TURNING THE TABLES ON STATE IGAMING TAXES

All eyes are on Nevada, Delaware, and New Jersey as Internet gaming takes hold and tax revenue starts to fill depleted state coffers. The primary reason, if not the only reason, that states are considering the legalization of iGaming is to generate additional tax proceeds. Like the dawn of land-based gaming more than two decades ago, iGaming will spread as states see untapped potential revenue, writes **Benjamin Blair, Esq**.

When a state approaches the idea of legalizing and taxing iGaming, there are many questions to be answered. What type of tax will be imposed? Who will pay the tax, and at what rate? How is iGaming impacted by constitutional restrictions on state taxation? As states balance the competing interests in establishing their tax regimes – and as taxpayers deal with the consequences of those decisions – it is important to consider an often-overlooked arrow in the taxpayer's quiver: the Internet Tax Freedom Act (ITFA).

At the turn of the last millennium, Congress was faced with the rapid growth of the Internet era. Access to the Internet became essential, and some states saw the Internet as a revenue gold mine. ITFA was Congress' response to state attempts to tax the still-developing Internet frontier. Originally passed in 1998, ITFA's express purpose is to restrict specific categories of state and local taxes and give e-commerce a chance to develop on equal footing with brick-and-mortar commerce. Because the Constitution declares that federal statutes pre-empt state laws, ITFA is the final word on the taxation of e-commerce. If a state or local tax violates ITFA, courts are obligated to find the tax void and unenforceable.

The first question is whether taxes on iGaming are even the type of taxes that fall under ITFA's shield. ITFA is a broad statute, and is not limited to specific taxes. The term "tax" is defined as any charge imposed by a governmental entity to generate revenues, but which is not a fee imposed for a specific benefit. An iGaming license fee would therefore likely not be considered a "tax" because the payer is getting the benefit of legally operating an online casino in a state, but a deposit tax or gross gaming revenue tax would likely qualify.

Restrictions

Assuming that taxes on iGaming are properly subject to ITFA scrutiny, what restrictions does ITFA place on state iGaming tax regimes? ITFA prohibits three types of state and local taxes: taxes on Internet access, multiple taxes on e-commerce, and discriminatory taxes on e-commerce. In the few situations where taxpayers have argued that a particular tax is a tax on Internet access, the courts have disagreed, and the reasoning applied in those cases probably applies to iGaming. The tax isn't imposed on Internet access *per se*, but on activity that occurs through the Internet.

ITFA's restriction on multiple taxes seems similarly inapplicable given the current state of the iGaming industry in the US, though it may impact future inter-state compacts. A multiple tax is any tax imposed on the same activity by more than one jurisdiction without an offsetting credit, even if the taxes are at different rates or have different bases. For example, ITFA would prohibit Nevada and New Jersey from each taxing the winnings from the same round of poker without a credit for taxes paid to the other. An inter-state compact on iGaming taxation could violate ITFA by allowing multiple states to tax the same gross gaming revenue without offsets. However, as long as each iGaming enterprise is located entirely within one state, any tax on that enterprise is unlikely to qualify as a forbidden multiple tax.

The third category of prohibited taxes, discriminatory taxes, presents the most interesting – and most immediate – questions for iGaming tax regimes because it does not require the activity to cross state lines, and therefore could apply to iGaming as it exists today.

Tax neutrality

ITFA was passed with the intent of ensuring tax neutrality between online and offline activities, which is why one of the most important concepts in ITFA is the similarity between an online activity and a real-world counterpart. Specifically, ITFA requires that a comparison be drawn between online activities and "similar property, goods, services, or information accomplished through other means." Whether the two things are similar is fact-specific, but a recent case shows that "similar" does not mean "identical."

The Illinois Supreme Court recently determined that Illinois' click-through nexus law was pre-empted by ITFA. The Court found that the law was discriminatory under ITFA because it imposed sales tax collection requirements on out-of-state retailers engaged in Internet-based marketing activities without imposing the same requirements on activities conducted through traditional media such as magazines and television. Marketing through Internet links was deemed similar enough to traditional marketing that the law came under ITFA scrutiny.

The best comparison for online gaming is gaming carried out "through other means." For example, in comparing land-based poker to Internet poker, the activity is identical except that instead of gamblers holding tangible cards, digital cards are dealt. The comparison is even stronger between Internet gaming and mobile gaming; there, the only difference is the location from which the player accesses the game: on a tablet at a casino or a tablet at home. Likewise, virtually all tangible slot machines run on algorithms; the jump to online slots is a small step, not a giant leap.

Under ITFA, a tax can be discriminatory in one of several statutorily-defined ways. First, a tax on e-commerce is discriminatory if it is not generally imposed and legally collectible by the state on similar activities accomplished through other means. If, for example, a state does not have a tax on casino poker, but imposes a tax on Internet poker, a court could find that the tax discriminates against e-commerce under ITFA. Further, because ITFA discusses individual taxes rather than entire tax systems, arguably the same *type* of tax must be imposed on online and offline gaming. Thus, a state could not impose a GGR tax on land-based poker while imposing a deposit tax on Internet poker, because the deposit tax would not be imposed across the board.

A tax is discriminatory if it is not imposed at the same rate as taxes on similar activities accomplished through other means. Examined through the lens of a state sales tax, ITFA makes clear that a state cannot impose an eight percent sales tax on goods purchased in-state while imposing a 15 percent sales tax on online purchases. ITFA defines as discriminatory any state or local tax that is not imposed at the same rate for online and offline activities. Many states employ progressive, marginal rates to gross gaming revenues; ITFA probably requires that the same scale apply to iGaming taxes for the same revenue brackets.

Finally, a tax is discriminatory if it imposes the obligation to collect or pay the tax on a different person than in the case of similar activities accomplished through other means. For example, some commentators have discussed imposing a French-style gaming tax to be collected by iGaming operators and paid by players. Whatever the merits of such a system, a state would need to impose the same obligations on land-based casinos and players if it wanted the tax to be valid under ITFA. ITFA invalidates discriminatory state and local taxes.

As states begin to legalize and tax iGaming, other states are likely to follow suit if legalization produces significant revenues. Such taxes must comply with federal restrictions, however, and states will also be keen to observe how iGaming taxes withstand legal challenges. Consequently, taxpayers should consider every alternative when challenging the assessment of tax.

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