

**OVERVIEW OF FEDERAL TAX LAWS AND REPORTING  
REQUIREMENTS RELATING TO GAMBLING  
IN THE UNITED STATES**

Scheduled for a Public Hearing  
Before the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on May 19, 2010

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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JCX-28-10

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## INTRODUCTION AND SUMMARY

The House Committee on Ways and Means has scheduled a public hearing for May 19, 2010, on tax proposals related to legislation to legalize Internet gambling. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of Federal tax laws and reporting requirements related to gambling in the United States. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

The United States gambling industry generated more than \$92 billion in revenue in 2007. This includes commercial casinos operating in 12 States, casinos operating on Indian tribal lands in 28 States, State lotteries operating in 42 States, and racetrack casinos operating in 12 States.

Part I provides a general overview of legal gambling operations in the United States, State taxation of gambling, and Internet gambling. The legal gambling market includes revenues from commercial casinos, Indian tribal casinos, State lotteries, pari-mutuel wagering, and other types of gambling which are discussed in this part.

Part II summarizes the Federal income taxation of gambling. This part includes the individual taxation of gambling winnings, the special limitation on gambling losses, the tax implications related to domestic and foreign persons engaged in a gambling business, and considerations related to the taxation of Internet gambling operations.

Part III describes the various reporting and withholding obligations imposed on gambling operators, casinos, and individuals. Generally, gambling proceeds are subject to 25 percent withholding if the amount exceeds \$5,000 and is at least 300 times the amount wagered. In addition, proceeds from gambling are generally subject to information reporting if the amount exceeds \$600 and is at least 300 times the amount wagered. Additionally, special rules applicable to certain types of gambling proceeds are discussed in this part.

Part IV provides an overview of the existing wagering and occupational taxes that are applicable to wagering in the United States. The excise tax imposed is 0.25 percent of a wager authorized under State law, and two percent of any unauthorized wager.

Part V summarizes the Federal tax and regulatory treatment of gaming of Indian tribes and Indian tribe members.

Part VI summarizes legislation pending in the United States Congress to license, regulate and tax Internet gambling activities.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Overview of Federal Tax Laws and Reporting Requirements Relating to Gambling in the United States* (JCX-28-10), May 17, 2010. This document can be found on the Internet at [www.jct.gov](http://www.jct.gov),

## I. GENERAL OVERVIEW OF GAMBLING IN THE UNITED STATES

### A. Market Overview

The legality and economics of gambling in the United States have changed substantially in the last forty years. There is no Federal ban on gambling, but States may regulate or prohibit it. Prior to 1976, casino gambling was legal only in the State of Nevada, although 13 States sponsored lotteries. In 1976, by referendum vote, the State of New Jersey legalized gambling in Atlantic City. The Indian Gaming Regulatory Act of 1988<sup>2</sup> (“IGRA”) created a regulatory framework for legal gambling on Indian lands, leading to the growth of the Indian gaming industry in the late 1980s and 1990s. By 2008, 42 States sponsored lotteries.

Figure 1 shows the total legal U.S. gambling market generated \$92.2 billion in revenues<sup>3</sup> in 2007. Estimated revenues from illicit Internet gambling, are \$5.8 billion. As of 2008 there were casinos operating on Indian lands in 28 States<sup>4</sup> and every State except for Utah and Hawaii allowed some form of gambling. The development and proliferation of the Internet in the 1990s created another medium for gambling, for which rules have not been established. The nature of the Internet allows individuals to place bets from locations across the world, including places where gambling is not legal, through an organization in a location where gambling is legal. Increased market penetration of authorized casinos gambling through Indian tribes and gambling through the Internet has led many States to legalize some forms of gambling in certain locations including lotteries, casino gambling, racetrack wagering, and electronic gambling.

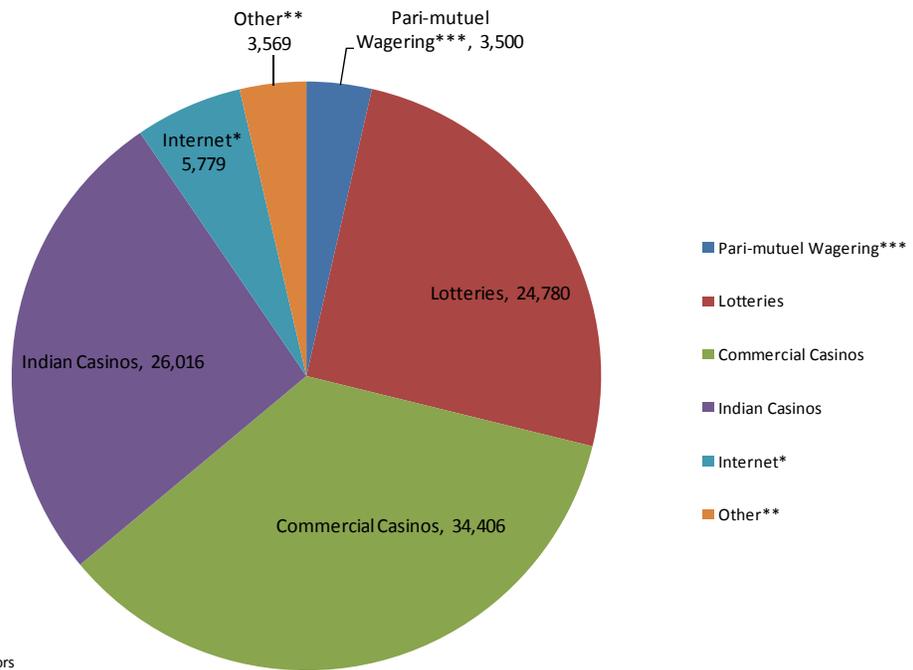
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<sup>2</sup> Pub. L. No. 100-497 and 25 U.S.C. secs. 2701-2721.

<sup>3</sup> Revenues equals wagers minus payouts.

<sup>4</sup> <http://www.nigc.gov/ReadingRoom/PressReleases/PressReleasesMain/PR113062009/tabid/918/Default.aspx> Accessed May 12, 2010.

**Figure 1.—U.S. Gambling Revenue in 2007**  
[Millions of Dollars]



Source: Christianson Capital Advisors

\* Internet estimate based on 2006 data

\*\* Other includes: Card Rooms, Legal Bookmaking, Charitable Games

\*\*\* Pari-mutuel wagering includes horse racing, dog racing and jai-alai

## B. Lotteries

Table 1 below shows the 42 States operating lotteries in 2008. Annual lottery ticket sales range from \$21 million in North Dakota to over \$13 billion in West Virginia. The states are ordered from lowest ticket sales at the top to highest ticket sales in the bottom.

**Table 1.—Ticket Sales in 2008**  
[Dollars in Millions]

<b>No State Lottery</b>	<b>Less than \$500</b>	<b>\$500-\$2,000</b>	<b>\$2,000 and over</b>
Alabama	North Dakota*	South Dakota*	Illinois
Alaska	Montana*	Kentucky*	Ohio
Hawaii	Vermont*	Indiana*	Rhode Island*
Mississippi	Nebraska*	South Carolina*	Michigan
Nevada	Idaho*	Missouri*	New Jersey
Utah	New Mexico*	Connecticut*	California
Wyoming	Oklahoma*	Tennessee*	Pennsylvania*
Arkansas*	Maine*	North Carolina*	Oregon*
	Kansas*	Virginia	Georgia
	Iowa*	Maryland	Texas
	New Hampshire*		Florida*
	Louisiana*		Massachusetts
	Minnesota*		New York
	Arizona*		Delaware*
	Wisconsin*		West Virginia*
	Colorado*		
	Washington		

\* Indicates state is a member of the Multi-State Lottery Association

Source: <http://www.census.gov/govs/state/08lottery.html>.

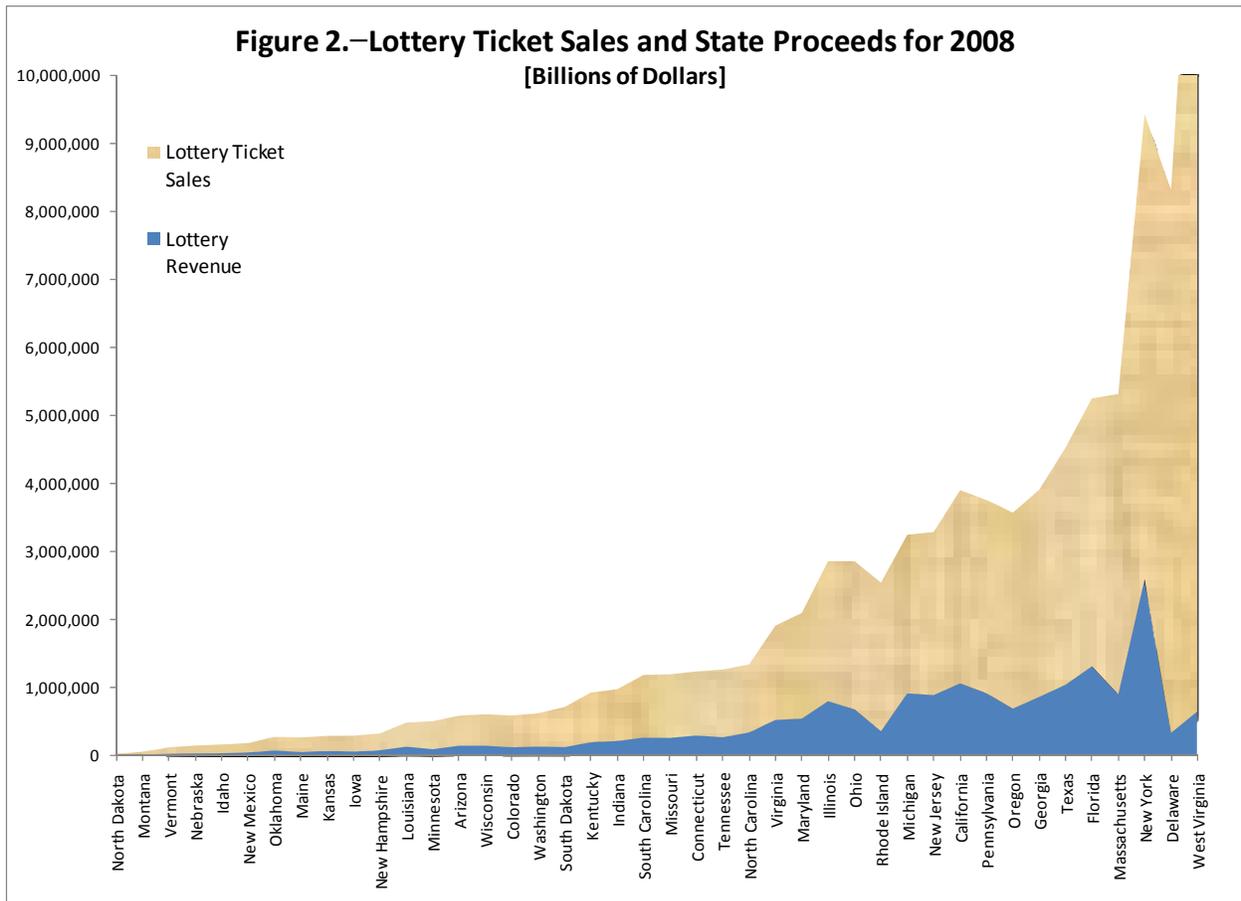
Figure 2 shows lottery ticket sales and proceeds from State lotteries by State and the wide variation in payouts, which range from 55 percent of ticket sales in North Dakota, Montana and Louisiana to 95 percent of ticket sales in Delaware and West Virginia. At the low end of the payout rate are States like Florida and New York with total ticket sales of \$3.9 and \$6.8 billion respectively and State proceeds of \$1.3 billion in Florida and \$2.6 billion in New York. At the high end of the payout rate scale are Delaware and West Virginia, whose ticket sales are \$8.0 billion and \$13.8 billion, respectively, but whose State proceeds are approximately \$300,000 and \$600,000, respectively, with the remainder being distributed as prizes.

