deposit tax for those funds withdrawn from player accounts at the end of each 30 day period, calculated using the same rate as was used in calculating the original deposit tax.

Potential Benefits of a Deposit Tax Over a GGR Tax

• Calculations for operators are easy and transparent, as is verifying they have paid the correct amount. Therefore, the costs of compliance from both the operator and regulators standpoint are reduced.

• The federal and state governments would receive funds without delay once a customer has chosen to engage in online gambling and without having to wait until the player commences wagering.

• States can readily determine how much are due them based on the residence of the customer at time of deposit or, alternatively, the customer's location.

• Federal and state governments do not have to address complex issues relating to "adjustments" for various forms of operator costs, as can happen in connection with adjustments to a GGR which operators have negotiated with some states. For example, if a GGR is reduced by contracts with software providers, or promotional costs, amounts calculated as net GGR could be substantially less than total GGR, reducing revenues to the governments.

Players opting to play with sites not licensed in the US incur the liability not only for the deposit tax but also a hefty penalty (50%), creating a strong enforcement nexus and a deterrent to play with "illegal" sites.

Concerns About a Deposit Tax

Some operators and regulators may be concerned that a Deposit Tax could be economically risky or burdensome to them. Their concerns are:

• Operators would have to pay taxes to the federal and state governments within 30 days, while customers might not generate sufficient revenues for the operators during that time. The Deposit Tax would not be deductible from player funds, but is instead paid by the operator. The method puts the business risk squarely on the operator.

• While unlikely in the real world, competitors or other malicious persons could "deposit" funds in an account and immediately withdraw the funds without activity, with the goal of causing economic injury to the operator.

o Each of these concerns can be negated through allowing operators to impose fees for early withdrawal on customers, sufficient to compensate the operator from the risk of non-play, or insufficient play, in light of the taxes. All of the Internet Gambling bills introduced to date permit this approach. Alternatively, a credit on withdrawals may be utilized to eliminate this risk.

• A Deposit Tax could result in higher overall taxes than a GGR, imposing an undue burden on all operators.

o The concern of higher overall taxes has not been justified by any independent study. Estimates by PWC, an independent auditing and accounting firm, suggest that each one per cent of a deposit tax is the equivalent of 2.6% of the GGR currently paid by land-based casinos. Thus, a total federal and state Deposit Tax of 10 per cent would be the equivalent of a 26% GGR. Many states impose a 25% GGR tax, as well as other fees, making a 10% deposit tax equivalent to existing taxes on land-based casinos in many jurisdictions.

o Land-based casinos face significant costs that do not apply to online casinos, for facilities, utilities and personnel, suggesting that the equivalent of a 26% GGR is reasonable in relation to state GGRs today.

o If a 10% Deposit Tax proved to be too high, it could be reduced.

IV. Other Considerations

• On-line operators would all face the same level of taxes under any scenario, deposit tax or GGR, and could impose other fees, increase "rakes," or change odds to accommodate the tax. This is already done in land-based casinos, which feature odds on slot machines that change from machine-to-machine, with some machines being

more profitable per transaction due to having lower odds.

• Online casinos will have additional revenue sources that are not available to land- based casinos. These could include advertising by third-parties offering other entertainment services; tie-ins with other types of businesses, such as airlines and hotels; and the interest on "float" from funds held in accounts which does not exist in the land-based worlds. These additional sources of funds could be used to offset some of the taxes paid by the casinos to the governments under a deposit tax.

V. Summary

A deposit tax is far simpler to administer for tax purposes and is more transparent and efficient than is a GGR tax applying to Internet Gambling operations due to three major factors:

First, Internet Gambling can take place involving persons from many states, making it difficult to allocate GGRs accurately to individual states, regardless of whether the GGR is based on the residence of the customer playing or is based on the location of the customer at the time of a game.

Second, in an intrastate operation, the ability to join inter-state compacts is enhanced or impaired by the licensing methods. A deposit tax model may make integration of systems faster, simpler and less expensive than a GGR model and therefore possible.

Third, Internet Gambling involves the creation of accounts, which do not exist in land-based gambling, and which have the result of deferring the recognition of what is GGR in any situation in which the customer chooses not to withdraw winnings (see earlier question re timing of calculation of GGR). This problem could seriously impact revenue collection by the federal government and the states in a system that is based on GGRs at the federal level. The same problems exist in an intrastate system in terms of the recognition of revenue.

These problems are avoided entirely through a system involving a Deposit Tax as an alternative to a federal/state GGR.

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