One reason that West Virginia may have more ticket sales than any other State is because many of its racetracks have video lotteries which are very similar to traditional slot machines located in commercial casinos. In 2002, video lottery became available in bars and convenience stores throughout the State. In 2007, table games were added at Wheeling Island Hotel Casino Racetrack and at several other sites within West Virginia, all of which are operated by the West Virginia Lottery.

After payouts to players, the remainder goes towards administration costs and State and local funding including public education, property tax relief and infrastructure. Lotteries provide some sponsoring States with hundreds of millions of dollars in revenue each year. The extent of lottery gambling varies greatly by State.

Multi-State Lottery Association

Some States choose to participate in the Multi-State Lottery Association, which is a government benefit association of 31 member States plus the District of Columbia and the U.S. Virgin Islands. The Association offers multi jurisdictional games, including Powerball, Mega Millions, a video lottery and scratch-off games.



Source: <http://www.census.gov/states/08lottery.html>.

### C. Commercial Casinos

Commercial gaming is private sector gaming generally including casino table games such as blackjack, craps, roulette and variations on these games, as well as electronic gaming such as slot machines and video poker. Throughout the United States, commercial gaming may be available on riverboats, at dockside or on land-based facilities. Total commercial gaming revenues were \$34.4 billion in 2007, 37 percent of the legal gambling market of \$92 billion.<sup>5</sup> Table 2 shows that slot machines are the most popular casino game. Consistent with these results, revenues from slot machines comprised two thirds of the overall casino revenues in Nevada and Atlantic City in 2007.<sup>6</sup>

**Table 2.—Favorite Games in 2009**

Slot machines	62%
Blackjack	21%
Poker	7%
Craps	3%
Roulette	3%

Source: State of the States 2009; American Gaming Association.

#### State Taxation of Gambling

Gambling is regulated (or prohibited) by State and local mandates. Where gambling is legal, the basis for State taxation is generally, “gambling revenues,” defined as the difference between the amount wagered and the amount paid out. Only Maine taxes the total amount wagered. Twelve states permit commercial gambling from either land-based or riverboat casinos. As shown below in Table 3, in these 12 states, commercial gambling enterprises paid \$5.7 billion into State and local treasuries in 2008 through direct gaming taxes.

Table 3 shows that all 12 States with legal commercial casinos tax these establishments in one or more ways. Most states apply a tax on gaming revenue, many with a graduated rate. Maximum rates vary from 6.75 percent in Nevada to a maximum rate of 50 percent in Illinois.

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<sup>5</sup> Christianson Capital Advisors, Volume 6 Issue 10, The 2007 Annual Wager of the United States, Exhibit 2.

<sup>6</sup> Ibid.

Some States have other methods of taxation in addition to a gaming revenue tax: Illinois, Indiana and Missouri apply a casino admissions tax of \$2 or \$3 per person. South Dakota taxes gaming devices at \$2,000 per gaming machine.

**Table 3.–Commercial Casino Gaming and Tax Statistics  
by State 2008**

State	Operating Casinos	Gaming Revenue (millions)	Tax Revenue (millions)	Tax Rate
Colorado	40	716	88	Graduated rate: Maximum 20%
Illinois	9	1,569	567	Graduated rate: 15%-50%
Indiana	11	2,668	838	Graduated rate: 15%-40%
Iowa	14	1,420	324	Graduated rate: Maximum 22% riverboats, 24% racinos (over \$100 million Revenue)
Louisiana	14	2,584	626	Riverboat/Land based casinos 21.5%* Racinos 18.5%
Michigan	3	1,360	322	Permanent facilities: 19% temporary facilities: 24% (taxes divided between State and City)
Mississippi	29	2,721	327	Graduated tax of 8% on gaming revenues;
Missouri	12	1,682	443	21% on gaming revenue
Nevada	266	11,599	924	Graduated rate: Maximum 6.75%;
New Jersey	11	4,503	427	Flat tax of 8% on gaming revenues;
Pennsylvania	1	1,616	767	Flat tax of 34%;
South Dakota	35	102	15	Flat tax of 8%;
Total	445	32,540	5,668	

\* Riverboats pay 4-6% in local fees and casinos pay 21.5% or 60 million, whichever is greater.

Source: [http://www.americangaming.org/assets/files/uploads/aga\\_sos2009web\\_FINAL.pdf](http://www.americangaming.org/assets/files/uploads/aga_sos2009web_FINAL.pdf)

#### **D. Pari-Mutuel Wagering**

Pari-mutuel betting is a style of betting where the odds are determined by the amounts wagered for each possible outcome. In 2007, racetracks generated revenues of \$3.5 billion from pari-mutuel wagering, which includes horse racing, dog racing and jai alai. Racetrack casinos, or (“racinos”), are racetracks where, in addition to racing, some form of commercial casino gambling is also available. This commercial casino gambling may vary from video lottery gaming, where machines are run through the State lottery (such as in some West Virginia locations), to private casinos with either slot machines or both slot machines and table games. There were twelve States with racinos in operation in 2008: Delaware, Florida, Indiana, Iowa, Louisiana, Maine, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island and West Virginia. Total gaming industry revenues were \$5.28 billion on the casino portion of racinos in 2007.<sup>7</sup> Commercial gambling at racetracks, such as those in Indiana, Iowa, Louisiana and Pennsylvania, are included as commercial gambling revenue rather than as pari-mutuel wagering.

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<sup>7</sup> State Gaming Regulatory Agencies compiled by the American Gaming Association in the State of the States 2009.

## E. Tribal Casinos

Gaming provides significant revenues for many Indian tribes. In 2008, Indian gaming industry participants included more than 240 of the nation's 562 Indian tribes and produced approximately \$26.7 billion in revenues, generated at more than 400 casinos and bingo halls throughout 28 States.<sup>8</sup> Facilities with annual revenues of less than \$100 million constituted over 80 percent of the total operations, while fewer than 20 percent of the operations generated about 70 percent of the \$26.7 billion in revenues.<sup>9</sup>

These gaming activities generally are regulated under IGRA,<sup>10</sup> a Federal law which establishes a detailed regulatory, recordkeeping, and reporting regime for tribal gaming. Under IGRA, the National Indian Gaming Commission ("NIGC"), an independent regulatory body composed of three full-time members located within the Department of the Interior, has general oversight responsibility for Indian gaming. IGRA established three classes of gaming to be regulated. Class I games are traditional and social games played for no significant financial stakes and are regulated solely by the tribe.<sup>11</sup> Class II games consists of "the game of chance commonly known as bingo (whether or not electric, computer or other technologic aids are used in connection therewith) . . . including (if played in the same location) pull-tabs, lotto, punch boards, tip jars, instant bingo, and other games similar to bingo," and certain nonbanking card games.<sup>12</sup> These games are regulated by the tribes pursuant to tribal ordinances approved by NIGC.<sup>13</sup> Class III is a residual category, consisting of all games not included in classes I and II, such as casino games, slot machines, and lotteries.<sup>14</sup> These games may only be conducted pursuant to tribal-state compacts approved by the Secretary of the Interior. States are required to negotiate these compacts in good faith with tribes to avoid suit in Federal court or imposition of gaming procedures by the Secretary of Interior.<sup>15</sup>

Gaming is permitted on "all lands within the limits of any Indian reservation,"<sup>16</sup> and "any lands title to which is either held in trust by the United States for the benefit of any Indian tribe

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<sup>8</sup> Press Release, Nat'l Indian Gaming Comm'n, National Indian Gaming Commission Announces Indian Gaming Revenues for 2008 (June 3, 2009). <http://www.nigc.gov/ReadingRoom/PressReleases/PressReleasesMain/PR113062009/tabid/918/Default.aspx> Accessed May 12, 2010.

<sup>9</sup> Ibid.

<sup>10</sup> 25 U.S.C. sec. 2710, et. seq., Pub. L. No. 100-497 (Oct. 17, 1988).

<sup>11</sup> 25 U.S.C. sec. 2703(6).

<sup>12</sup> 25 U.S.C. sec. 2703(7).

<sup>13</sup> 25 U.S.C. sec. 2704.

<sup>14</sup> 25 U.S.C. sec. 2703(8). NIGC determines whether the games are classified as class II or class III.

<sup>15</sup> 25 U.S.C. sec. 2710(d)(3).

<sup>16</sup> 25 U.S.C. sec. 2703(4)(A); 25 C.F.R. sec. 502.12.

or individual or held by any Indian tribe or individual subject to the restriction by the United States against alienation and over which an Indian tribe exercises governmental power.”<sup>17</sup> IGRA limits the extent to which trust land acquired after its effective date can be used for gaming and provides for a significant role for the States in this decision.

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<sup>17</sup> 25 U.S.C. sec. 2703(4)(B).

## F. Internet Gambling

While the activity of gambling is primarily a State matter, operating an Internet gambling facility is illegal due to several Federal statutes relating to interstate commerce and telecommunications.<sup>18</sup> For example, the Wire Act<sup>19</sup> specifically outlaws the use of a “wire communication facility” to transmit bets or gambling related information.

Figure 1 shows that U.S. Internet gambling has been estimated at \$5.8 billion in 2007. However, estimates on the size of this market vary. For example, one recent study estimated that the legalization of Internet gambling in the largest 12 potential U.S. markets would generate \$65 billion in revenue for the operators during the first five years.<sup>20</sup>

Internet gambling corporations are commonly located on the Isle of Man, a British Protectorate with low tax rates,<sup>21</sup> or Gibraltar, a British Overseas Territory with an infrastructure conducive to operating multinational gambling operations. Gibraltar is home to Partygaming.com, with 2008 revenues of \$473 million,<sup>22</sup> as well as 19 other Internet gambling ventures as of September, 2008.<sup>23</sup>

### Internet Poker

The combination of an increase in Internet gaming and the growth of the poker market that began in 2003 has caused online poker to become the fastest growing segment of the Internet gaming market.<sup>24</sup> A 2004 report estimated Internet poker attracts an average of 1.8 million players per day, with 70 percent of these players coming from the United States. Internet poker revenues total \$2.4 billion per year as of 2005.<sup>25</sup> Although betting on poker is prohibited under Federal law, Internet poker providers are able to advertise within the United States under the auspices of providing poker educational websites.<sup>26</sup>

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<sup>18</sup> Charles Doyle, “Internet Gambling: Overview of Federal Criminal Law,” Congressional Research Service, November 27, 2006, 97-619.

<sup>19</sup> Pub. L. No. 87-216

<sup>20</sup> H2 Gambling Capital, “United States Internet Gambling: Job Creation - Executive Summary,” April 15, 2010.

<sup>21</sup> See <http://www.mega.im/page6.aspx>. Accessed May 11, 2010.

<sup>22</sup> See <http://www.egrmagazine.com/resources/260807/the-2009-egaming-review-power-50-top-10.shtml>. Accessed. May 11, 2010.

<sup>23</sup> See <http://www.gra.gi/index.php?article=135&topic=licences&section=licences&site=gambling> Accessed. May 11, 2010.

<sup>24</sup> Sharlene Goff and Matthew Garrahan, “PartyGaming looks set to be a winner,” *Financial Times*. June 27, 2005.

<sup>25</sup> See <http://www.newsweek.com/id/56438> (Going All In For Online Poker), August 15, 2005.

<sup>26</sup> Ibid.

## Unlawful Internet Gambling Enforcement Act (“UIGEA”)

The United States Department of Justice takes the position that all Internet wagering is prohibited if initiated in the United States.<sup>27</sup> Consistent with this position, the Unlawful Internet Gambling and Enforcement Act (“UIGEA”) was signed into law on October 13, 2006, as a part of the Safe Port Act of 2006 to improve enforcement.<sup>28</sup>

UIGEA grants authority to the Treasury Department and the Board of Governors of the Federal Reserve in consultation with the Department of Justice, and other agencies to prevent the movement of funds from originating U.S. gamblers to domestic or offshore Internet gambling operations. More specifically, regulations require payment systems to “identify and block or otherwise prevent or prohibit restricted transactions through the establishment of policies and procedures.”<sup>29</sup>

UIGEA prohibits the receipt of checks, credit card charges and electronic fund transfers by unlawful Internet gambling businesses.<sup>30</sup> However, following a flow of funds from the U.S. gambler to an Internet gambling operator and from the Internet gambling operator back to the U.S. gambler is complicated. The law and the subsequent regulations,<sup>31</sup> which are scheduled to take effect on June 1, 2010, require participants involved in card<sup>32</sup> and money transmission to block transactions with illegal gambling operations. This may include the requirement that these financial organizations know the nature of their clients’ business and have the ability to reverse illicit transactions.<sup>33</sup> Relevant financial institutions must determine the nature of any client’s business before establishing a relationship and must determine that the client has a minimal risk of engaging in an Internet gambling business (legal or illegal). Institutions responsible for meeting these requirements include those offering payment instruments including credit cards and wire transfers and money transmitting businesses such as Western Union and PayPal.

The statute targets “unlawful Internet gambling” and bets or wagers initiated where the Federal, State or tribal laws apply. The term “bet or wager” includes bets on sporting events, games of chance and lotteries; however, many events are excluded from the definition of bets or wagers in the statute including: securities transactions, over-the-counter derivatives, indemnity

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<sup>27</sup> Charles Doyle, “Internet Gambling: Overview of Federal Criminal Law,” Congressional Research Service, November 27, 2006, 97-619.

<sup>28</sup> Pub. L. 109-347.

<sup>29</sup> 31 U.S.C. sec. 5364 (a).

<sup>30</sup> Charles Doyle and Brian T. Yeh, “Unlawful Internet Gambling Enforcement Act (UIGEA) and Its Implementing Regulations,” Congressional Research Service, November 30, 2009.

<sup>31</sup> Fed. Reg. 69382, November 18, 2008.

<sup>32</sup> This includes credit cards, debit cards, prepaid cards or stored value “cards.”

<sup>33</sup> Charles Doyle and Brian T. Yeh, “Unlawful Internet Gambling Enforcement Act (UIGEA) and Its Implementing Regulations,” Congressional Research Service, November 30, 2009.

and insurance contracts, insured deposits, bets for free participation in further games, fantasy or simulation sports bets and others.<sup>34</sup> UIGEA does not make Internet gambling illegal, rather it is designed to provide a tool for enforcing Federal and State gambling laws as applied to the Internet.

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<sup>34</sup> 31 U.S.C. sec. 5362 (E).

## II. FEDERAL INCOME TAXATION OF GAMBLING

### A. Individual Income Tax and Gambling Winnings and Losses

#### In general

An income tax is imposed on individual citizens and residents of the United States.<sup>35</sup> The tax is based on an individual's taxable income. An individual computes his or her taxable income by reducing gross income by the sum of (i) the deductions allowable in computing adjusted gross income, (ii) the standard deduction (or itemized deductions, at the election of the taxpayer), and (iii) the deduction for personal exemptions. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her income tax liability. Lower rates apply to net capital gain and qualified dividend income. A taxpayer may also be subject to an alternative minimum tax. A taxpayer may reduce his or her income tax liability by certain tax credits.

#### Gross income

Gross income means "income from whatever source derived" other than certain items specifically excluded from gross income. Sources of gross income generally include, among other things, compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,<sup>36</sup> and trusts or estates.<sup>37</sup> Exclusions from gross income include death benefits payable under a life insurance contract, interest on certain tax-exempt State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

#### Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain allowable deductions from gross income. These deductions are known as "above-the-line" deductions. These deductions are generally the expenses incurred to produce gross income. For

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<sup>35</sup> Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

<sup>36</sup> In general, partnerships and S corporations are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of these entities is passed through and taxed to the partners or shareholders.

<sup>37</sup> In general, estates and trusts (other than grantor trusts) pay an individual income tax on the taxable income of the estate or trust. Items of income which are distributed or required to be distributed under governing law or under the terms of the governing instrument generally are included in the income of the beneficiary and not the estate or trust. These entities determine their tax liability using a special tax rate schedule and may be subject to the alternative minimum tax. Certain trusts are treated as being owned by grantors in whole or in part for tax purposes; in such cases, the grantors are taxed on the income of the trust.

example, these deductions include trade or business deductions (other than certain deductions for services performed as an employee), losses from the sale or exchange of property, deductions attributable to rents and royalties, contributions to pensions and other retirement plans, alimony payments, and moving expenses.

### **Taxable income**

In order to determine taxable income, a taxpayer reduces AGI by any personal exemption deductions and either the applicable standard deduction or the taxpayer's itemized deductions. Some miscellaneous itemized deductions are allowed as itemized deductions but may be subject to a two-percent of AGI limit. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2010, the amount deductible for each personal exemption is \$3,650. This amount is indexed annually for inflation. For 2010, the deduction for personal exemptions is not reduced or eliminated for taxpayers with incomes over certain thresholds. A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2010, the amount of the standard deduction is \$5,700 for single individuals and married individuals filing separate returns, \$8,400 for heads of households, and \$11,400 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.<sup>38</sup> The amounts of the basic standard deduction and the additional standard deduction are indexed annually for inflation.

### **Gambling winnings**

Gambling winnings (from both legal and illegal gambling) are included in gross income. Such gambling income includes winnings from lotteries, raffles, horse races and casinos. In addition to cash winnings, gross income also includes the fair market value of prizes such as cars and trips. Investment in interest-bearing high-risk debentures is not a gambling activity.<sup>39</sup>

In the case where gambling constitutes a trade or business of the taxpayer, gambling losses and gambling winnings are netted in calculating adjusted gross income. However, gambling losses are only allowed to offset gambling winnings.<sup>40</sup> A taxpayer cannot offset any net gambling loss against other income or to create a net operating loss. Whether an activity constitutes a trade or business for this purpose is determined by the facts and circumstances of the case.<sup>41</sup>

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<sup>38</sup> For 2010, the additional amount is \$1,100 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,400. If an individual is both blind and aged, the individual is entitled to two additional standard deductions, for a total additional amount (for 2010) of \$2,200 or \$2,800, as applicable.

<sup>39</sup> *Jasinski v. Commissioner*, T.C. Memo 1978-1.

<sup>40</sup> Sec. 165(d).

<sup>41</sup> *Commissioner v. Groetzinger*, 107 S. Ct. 980.

Otherwise gambling losses may be allowed as an itemized deduction. Any itemized deduction for gambling losses is not allowed in excess of gambling winnings.<sup>42</sup>

Gambling winnings may be subject to withholding as discussed below in part III. Also, taxpayers may be required to make estimated tax payments on gambling winnings.

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<sup>42</sup> Sec. 165(d).

## **B. U.S. Taxation of Business Income**

This section provides a brief overview of certain U.S. income tax rules relating to the taxation of business income. It also discusses certain potential U.S. income tax consequences from the conduct of an online gambling business.

### **1. U.S. tax rules applicable to business operations**

The United States employs a worldwide tax system under which U.S. persons (including U.S. citizens, U.S. resident individuals, and domestic corporations) generally are taxed on all income, whether derived in the United States or abroad. However, special rules apply that defer the U.S. taxation of certain income earned by a U.S. person from foreign operations that it conducts indirectly through a foreign corporation.

A U.S. person who earns income in a foreign country also may be taxed on that income by the foreign country. The United States generally cedes the primary right to tax the non-U.S. source income of a U.S. person to the foreign country in which the income is derived. This concession is effected by the allowance of a credit against the U.S. income tax imposed on foreign-source income for foreign taxes paid on that income. The amount of the credit for foreign income tax paid on foreign-source income generally is limited to the amount of U.S. tax otherwise owed on that income. Accordingly, if the amount of foreign tax paid on foreign-source income is less than the amount of U.S. tax owed on that income, a foreign tax credit generally is allowed in an amount not exceeding the amount of the foreign tax, and a residual U.S. tax liability remains.

In contrast to the taxation of U.S. persons, foreign persons (including nonresident alien individuals and foreign corporations) are taxed in the United States only on income that has a sufficient nexus to the United States.

Foreign persons are subject to U.S. tax on income that is effectively connected with the conduct of a trade or business in the United States without regard to whether the income is derived from U.S. or foreign sources. This income generally is taxed in the same manner and at the same rates as income of a U.S. person. In addition, foreign persons generally are subject to U.S. tax at a 30-percent rate on certain gross income (such as interest, dividends, rents, and royalties) derived from U.S. sources.

An income tax treaty between the United States and a foreign country may reduce or eliminate the 30-percent gross-basis withholding tax on certain payments. A tax treaty also may permit the United States to tax a foreign person's income from business operations only to the extent the income is attributable to that person's permanent establishment in the United States.

#### **U.S. persons—income from a foreign business**

The tax rules applicable to U.S. persons that control business operations in foreign countries depend on whether the business operations are conducted directly (through a foreign branch, for example) or indirectly (through a separate foreign corporation). A U.S. person that conducts foreign operations directly includes the income and losses from such operations on the person's U.S. tax return for the year the income is earned or the loss is incurred. Detailed rules

are provided for the translation into U.S. currency of amounts with respect to such foreign operations. The income from the U.S. person's foreign operations thus is subject to current U.S. tax. However, the foreign tax credit may reduce or eliminate the U.S. tax on such income.

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The repatriated income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time.

Notwithstanding that the U.S. tax on such income generally is deferred until repatriation, certain anti-deferral regimes may cause a U.S. person to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by certain foreign corporations, regardless of whether the income has been distributed as a dividend to the U.S. person. The Code sets forth two principal anti-deferral regimes: the controlled foreign corporation rules of subpart F<sup>43</sup> and the passive foreign investment company ("PFIC") rules.<sup>44</sup> Detailed rules for coordination among these anti-deferral regimes are provided to prevent a U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.<sup>45</sup>

Under the subpart F rules, the United States generally taxes any U.S. person who owns at least 10 percent of the stock (measured by vote only) of a controlled foreign corporation on that person's pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.<sup>46</sup> A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).<sup>47</sup>

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<sup>43</sup> Secs. 951-964.

<sup>44</sup> Secs. 1291-1298. A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income. Sec. 1297.

<sup>45</sup> The accumulated earnings tax rules are a third anti-deferral regime. Secs. 531-537. Under this regime, a tax, in addition to the corporate income tax, is imposed at the rate of 15 percent (39.6 percent for taxable years beginning after December 31, 2010) on the accumulated taxable income of a corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed. Secs. 531, 532(a). The accumulated earnings tax does not apply to any PFIC. Sec. 532(b). This exception, along with the current inclusion of subpart F income in the gross incomes of the U.S. 10-percent shareholders of a controlled foreign corporation, results in only a very limited application of the accumulated earnings tax to foreign corporations.

<sup>46</sup> Sec. 951(a).

<sup>47</sup> Secs. 951(b), 957, 958.

Subpart F income generally includes passive income and certain active income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,<sup>48</sup> insurance income,<sup>49</sup> and certain income relating to international boycotts and other violations of public policy.<sup>50</sup> Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, royalties, and annuities, and a number of categories of income from business operations, including foreign base company sales income,<sup>51</sup> foreign base company services income,<sup>52</sup> and foreign base company oil-related income.<sup>53</sup>

A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the U.S. person, repatriated as an actual dividend, or included in the U.S. person's income under one of the anti-deferral regimes.<sup>54</sup>

### **Foreign persons—income from a U.S. business**

The United States taxes on a net basis a foreign person's income that is effectively connected with the conduct of a trade or business in the United States.<sup>55</sup> Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.<sup>56</sup>

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as

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<sup>48</sup> Sec. 954.

<sup>49</sup> Sec. 953.

<sup>50</sup> Sec. 952(a)(3)-(5).

<sup>51</sup> Foreign base company sales income generally consists of sales income of a controlled foreign corporation located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person. Sec. 954(d).

<sup>52</sup> Foreign base company services income consists of income from services performed outside the controlled foreign corporation's country of incorporation for or on behalf of a related party. Sec. 954(e).

<sup>53</sup> Foreign base company oil-related income generally includes all oil-related income, other than income derived from a source within a foreign country in connection with either (1) oil or gas that was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas that is sold by the controlled foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for such vessel or aircraft. Sec. 954(g). An exception is available for any controlled foreign corporation that, together with related persons, does not constitute a large oil producer.

<sup>54</sup> Secs. 901, 902, 960, 1291(g), 1293(f).

<sup>55</sup> Secs. 871(b), 882.

<sup>56</sup> Secs. 871(b)(2), 882(a)(2).

engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.<sup>57</sup>

The Code expressly provides that the performance of personal services within the United States generally constitutes a trade or business within the United States.<sup>58</sup> More broadly, the question whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law.<sup>59</sup> Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person.

## 2. OECD commentary on electronic commerce

The OECD, of which the United States is an original member, has produced a Model Tax Convention on Income and on Capital. One article of the treaty, article 5, defines a permanent establishment (a “PE”), which is a concept used to determine the right of one treaty country to tax the profits of a resident of an enterprise of the other treaty country. To assist persons in understanding and applying the OECD model treaty, the OECD also publishes commentary on the model treaty. One issue specifically addressed in the OECD commentary on article 5 is the extent to which engaging in electronic commerce may result in a PE. The United States has not made any observations or reservations with respect to these aspects of the commentary.

In general, the OECD commentary states that a web site does not itself involve any tangible property, and thus cannot constitute a PE. In contrast, the server on which a web site is stored and through which it is accessible is a piece of equipment having a physical location, which may be fixed and thus constitute a PE. This distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. In fact, an enterprise carrying on a business through a web site will often do so on a server owned by an unrelated Internet service provider. A contract for such hosting services does not typically result in the server and its location being at the disposal of the enterprise carrying on a business through the web site. In such a case, the enterprise does not have any physical presence at the location where the server is located since the web site is not tangible and the server is not at the disposal of the enterprise. The commentary also notes that it would be very unusual for the Internet service provider to be deemed to constitute a PE of the enterprise carrying on a business through a web site hosted on the Internet service provider’s servers. Generally, the Internet service provider will lack authority to conclude contracts in the name of the enterprise

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<sup>57</sup> Secs. 875.

<sup>58</sup> Sec. 864(b).

<sup>59</sup> For example, in *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941), *aff’d*, 127 F.2d 260 (5th Cir. 1942), the court held that a Mexican radio station was not engaged in a U.S. trade or business, despite the fact that its broadcasting advertisements were directed principally toward U.S. audiences and paid for predominantly by U.S. advertisers.

conducting the web site business (and will not regularly conclude such contracts) and will constitute an independent agent acting in the ordinary course of its business.

The result may be different if the enterprise carrying on business through a web site has the server at its disposal because, for example, it owns (or leases) and operates the server. In such a case, the place where the server is located may constitute a PE.

### **3. Potential U.S. tax consequences for internet gambling operators**

Under present law, there are several reasons why an enterprise conducting online gambling operations may be foreign based, instead of U.S. based. Perhaps the most obvious reason for preferring a foreign location is that online gambling is generally illegal in the United States.<sup>60</sup> A foreign location may also result in more favorable tax consequences. Under the rules discussed above, a foreign enterprise conducting an online gambling operation may have little, or no, foreign tax liability if it is resident in a foreign jurisdiction that has a low, or zero, tax rate. In addition, the foreign enterprise may have little, or no, U.S. income tax liability, even if most, or all, of its customers are U.S. citizens or residents. It is unlikely that such an enterprise will be considered to have any effectively connected income so long as it does not have any employees, offices, or other assets in the United States. The web site accessed by its U.S. customers for the purpose of online gambling is likely stored on and accessed through a server owned by a third party. In contrast, if the enterprise were located in the United States, its worldwide income would be subject to U.S. tax (where the highest statutory individual and corporate rates are both 35 percent).

If online gambling were legalized in the United States, that would eliminate the concern noted above about locating an enterprise conducting such a business in a jurisdiction in which it is illegal. However, the potential tax advantages of locating the enterprise abroad would remain. Consequently, one might anticipate that even with the legalization of online gambling in the United States, most enterprises choosing to conduct such business would choose to locate outside the United States. This incentive is the same whether the ultimate owner of the online gambling operation is a U.S. or a foreign person. If the ultimate owner is a U.S. person, and thus subject to tax on its worldwide income, it may still benefit from the deferral rules of the Code. Delaying the U.S. taxation of that income may be valuable because a delay reduces the present value of the eventual tax liability. Deferral of tax for a long period can approximate tax exemption on a present value basis. Absent modification of the anti-deferral rules, a U.S. person may thereby achieve an outcome similar to the one achieved by a foreign person.

If an enterprise conducting an online gambling business was nevertheless resident in the United States (or engaged in a U.S. trade or business), the enterprise would be subject to U.S. tax on its worldwide income. However, even then, there may be significant deductions available in certain circumstances that would reduce the enterprise's U.S. tax liability. For example, if the U.S. enterprise is owned by a foreign person, that foreign person may also own valuable property rights (such as a brand name and computer software) essential to the success of the online

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<sup>60</sup> Other reasons for preferring a foreign location might include a more favorable regulatory environment or a more favorable legal system.

gambling business. If the U.S. enterprise uses those property rights in its U.S. operations, it may be required to pay a royalty to its foreign parent. Any such royalty would have to be set at arm's length under U.S. tax principles, and that rate may be quite high. In such a case, the U.S. enterprise may earn a relatively small profit, reflecting the low value added nature of its business. In addition, the United States may subject any royalty paid by the U.S. enterprise to a 30-percent withholding tax. However, that tax may be reduced, or eliminated, under a U.S. tax treaty. Other than the withholding tax, the foreign parent is unlikely to be subject to any further U.S. tax liability in this case.

### III. INFORMATION REPORTING AND WITHHOLDING REQUIREMENTS RELATED TO GAMBLING IN THE UNITED STATES

#### A. Reporting Obligations Imposed by the Internal Revenue Code

In addition to income tax consequences that they may incur, persons engaged in gambling activities are subject to a variety of reporting obligations. Gambling triggers responsibilities under the Internal Revenue Code for both the gaming establishments and the gambler, as explained below.

##### 1. Third-party information reporting and withholding requirements of the casino or gaming establishment

As a general rule, every person making payment of gambling winnings from a wagering transaction subject to withholding must withhold 25 percent of such payment.<sup>61</sup> If the winnings are payable to a nonresident alien individual or a foreign corporation, the extent to which the payment is subject to withholding is determined under the withholding regime generally applicable to foreigners.<sup>62</sup> Withholding applies to the entire amount of wagering proceeds, which are determined by reducing the amount received by the amount of the wager.<sup>63</sup> Proceeds which are not money are taken into account at fair market value.<sup>64</sup> Amounts paid with respect to identical wagers are treated as paid with respect to a single wager.<sup>65</sup>

Withholding obligations vary depending on the form of wager or game. In general, proceeds from a wagering transaction are subject to withholding if the amount of such proceeds exceeds \$5,000 and is at least 300 times the amount wagered.<sup>66</sup> This general rule also applies to wagering pools such as parimutuel pools with respect to horse races, dog races, or jai alai.<sup>67</sup> However, in the case of sweepstakes, wagering pools, or lotteries other than State-conducted lotteries withholding is required if the amount of such proceeds exceeds \$5,000, regardless of the amount of the wager.<sup>68</sup> A similar rule applies to all proceeds from a wager in a State-conducted lottery.<sup>69</sup> In the case of poker tournaments, in which the sponsor pays winnings out of a pool

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<sup>61</sup> Section 3402(q)(1) imposes the withholding requirement and sets the rate at the third lowest rate of tax applicable under Section 1(c). Under secs. 1(c) and 1(i), the third lowest rate is 25 percent.

<sup>62</sup> Sec. 3402(q)(2). This regime generally applicable to foreigners is under Section 1441(a) (relating to withholding on nonresident aliens) and sec. 1442(a) (relating to withholding on foreign corporations).

<sup>63</sup> Sec. 3402(q)(4)(A).

<sup>64</sup> Sec. 3402(q)(4)(B).

<sup>65</sup> Treas. Reg. sec. 31.3402(q)-1(c)(1)(ii).

<sup>66</sup> Sec. 3402(q)(3)(A).

<sup>67</sup> Sec. 3402(q)(3)(C)(ii).

<sup>68</sup> Sec. 3402(q)(3)(B).

<sup>69</sup> Sec. 3402(q)(3)(C)(i).

comprised of all participants' fees, the sponsor of the tournament is required to withhold on payments of winnings more than \$5,000, reduced by the amount of the entrance fee.<sup>70</sup> Finally, withholding is generally not required with respect to winnings from bingo, keno, or slot machines.<sup>71</sup>

The third-party information reporting applicable to gambling activities is closely related to the extent to which the payments are subject to withholding. If the payment of winnings is subject to withholding, the payor must file Form W-2G to report income and withholding of taxes from gambling winnings of the gambler.<sup>72</sup>

The general informational reporting requirements apply to gambling winnings that are not from bingo, keno, or slot machines and not subject to withholding. Under these requirements, every person engaged in a trade or business is required to file informational returns for each calendar year for payments of \$600 or more made in the course of the payer's trade or business.<sup>73</sup> Regulations narrow these requirements by providing that gambling winnings are reportable on Form W-2G only if the amount paid with respect to the wager is \$600 or more and the proceeds are at least 300 times the amount of the wager.<sup>74</sup>

These requirements do not apply to winnings from bingo, keno, and slot machines. Instead, Treasury Regulations describe special information reporting rules that apply for purposes of winnings from bingo, keno, and slot machines. Specifically, regulations provide that winnings (not reduced by the wager) of \$1,200 or more from bingo or slot machines, and winnings (reduced by the wager) of \$1,500 or more from keno, are subject to information reporting on Form W-2G, regardless of the odds of the wager.<sup>75</sup>

## **2. Reporting required of the person placing a wager**

Under the Code, a person receiving gambling winnings may be required to disclose the existence of accounts with gambling establishments, in addition to the requirement to include the winnings in gross income. The disclosure required is contemporaneous with filing of one's return. The recently enacted Hiring Incentives to Restore Employment ("HIRE") Act<sup>76</sup> added section 6038D, which requires disclosure of certain foreign financial assets and imposes penalties for failure to disclose such assets. An individual taxpayer with an interest in a

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<sup>70</sup> Rev. Proc. 2007-57.

<sup>71</sup> Sec. 3402(q)(5). Gambling winnings, including winnings from bingo, keno, and slot machines, are subject to backup withholding under certain circumstances. Sec. 3406.

<sup>72</sup> Treas. Reg. sec. 31.3402(q)-1(f).

<sup>73</sup> Sec. 6041(a).

<sup>74</sup> Treas. Reg. sec. 31.3406(g)-2(d)(3).

<sup>75</sup> Treas. Reg. sec. 7.6041-1(a), (b)(1), (b)(2).

<sup>76</sup> Pub. L. No. 111-147.

“specified foreign financial asset” during the taxable year is required to attach a disclosure statement to his or her income tax return for any year in which the aggregate value of all such assets is greater than \$50,000.

“Specified foreign financial assets” are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution, (1) stocks or securities issued by foreign persons, (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and (3) any interest in a foreign entity. Thus, an account at a foreign casino or gambling operator is likely to be a specified foreign financial asset. The statement must include identifying information for each asset and its maximum value during the taxable year. For an account, the name and address of the institution at which the account is maintained and the account number are required. For a stock or security, the name and address of the issuer, and any other information necessary to identify the stock or security and terms of its issuance must be provided. For all other instruments or contracts, or interests in foreign entities, the information necessary to identify the nature of the instrument, contract or interest must be provided, along with the names and addresses of all foreign issuers and counterparties. In addition, the provision permits the Secretary of the Treasury to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly.

Individuals who fail to make the required disclosures without reasonable cause are subject to a penalty of \$10,000 for the taxable year. Foreign law prohibitions against disclosure of the required information cannot be relied upon to establish reasonable cause. An additional penalty may apply if the Secretary of the Treasury notifies an individual by mail of the failure to disclose and the failure to disclose continues. If the failure continues beyond 90 days following the mailing, the penalty increases by \$10,000 for each 30 day period (or a fraction thereof), up to a maximum penalty of \$50,000 for one taxable period. To the extent the Secretary of the Treasury determines that the individual has an interest in one or more foreign financial assets but the individual does not provide enough information to enable the Secretary of the Treasury to determine the aggregate value thereof, the aggregate value of such identified foreign financial assets is presumed to have exceeded \$50,000 for purposes of assessing the penalty.

## **B. Applicability of Bank Secrecy Act to Gambling Activities**

The Bank Records and Foreign Transactions Act, now known as the Bank Secrecy Act,<sup>77</sup> requires U.S. financial institutions to maintain records and submit reports on certain cash or cash equivalent transactions. Since its enactment, in one of the first efforts to address law enforcement problems posed by the growing use of offshore accounts, the Bank Secrecy Act has expanded beyond its original focus on large currency transactions, while retaining its broad purpose of obtaining reports with “a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.” As the reporting regime has expanded,<sup>78</sup> it has imposed reporting obligations on both financial institutions and the account holders.

The Financial Crimes and Enforcement Network (“FinCEN”) is the agency within the Treasury Department responsible for patrolling the United States’ financial system. Its primary purpose is to fight money laundering and terrorist financing. Because casinos and gambling have been identified as a business sector that is vulnerable to exploitation for money laundering, their activities are subject to the monitoring of FinCEN.<sup>79</sup>

### **1. Casinos, card clubs and gambling establishments as financial institutions**

Entities within the definition financial institutions include money services businesses<sup>80</sup> casinos,<sup>81</sup> and card clubs.<sup>82</sup> Thus, most gambling establishments will be subject to the recordkeeping and reporting obligations identified in the statute.<sup>83</sup> As a financial institution, the

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<sup>77</sup> 31 U.S.C. secs. 5311-5314e, 5316-5332e; 12 U.S.C. secs. 1829b and 1951-1959e.

<sup>78</sup> E.g., Title III of the US PATRIOT Act, Pub. L. No. 107-56 (October 26, 2001), Sections 351 through 366, amended the Bank Secrecy Act as part of a sweeping series of reforms directed at international financing of terrorism.

<sup>79</sup> FinCEN periodically publishes “The SAR Activity Review: Trends Tips and Issues.” Issue 17, published May 2010 focuses on the casino and gaming industry, but also includes a summary of enforcement news. Together the articles provide an overview of the roles played by both FinCEN and IRS in administering BSA in the gaming industry.

<sup>80</sup> 31 C.F.R. sec 103.11(uu) defines money service businesses (“MSB”) as financial service providers in the following categories: (1) currency dealer or exchanger, (2) check casher, (3) issuer of traveler’s checks, money orders, or stored value, (4) seller or redeemer of traveler’s checks, money orders, or stored value, (5) money transmitter, and (6) the United States Postal Service.

<sup>81</sup> 31 U.S.C. sec. 5312(a)(2)(X) and 31 C.F.R. sec 103.11(n)(7)(i) defines casino as any casino or gaming establishment that has gross gaming revenue in excess of \$1 million in one year and is licensed as such under State or local law and Indian gaming operation conducted under the Indian Gaming Regulatory Act, other than one limited to class I gaming activities as defined in that statute.

<sup>82</sup> 31 C.F.R. sec. 103.11(n)(8)(i).

<sup>83</sup> For example, see FinCEN Ruling 2005-5, Definition of Money Services Business (Casinos as Money Services Businesses) issued July 6, 2005, in which FinCEN advised that although MSBs and casinos are defined separately and are subject to distinct sets of reporting obligations, a gaming establishment that is not within the regulatory definition of casino may be subject to the rules applicable to MSBs.

casino or gambling establishment is required to report currency transactions in excess of \$10,000,<sup>84</sup> cross-border transportation of currency or monetary instruments valued at more than \$10,000<sup>85</sup> and suspicious activity.<sup>86</sup> They are also required to maintain records, which may include information about who the ultimate owners are of accounts held at the gaming establishment.

Most financial institutions are required to comply with anti-money laundering laws which require adherence to certain know-your-customer due diligence rules and procedures. In general, however, anti-money laundering laws impose risk-based requirements for financial institutions to confirm the identity of their customers. Within the anti-money laundering framework, a financial institution develops customer identification and due diligence programs based on the financial institution's risk profile. The financial institution is expected to conduct risk assessments and develop controls designed to mediate or reduce the effect of identified risks associated with its operations. This can include an assessment of its business line risk (i.e., the inherent risk posed by the customer base, the products or services offered, the types of transactions, and the geographic footprint of the institution) and its customer risk (i.e., types of customers, types of accounts, customer segments). The specific risks identified with respect to the gambling industry are analyzed at length in a report issued by the Financial Action Task Force on Money Laundering in 2009 and in its risk-based guidance to casinos.<sup>87</sup> Although online gambling was outside the scope of that report, the authors concluded that similar vulnerabilities exist and recommended further study and information sharing to gain an understanding of the risks specific to that sector of the industry. They noted that a number of jurisdictions license physical casinos and online casinos under a similar process.<sup>88</sup>

## 2. Account holder reporting requirements

In the gaming industry, both gamblers and the gaming establishments may be subject to the reporting obligations imposed by the Bank Secrecy Act on account holders. The detailed

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<sup>84</sup> FinCEN Form 103 CTR-C is the currency transaction reporting form for casinos; FinCEN Form 8300 is the form on which receipt of cash over \$10,000 in the course of a trade or business is reported. The same form also serves as IRS Form 8300 for purposes of complying with reporting cash transactions under Code section 6050I.

<sup>85</sup> 31 U.S.C. sec. 5316; FinCEN Form 105 Report of International Transportation of Currency or Monetary Instruments.

<sup>86</sup> 31 C.F.R. 103.21 requires filing of a "FinCEN Suspicious Activity Report by Casino" ("FinCEN Form 102 SAR-C") if a casino suspects that the transaction involves illegal activity or if the transactions involves at least \$5,000, in aggregate, and is coupled with suspicious activity.

<sup>87</sup> Financial Action Task Force on Money Laundering, "Vulnerabilities of Casinos and Gaming Sector," (March 2009), [http://www.ustreas.gov/offices/enforcement/money\\_laundering.shtml](http://www.ustreas.gov/offices/enforcement/money_laundering.shtml), developed with the Asia Pacific Group on Money Laundering. ("FATF Report 2009") Another report providing risk-based advice for casinos by FATF and OECD was published in 2008, and is available at <http://www.fatf-gafi.org/dataoecd/5/61/41584370.pdf>. Finally, for a detailed discussion of U.S. anti-money laundering laws, see Protiviti Inc., *Guide to U.S. Anti-Money Laundering Requirements*, (2008, 3<sup>rd</sup> Ed.), available at <http://www.protiviti.com/en-US/Insights/Resource-Guides/Pages/Guide-to-US-AML-Requirements.aspx>.

<sup>88</sup> FATF Report 2009, paragraph 197.

requirements are set forth in regulations, as supplemented by other guidance such as the instructions to the “Report of Foreign Bank and Financial Accounts,” Treasury Department Form TD F 90-22.1, (“FBAR”).<sup>89</sup> To the extent that a person engaged in a U.S. business, a citizen, or a resident is engaging in foreign activity directly, and such activity necessitates the opening of a foreign bank account, such person may be required to file an annual FBAR. The report is required if the value in the foreign accounts in which the person has a financial interest exceeds \$10,000 at any time during the year. For example, a U.S. citizen who wires or otherwise deposits \$15,000 with poker.net, located in the Isle of Man, is subject to this reporting requirement, even if that person promptly loses money and the account never again has a value over \$10,000. An FBAR may also be required if the U.S. person holds a financial interest in a foreign account indirectly.<sup>90</sup> The financial interest sufficient to trigger the filing requirement includes signature authority (in which case the filer must identify the owner of the account). Failure to file the FBAR is subject to both criminal<sup>91</sup> and civil penalties.<sup>92</sup>

The FBARs are due by June 30 of the year following the year in which the \$10,000 threshold is met.<sup>93</sup> The FBAR is filed with the Treasury Department at the IRS Detroit Computing Center. Although the FBAR is received and processed by the IRS, it is neither part of the income tax return filed with the IRS nor filed in the same office as that return. Until 2003, the Financial Crimes and Enforcement Network (“FinCEN”), an agency of the Department of the Treasury, had responsibility for civil penalty enforcement of FBAR.<sup>94</sup> In 2003, the Secretary

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<sup>89</sup> 31 USC 5314(a) provides: Considering the need to avoid impeding or controlling the export or import of monetary instruments and the need to avoid burdening unreasonably a person making a transaction with a foreign financial agency, the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency. See the Instructions to Treasury Department Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts,” which is the form on which the annual report is filed.

<sup>90</sup> The definition of “financial interest” in the instructions specifically includes an account held by a corporation in which a U.S. person owned, directly or indirectly, more than 50 percent of the value “or the voting power” of the corporation, a partnership in which the U.S. person owns an interest, “either directly or indirectly,” in more than 50 percent of the profits “or capital of the partnership” and any beneficial interest in an account for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by a U.S. person and for which a trust protector, usually a foreign person, has been appointed. A trust protector is a third party responsible for monitoring the trustee’s activities with authority to replace the trustee under certain specified conditions. U.S. persons have sometimes used trust protectors in attempts to avoid FBAR requirements.

<sup>91</sup> 31 U.S.C. sec. 5322 provides that failure to file is punishable by a fine up to \$250,000 and imprisonment for five years, which may double if the violation occurs in conjunction with certain other violations.

<sup>92</sup> 31 U.S.C. sec. 5321(a)(5). The civil sanctions include a penalty of up to \$10,000 for failures to file that are not willful, and a penalty of the greater of \$100,000 or 50 percent of the balance in the account for willful failures.

<sup>93</sup> 31 C.F.R. sec. 103.27(c).

<sup>94</sup> However, the IRS had authority to investigate criminal violations of the Bank Secrecy Act, by delegation of authority under Treasury Directive 15-14 (December 1, 1992). If the IRS Criminal Investigation Division declined to pursue a possible criminal case, it would refer the matter to FinCEN for civil enforcement.

delegated civil enforcement to the IRS.<sup>95</sup> This change reflected the fact that a major purpose of the FBAR was to identify potential tax evasion, and therefore was not closely aligned with FinCEN's core mission.<sup>96</sup> The authority delegated to the IRS in 2003 included the authority to determine and enforce civil penalties,<sup>97</sup> as well as to revise the form and instructions.

Due to questions about the extent to which revisions to the instructions in 2008 had expanded the FBAR filing requirements with respect to non-U.S. persons, the treatment of commingled funds and the definitions of financial interest, non-U.S. persons are permitted to continue to rely on earlier guidance on filing requirements, pending publication of guidance on the scope of the statute.<sup>98</sup> In addition, the IRS granted administrative relief to persons with only signature authority over foreign financial accounts as well as signatories or owners of a financial interest in a foreign commingled fund.<sup>99</sup>

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<sup>95</sup> 31 C.F.R. sec. 103.56(g). Memorandum of Agreement and Delegation of Authority for Enforcement of FBAR Requirements (April 2, 2003); News Release, Internal Revenue Service, IR-2003-48 (April 10, 2003).

<sup>96</sup> Secretary of the Treasury, "A Report to Congress in Accordance with sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)" (April 24, 2003).

<sup>97</sup> A penalty may be assessed before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed. 31 U.S.C. sec. 5321(b)(1). A civil action for collection may be commenced within two years of the later of the date of assessment and the date a judgment becomes final in any a related criminal action. 31 U.S.C. sec. 5321(b)(2).

<sup>98</sup> Announcement 2009-51, 2009-25 I.R.B. 1105 (June 5, 2009). On February 26, 2010, the IRS announced that non-U.S. persons may continue to rely on the instructions as in effect prior to the 2008 revision. (Ann. 2010-16, I.R.B. 2010-11). Proposed regulations, including newly revised instructions for the FBAR, were published in the Federal Register on February 26, 2010. Fed. R. Vol. 75, No. 38. 31 C.F.R. Part 103. The proposed regulations provide new definitions of United States person, specify the types of interest that may constitute a foreign financial interest, provide special rules for persons with multiple accounts, and create an anti-avoidance rule to prevent use of an entity created for the purpose of evading the reporting requirements.

<sup>99</sup> On August 7, 2009, Notice 2009-62, 2009-35 I.R.B. extended the due date for filing an FBAR for 2008 and earlier years to June 31, 2010. In that Notice, the IRS specifically requested comments concerning when a person having only signature authority or having an interest in a commingled fund should be relieved of filing an FBAR; the circumstances under which the FBAR filing exceptions for officers and employees of banks and some publicly traded domestic corporations should be expanded; when an interest in a foreign entity should be subject to FBAR reporting; and whether the passive asset and passive income thresholds are appropriate and should apply conjunctively. On February 26, 2010, the IRS extended the suspended filing date to June 10, 2011 for calendar years 2009 for those with signatory authority only (Notice 2010-23, I.R.B. 2010-11).

## IV. EXCISE TAXES ON GAMBLING ACTIVITIES IN THE UNITED STATES

### **In general**

An excise tax of 0.25 percent is imposed on any wager authorized under the law of the State in which the wager is accepted and a tax of two percent of any wager that is not so authorized.<sup>100</sup> Each person who is engaged in the business of accepting wagers is liable for the tax on all wagers placed with such person. Each person who conducts any wagering pool or lottery is liable for the tax on all wagers placed in such pool or lottery. Certain wagering activities conducted by States (sweepstakes, wagering pools, or lotteries) are exempt from these excise taxes.<sup>101</sup> Wagers placed in a coin-operated device, such as slot machines and electronic pull-tabs, and certain wagers placed with State-licensed pari-mutuel wagering enterprises also are exempt from the wagering tax.<sup>102</sup>

An occupational tax of \$50 per year (\$500 in the case of persons accepting wagers not authorized by the law of the State in which the wager is accepted) is imposed on each person liable for the wagering tax and on each person who is engaged in receiving wagers for or on behalf of a person liable to pay the wagering tax.<sup>103</sup> In general, where multiple persons do business in co-partnership at any one place, only one occupational tax must be paid.<sup>104</sup>

Each person required to pay the occupational tax must register with the IRS. The registration must include: (1) the person's name and place of residence; (2) if such person is liable for the wagering excise tax, each place of business where the activity which makes him so liable is carried on, and the name and place of residence of each person who accepts wagers for such person or on his behalf; and (3) if he is engaged in accepting wagers for or on behalf of any person liable for the wagering excise tax, the name and place of residency of each such person.<sup>105</sup> The Secretary of the Treasury is authorized to require, by regulation, supplemental information from persons required to register as may be needed to enforce the wagering provisions. Pursuant to Treasury regulations, a supplemental registration must be filed if any one of the following occurs: (1) the taxpayer changes either the business or home address; (2) the business of a deceased person who had paid the occupational tax is continued by the surviving spouse or child, executor, administrator, or other legal representative; (3) the business is continued by a receiver or trustee in bankruptcy; (4) the business is continued by an assignee for creditors; (5) one or more members withdraws from the firm or partnership; or (6) the corporate name is changed.<sup>106</sup>

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<sup>100</sup> Sec. 4401.

<sup>101</sup> Sec. 4402(3).

<sup>102</sup> Sec. 4402(1) and (2).

<sup>103</sup> Sec. 4411.

<sup>104</sup> Sec. 4902.

<sup>105</sup> Sec. 4412.

<sup>106</sup> Treas. Reg. sec. 44.4412-1(b)(2) and (b)(3); and Treas. Reg. secs. 44.4905-1 (relating to change of ownership) and 44.4905-2 (relating to change of address).

A supplemental registration also must be filed each time an additional employee or agent is engaged to receive wagers.

In the event of a failure to register by a person required to pay the occupational tax, a penalty of \$50 is imposed.<sup>107</sup> Any person who is liable for the occupational tax but does not pay such tax will, in addition to being liable for such tax, be fined not less than \$1,000 and not more than \$5,000.<sup>108</sup>

### **Definition of wager**

A wager is defined as any (1) wager with respect to a sports event or contest placed with a person engaged in the business of accepting such wagers, (2) a wager placed in a wagering pool with respect to a sports event or contest, if such pool is conducted for profit, and (3) any wager placed in a lottery conducted for profit.<sup>109</sup>

A wagering pool conducted for profit includes any scheme or method for the distribution of prizes to one or more bettors based on the outcome of a sports event or contest, or on a combination of such events or contests.<sup>110</sup> The term sports event includes amateur, scholastic, and professional events, horse racing, auto racing, dog racing, boxing, wrestling, baseball, football, basketball, tennis, golf, track meets, and all other types. A contest is any type involving speed, skill, endurance, popularity, politics, strength, appearances, and all other types.

The term lottery includes numbers games, policy games, and similar types of wagering.<sup>111</sup> The term lottery generally does not include any drawing conducted by a tax exempt organization. Any scheme or method for the distribution of prizes among persons that have paid for a chance to win is a lottery subject to the wagering tax if it is conducted for profit.<sup>112</sup> The term lottery includes types of wagering where the player pays to select a number, or combination of numbers, in which the operator of the lottery agrees to pay a prize or fixed sum of money if the selected number or combination of numbers appear. The operation of a punch board for profit is also considered the operation of a lottery. Pull-tabs, raffles, and tip jar games generally are considered lotteries subject to the excise tax.<sup>113</sup> Pull-tab games involve pulling tabs off the front of the game to determine if they match numbers or symbols on the back, similar to instant scratch-off games in State lotteries.

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<sup>107</sup> Sec. 7272(a).

<sup>108</sup> Sec. 7262.

<sup>109</sup> Sec. 4421(1).

<sup>110</sup> Treas. Reg. sec. 44.4421-1(c).

<sup>111</sup> Sec. 4421(2).

<sup>112</sup> Treas. Reg. sec. 44.4421-1(b).

<sup>113</sup> Rev. Rul. 57-258, 1957-1 C.B. 418.

The term lottery excludes any game of a type where usually (1) the wagers are placed, (2) the winners are determined, and (3) the distribution of prizes or other property is made in the presence of all persons placing wagers in such game. Games such as bingo or keno are not lotteries since such games are usually conducted in a manner where wagers are placed, winners are determined, and the prizes are distributed in the presence of the persons participating in the game. Similarly, card games, dice games, or games involving wheels of chance (such as roulette and carnival wheels) are also generally conducted in such manner and are, therefore, not subject to the wagering excise tax.

### **Territorial extent**

The excise tax imposed by section 4401 applies to wagers (1) accepted in the United States, or (2) placed by a person who is in the United States (a) with a person who is a citizen or resident of the United States, or (b) in a wagering pool or lottery conducted by a person who is a citizen or resident of the United States. All wagers made within the United States are taxable irrespective of the citizenship or place of residence of the parties to the wager. Thus, the tax applies to wagers placed within the United States, even though the person for whom, or on whose behalf, the wagers are received is located in a foreign country and is not a citizen or resident of the United States. Likewise, a wager accepted outside the United States by a citizen or resident of the United States is taxable if the person making such wager is within the United States at the time the wager is made.<sup>114</sup> A wager accepted outside the United States by a non-citizen or nonresident of the United States is not taxable regardless of the location of the person placing the wager.

### **Disclosure of wagering tax information**

There are strict limits on disclosure of returns, payments, registrations, and related records prepared in compliance with the wagering and occupational provisions.<sup>115</sup> Disclosure of such information may only be made in connection with the administration or civil or criminal enforcement of the wagering and occupational tax provisions. Prior to the enactment of these non-disclosure rules, the U.S. Supreme Court held that proper assertion of the constitutional privilege against self-incrimination was a complete defense to the prosecution for failure to pay the excise and occupational taxes on wagers since wagering activities were at that time, and still are, widely prohibited by Federal and State law and tax information was readily available to prosecuting law enforcement officers.<sup>116</sup> The strict rules on disclosure were intended to remove any constitutional problems with enforcement of the wagering taxes.

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<sup>114</sup> Sec. 4404. Treas. Reg. sec. 44.4404-1.

<sup>115</sup> Secs. 4424, 6103(o)(2).

<sup>116</sup> For example, see *Marchetti v. U.S.*, 390 U.S. 39 (1968) and *Grosso v. U.S.*, 390 U.S. 62 (1968).

## V. FEDERAL TAX AND REGULATORY TREATMENT OF GAMING OF INDIAN TRIBES AND INDIAN TRIBE MEMBERS

This part provides a brief overview of the federal tax and regulatory rules applicable to Indian tribal gaming.

### A. Taxation of Income from Gaming Operations and Federal Regulatory Treatment of Indian Tribes

Federally recognized Indian tribes and wholly owned tribal corporations chartered under Federal law or the Oklahoma Indian Welfare Act generally are not subject to Federal income tax, regardless of whether the activities that produced the income are commercial or noncommercial in nature or are conducted on or off the reservation.<sup>117</sup> The Code does not provide a specific exemption from income tax for tribes and chartered tribal corporations but the IRS has concluded that these entities are not subject to Federal income tax in various rulings.<sup>118</sup> Therefore, gaming income of such tribes or tribal corporations generally is not taxable.<sup>119</sup>

IGRA provides that the net revenues from any tribal gaming are not to be used for purposes other than to: (1) fund tribal government operations or programs; (2) provide for the general welfare of the Indian tribe and its members; (3) promote tribal economic development;

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<sup>117</sup> Some groups claiming tribal status are not recognized. See Internal Revenue Service Office of Indian Tribal Governments, FAQs Regarding Status of Tribes (Taxable vs. Nontaxable vs. Not Subject to Tax), <http://www.irs.gov/govt/tribes/article/0,,id=102543,00.html> (last visited May 14, 2010).

<sup>118</sup> See Rev. Rul. 67-284, 1967-2 C.B. 55 (Indian tribes are not taxable entities); Rev. Rul. 81-295, 1981-2 C.B. 15 (federally chartered Indian tribal corporation has the same tax status as the tribe and is not taxable); Rev. Rul. 94-16, 1994-1 C.B. 19 (neither an unincorporated Indian tribe nor a corporation organized under section 17 of the Indian Reorganization Act of 1934 is subject to federal income tax on its income, regardless of the location of the activities that generate the income; however a tribal corporation incorporated under State law is subject to federal income tax regardless of the location of the activities that generate the income); and Rev. Rul. 94-65, 1994-2 C.B. 14 (extending Rev. Rul. 94-16, 1994-1 C.B. 19 to Oklahoma tribal corporations organized under the Oklahoma Indian Welfare Act).

<sup>119</sup> Some commentators have suggested that Congress authorize Federal taxation of income from Indian gaming, which bears little relationship to tribal values and which competes with taxable gaming enterprises. See Erik M. Jensen, *Taxation and Doing Business in Indian Country*, 60 Me. L. Rev. 1, 42 (2008) (citing Stephanie Dean, Getting a Piece of the Action: *Should the Federal Government Be Able to Tax Native American Gambling Revenue?*, 32 Colum. J. L. & Soc. Probs. 157, 178-85 (1999)). Moreover, commentators generally have concluded that under the “so-called Indian Commerce Clause [article I, section 8 of the Constitution] and Supreme Court cases, there is little constitutional limitation on the ability of the Federal government to tax Indian tribes or tribal members.” Ellen P. Aprill, *Tribal Bonds: Indian Sovereignty and the Tax Legislative Process*, 46 Administrative Law Review 333, 334 (1994). However, others commentators have noted that insofar as tribal income is treated analogously to income of States, there is no greater justification for imposing Federal taxes on tribal gaming than on State lotteries. See Felix S. Cohen, *Handbook of Federal Indian Law* (Nell Jessup Newton ed., 2005) (citing Scott A. Taylor, *An Introduction and Overview of Taxation and Indian Gaming*, 29 Ariz. St. L.J. 251, 253 (1997)).

(4) donate to charitable organizations; or (5) help fund operations of local government agencies.<sup>120</sup>

IGRA also provides that net revenues from gaming may be used to make per capita payments to members of the Indian tribe, if the tribe has prepared a revenue allocation plan (approved by the Secretary of Interior) to allocate revenues to uses authorized by IGRA.<sup>121</sup> Indian tribe members are subject to Federal income tax upon receipt of per capita distributions of gaming proceeds.<sup>122</sup> In addition, IGRA explicitly subjects the receipt of such distributions to Federal income tax and requires that tribes notify their members of the tax liability when payments are made.<sup>123</sup> Such distributions also are subject to special withholding and reporting requirements.<sup>124</sup>

Individual Indian tribe members are American citizens and are generally subject to Federal income taxes with significant exceptions which are not applicable here.<sup>125</sup> As under the general income tax rules described in part II.A. above, gambling winnings are includible in an Indian tribe member's gross income and a tribe member may deduct gambling losses from wagering transactions, but only to the extent of the winnings.<sup>126</sup> The Indian tribe member is also

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<sup>120</sup> 25 U.S.C. sec. 2710(b)(2).

<sup>121</sup> 25 U.S.C. sec. 2710(b)(3). IGRA also requires that the interests of minors and other legally incompetent persons entitled to receive any of the payments be protected and preserved.

<sup>122</sup> See Brian Hallenbeck, "Tribal Stipends under Scrutiny," *The Day*, <http://www.theday.com/article/20091025/NWS01/310259936/1018> (the Mohegan Sun Tribe's plan provides for 40 to 50 percent of the tribe's net gaming revenues to be distributed to the tribe's 800 adult members on a quarterly basis and reportedly the payments are about \$28,000 per year; the Mashantucket Pequot Tribe's plan provides for 30 percent of the net gaming revenues generated by Foxwoods Resort Casino to be distributed to tribal adults monthly in amounts that vary based on age "to help advance their personal health, safety, and welfare" and reportedly the payments are between \$90,000 and \$120,000 per year).

<sup>123</sup> 25 U.S.C. sec. 2710(b)(3)(D). Indian tribe members are also subject to income taxation, withholding and reporting rules on their individual gambling winnings.

<sup>124</sup> Sec. 3402(r). Every person, including an Indian tribe, making a payment to a member of an Indian tribe from the net revenues from class II or class III gaming activity must withhold income taxes from the payment. Tribal governments must report the total amount of taxable per capita payments made to each tribal member on IRS Form 1099-MISC. Also, Tribal governments are to report any federal income tax withheld on per capita payments on Form 945, and make any necessary federal tax deposits.

<sup>125</sup> See *Choteau v. Burnet*, 283 U.S. 691, 696 (1931) (Internal Revenue Act applied to Indians); *United States v. Brown*, 824 F. Supp. 124 (S.D. Ohio 1993) (in absence of treaty or statutory tax exemption, federal income taxes apply to Indians); *Squire v. Capoeman*, 351 U.S. 1 (reiterated that one's status as an Indian did not warrant exemption from the Federal income tax but held that Federal law prohibited the taxation of income or capital gains derived directly from allotted land while it remains in trust). Some income is not subject to Federal income tax such as income derived from restricted trust allotments (as in *Capoeman*) and income derived from specific treaty or statutory rights, such as fishing rights (as per section 7873 of the Code).

<sup>126</sup> Sec. 165(d).

subject to the withholding and information reporting requirements applicable to all individuals discussed in part III above.<sup>127</sup>

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<sup>127</sup> For additional information on the Federal tax treatment of Indian tribe members and Indian tribes, see Joint Committee on Taxation, *Overview of Federal Tax Provisions Relating to Native American Tribes and Their Members* (JCX-61-08), July 18, 2008. This document can be found on the Internet at [www.jct.gov](http://www.jct.gov).

## B. Applicability of Excise Taxes on Wagering to Indian Tribes

Although Federally recognized tribes and wholly owned tribal corporations chartered under Federal law are exempt from income taxation, they are subject to Federal excise taxes on wagering. The Code provides that for some excise taxes, including taxes on special fuels, manufacturers' excise taxes, the communications excise tax, and highway vehicle use taxes, tribal governments are treated as States.<sup>128</sup> In these cases, tribes should generally be exempt from the taxes if engaged in the exercise of "an essential government function."<sup>129</sup> However, the wagering excise taxes are not included in this list and the Supreme Court has ruled that tribes are subject to these taxes even though States are exempt.<sup>130</sup>

The Federal wagering excise and occupational taxes, as discussed in part IV above, apply to wagering activities of gaming establishments owned by Indian tribes. In some cases, Indian tribes and other entities may accept wagers that are not authorized under the law of the State in which the wagers are accepted. In these cases, the higher two percent excise tax on wagers and \$500 occupational tax apply.

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<sup>128</sup> Sec. 7871(a)(2).

<sup>129</sup> Sec. 7871(b).

<sup>130</sup> *Chickasaw Nation v. United States*, 534 U.S. 84 (2001) (holding that the Indian Gambling Regulatory Act does not exempt tribal governments from Federal excise taxes on wagering in the same manner as States).

## VI. BILLS INTRODUCED IN THE 111<sup>TH</sup> CONGRESS TO LICENSE, REGULATE, AND TAX INTERNET GAMBLING ACTIVITIES

Several bills have been introduced in the 111<sup>th</sup> Congress proposing to regulate and impose new excise taxes on Internet gambling activities. These bills include H.R. 2267, the Internet Gambling Regulation, Consumer Protection, and Enforcement Act, introduced by Mr. Frank; H.R. 2268, the Internet Gambling Regulation and Tax Enforcement Act of 2009, introduced by Mr. McDermott; H.R. 4976, the Internet Gambling Regulation and Tax Enforcement Act of 2010, introduced by Mr. McDermott; and S. 1597, the Internet Poker and Game of Skill Regulation, Consumer Protection, and Enforcement Act of 2009, introduced by Mr. Menendez.<sup>131</sup>

### A. Regulation and Licensing of Gambling Activities

#### H.R. 2267, the Internet Gambling Regulation, Consumer Protection, and Enforcement Act, introduced by Mr. Frank

H.R. 2267 grants the Secretary of the Treasury regulatory and enforcement jurisdiction over the Internet gambling licensing regime established by the bill. It prescribes administrative and licensing requirements for the operation of Internet gambling facilities, and prohibits any unlicensed person from knowingly accepting bets or wagers from persons located in the United States.

The bill establishes standards for licensing applicants and requires licensees to ensure appropriate safeguards to: (1) ensure that individuals placing bets are of legal age and physically located in a jurisdiction that permits Internet gambling; (2) ensure that all taxes from persons engaged in Internet gambling are collected at the time of any payment of proceeds from Internet gambling; (3) ensure that all taxes from any licensee are collected and disbursed as required by law; (4) combat fraud, money laundering, and terrorist finance; (5) combat compulsive Internet gambling; (6) ensure assessments are paid to the Secretary of the Treasury; and (7) comply with other requirements as the Secretary of the Treasury may establish.

The bill requires the Secretary of the Treasury and any qualified State or tribal regulatory body to develop a problem gambling, responsible gambling, and self-exclusion program. It prohibits disbursement of funds or recovery of losses that arise as a result of prohibited gambling activity, and shields financial transaction providers from liability for engaging in financial activities and transactions if such activities are in compliance with Federal and State laws. The bill permits States and tribal authorities to opt-out of Internet gambling activities within their respective jurisdictions.

The bill uses the definitions of bet or wager as such terms are defined in section 5362 of chapter 53 of title 31 of the United States Code. Under this section a bet or wager is defined as the staking or risking by a person of something of value dependent upon the outcome of a contest

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<sup>131</sup> S. 3018, the Bipartisan Tax Fairness and Simplification Act of 2010, also includes provisions regulating and taxing internet gambling. These provisions are similar to the provisions in H.R. 2267 and H.R. 2268.

of others, a sporting event, or a game subject to chance. It includes the purchase of a chance or opportunity to win a lottery or other prize, and does not exclude transactions such as those governed by the securities laws, the Commodity Exchange Act, over-the-counter derivative instruments, insurance contracts, and others.

S. 1597, the Internet Poker and Game of Skill Regulation, Consumer Protection, and Enforcement Act of 2009, introduced by Mr. Menendez

S. 1597 imposes regulatory and licensing requirements administered by the Secretary of the Treasury similar to those imposed under H.R. 2267. However, S. 1597 does not apply broadly to any Internet gambling facility, rather it applies only to an Internet game-of-skill facility, which is defined as an Internet site through which a bet or wager is initiated, received, or otherwise made with respect to an Internet game of skill. An Internet game of skill is an Internet-based game in which success is predominantly determined by the skill of the players, including poker, chess, bridge, mah-jong, and backgammon.

The bill establishes standards similar to those under H.R. 2267 for licensees to maintain appropriate mechanisms and safeguards for ensuring compliance with the bill, but the age requirement for individuals placing bets or wagers is set at 21 years of age.

The bill also requires the Secretary of the Treasury and any State or tribal regulatory body to develop a compulsive gaming, responsible gaming, and self-exclusion program. The bill prohibits disbursement of funds or recovery of losses that arise as a result of prohibited gambling activity, and shields financial transaction providers from liability for engaging in financial activities or transactions in connection with activities permitted under the bill and the Interstate Horseracing Act of 1978, unless the provider knows or has reason to know such activities violate Federal or State law. The bill permits States and tribal authorities to opt-out of Internet gaming activities, and prohibits wagers on games of chance and sporting events.

## **B. Taxation of Internet Gambling Activities**

### H.R. 2268, the Internet Gambling Regulation and Tax Enforcement Act of 2009, introduced by Mr. McDermott

H.R. 2268 is a companion bill to H.R. 2267 and imposes an Internet gambling license fee on Internet gambling operators licensed under the provisions of that bill. The fee is payable at the end of each calendar month and is equal to two percent of all funds deposited by customers during the preceding month. Deposits made by the licensee of Internet gambling winnings or returns of funds to the account of a customer are not treated as deposits for purposes of the license fee. The fee is imposed on the licensed Internet gambling operator and may not be deducted from the amounts available as deposits to the person placing the bet. A 50-percent fee is imposed on any person making a deposit for the purpose of placing a bet or wager with any non-licensed operator.

A licensed Internet gambling operator would also be required to furnish a report to the Secretary and to each person placing a bet or wager with the following information: (1) name, address, and taxpayer identification number of the licensee; (2) the name, address, and taxpayer identification number of each person placing a bet or wager with the licensee; (3) the gross winnings, gross wagers, and gross losses for the calendar year for each person placing a bet or wager; (4) the net Internet gambling winnings (defined as gross winnings over the amounts wagered) for each such person for the calendar year; (5) the amount of tax withheld with respect to each such person for the calendar year; (6) beginning and end-of-year account balances for each such person for the calendar year; and (7) amounts deposited and withdrawn by each such person during the calendar year.

Net Internet gambling winnings would be subject to the backup withholding provisions. Additionally a 30-percent withholding tax will apply to payments of gross winnings from wagers placed by foreign persons placing wagers with licensees.

The bill expands the territorial extent of the present law wagering tax to include wagers placed within the United States or any Commonwealth, territory, or possession of the United States by a United States citizen or resident.

### H.R. 4976, the Internet Gambling Regulation and Tax Enforcement Act of 2010, introduced by Mr. McDermott

H.R. 4976 is an updated version of H.R. 2268 and imposes an Internet gambling license fee of two percent of deposited funds similar to the fee imposed under H.R. 2268. In addition, a fee is imposed and paid to each qualified State and each qualified Indian tribal government equal to the monthly pro rata State and Indian tribal government online gambling fee amount. This amount is equal to six percent of all deposited funds deposited by customers residing in each State or area subject to the jurisdiction of an Indian tribal government. A qualified State or Indian tribal government is one that has not elected to be excluded from the receipt of funds under this bill. If a State or Indian tribal government receives funds under this bill, licensees will not have an obligation to pay any other fee or tax to the State or Indian tribal government relating

to its online gambling services, except for applicable State individual and corporate income taxes.

Like H.R. 2268, the bill imposes reporting requirements. Net Internet gambling winnings are subject to the backup withholding provisions, and withholding tax is imposed on payments made to foreign persons.

The present-law wagering tax is amended to impose an excise tax equal to 0.25 percent of wagers authorized under this bill and the territorial extent is expanded as under H.R. 2268.

The bill establishes the American heritage Block Grant Fund which is funded with an amount equal to 0.5 percent of the excise taxes received after December 31, 2010. States can receive grants from this fund for activities that develop projects, productions, workshops, or programs encouraging public knowledge, education, understanding, and appreciation of American heritage and the arts.

Additionally, the bill establishes the Transitional Assistance Trust Fund with amounts equivalent to 25 percent of the taxes received attributable to Internet gambling (and not otherwise appropriated) appropriated to this fund. Amounts from this trust fund can be used by States to provide expanded educational and job training opportunities for individuals in, or formerly in, foster care; provide expanded post-secondary education and job training for declining sectors of the economy; and provide subsidies for the use of public transportation for individuals in programs such as the State Unemployment Insurance Program.

S. 1597, the Internet Poker and Game of Skill Regulation, Consumer Protection, and Enforcement Act of 2009, introduced by Mr. Menendez

S. 1597 imposes a fee, payable each calendar month, equal to the sum of the Federal Internet gaming license fee and the State or Indian tribal government gaming license fee. The Federal Internet gaming license fee is equal to five percent of a licensee's Internet gambling deposited funds for the calendar month. Similarly, the State or Indian tribal government license fee is equal to five percent of a licensee's Internet gambling deposited funds for the calendar month. Internet gaming deposited funds are all funds deposited by persons located within the United States. Funds received from a customer by an operator of an Internet game-of-skill facility and made available to a customer for the purpose of placing a bet or wager, and funds paid to reimburse an operator for value previously advanced to the customer are included in deposits for these purposes. Deposits made of Internet gaming winnings and return of funds are not treated as deposits. Each unlicensed person who operates an Internet game-of-skill facility is subject to a 50-percent Federal Internet gaming licensing fee.

The bill imposes reporting requirements similar to the reporting required under H.R. 2268.

The bill establishes the State and Indian Tribal Government Gaming License Fee Trust Fund with amounts appropriated to the fund each calendar month equal to the State or Indian tribal government license fees received. Each month, the Secretary is required to pay to each qualified State and each qualified Indian tribal government a pro rata gaming license fee amount equal to the amount of fees attributable to deposits made by persons located within the jurisdiction

of such State or tribal government. Qualified State and tribal governments are those that have not elected to be excluded from the receipt of funds under the bill.

The bill removes the withholding requirements for winnings from pari-mutuel pools with respect to horse races, dog races, or jai alai. It requires reporting of such payments only if the amount paid with respect to the wager is at least \$1,200 and 300 times the amount wagered. Like H.R. 2268, net Internet gambling winnings are subject to the backup withholding provisions and withholding tax for payments made to foreign persons and expands the territorial extent of the present law wagering tax.

The bill exempts deposits, bets, or wagers placed with a licensee subject to the fees under the bill from any State or Indian tribe taxation unless such State or Indian tribe elects not to receive funds from the trust fund. Additionally, the income of a licensee is also exempt from State or local taxes unless the licensee maintains a permanent physical presence in the State or within the area of the jurisdiction of the Indian tribe.