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# Sales Tax Corner

## *Don't Gamble With Sales Tax— Considerations for Sportsbook and Commercial Online Gaming Providers*

By Ilya A. Lipin and Brian Baillie

**H**istorically, betting on sporting events has been viewed as a vice that may affect the integrity of the game. Because of prior scandals, such as point shaving affecting the spread in basketball games,<sup>1</sup> the Professional and Amateur Sports Protection Act (PASPA) was enacted to prohibit states from authorizing and regulating sports betting except in the grandfathered states of Delaware, Nevada, Montana, and Oregon.<sup>2</sup> However, even with PASPA in place, Americans continued to place illegal wagers of as much as \$380 billion per year.<sup>3</sup>

Since the 2018 *Murphy v. NCAA* decision<sup>4</sup> invalidating PASPA, at least 36 states and the District of Columbia (23 of which permit sports betting through online sportsbooks)<sup>5</sup> softened their stance and enacted legislation regulating and taxing sports betting.<sup>6</sup> Approximately seven of those states provide online casino-style games, which players may access *via* their mobile devices, similar to sportsbooks.<sup>7</sup> That legalization of previously prohibited activities is creating a market for operators and technology companies that support interactive sports betting and gaming platforms.

Many gaming laws do not have explicit in-lieu-of provisions, which can preclude a state from imposing different types of taxes, such as sales tax, on a similar activity. Thus, states may use existing sales tax laws applicable to the taxation of software products to impose sales tax on similar products used by operators to facilitate sports betting and online games. If you operate sportsbooks or commercial online gaming or supply technology, software, or services to operators and wonder what is subject to U.S. sales tax, how the tax will be calculated, and who is required to collect the tax, this article will help you identify key issues and considerations when working through those challenging sales tax complexities.

### Overview of Common Offerings

Online gaming models consist of games of skill or chance.

Games of skill, such as chess, fantasy sport leagues, some e-sport games, and sportsbooks, require players to use strategies and their knowledge of the game to outsmart their opponents. While there may be a component of luck or chance

in a game of skill, the player has a role in determining the game's outcome.

Conversely, players in games of chance, such as dice, roulette, and slot machines, rely on luck, rather than skill, to win. Some games, like blackjack, may also require skill, such as the ability to make decisions based on prior play. Games of chance are typically illegal, unless otherwise specified by state law.<sup>8</sup>

When both chance and skill are involved, jurisdictional rules often define the game as one or the other, thus determining the game's legality and potential tax implications.<sup>9</sup>

Gaming platforms are either monetary or free. Monetary platforms, such as pay-to-play casino slot games, charge users for participation or require a monetary investment to be eligible to win pooled prizes. Others may provide free access to the game but require in-game purchases to enhance the gaming experience.

Users generally access operators' sportsbooks to facilitate the placing of bets on sporting events through a phone or a software application, which can be downloaded, accessed remotely through the cloud, or both. However, wagers can also be placed through retail sportsbook kiosks at a physical location, such as a casino, bar, or gaming hall. Users access online games in similar ways.

To correctly categorize products with remote access for sales tax purposes, operators and their suppliers must differentiate among and understand three common types of cloud computing: Software as a Service (SaaS), Infrastructure as a Service (IaaS), and Platform as a Service (PaaS).

- SaaS allows Internet users to access prewritten software hosted in the cloud and operated by a vendor or through a third party on a per-transaction, service contract, or subscription basis. Customers pay for the right to use the software, rather than owning it.<sup>10</sup>
- IaaS is a form of cloud computing that gives users the ability to remotely access hardware (servers, networks, storage, *etc.*) on demand through the Internet. A provider typically owns, maintains, and operates the equipment, while customers can access their applications, data, and systems on that equipment.
- PaaS, which often contains elements of SaaS and IaaS, is a set of software and product development tools hosted on a provider's infrastructure. It involves the provision of hardware and software as one product offering. PaaS users access providers' networks, servers, storage, and operating systems and use that infrastructure to access provider software. PaaS providers generally fully retain and operate software applications that are accessed remotely by users.

## Nexus Considerations

A company may have an obligation to collect and remit sales tax on its U.S. sales if it has nexus with a state that imposes sales tax on its products and services.

For most companies, nexus is created through physical presence, such as having physical property (office, inventory, retail kiosks, servers, *etc.*) or employees in the state. Following the 2018 Supreme Court decision in *Wayfair*,<sup>11</sup> nexus can also be established by eliciting sales that exceed economic thresholds (for example, \$100,000 of gross sales or 200 separate transactions in the past or current year). All states that impose sales tax have economic nexus standards.

For companies operating in a regulated industry, such as legalized sports betting or commercial gaming, nexus can also be created through state regulation, which may require operating only through an in-state licensed retail operator and agreeing to file and be compliant with all applicable taxes to obtain a license or have a server in a state. For example, Arizona requires operators and management service providers to accept wagers only on servers located in the state and notify the Department of Gaming of the physical location of each server used in event wagering.<sup>12</sup> New Jersey allows casinos with gaming permits and sports wagering licenses to contract with gaming companies to provide Internet gaming and operate online sports pools in the state.<sup>13</sup> It also requires gaming companies to obtain a permit to operate and have equipment engaged in Internet gaming activity in the state.<sup>14</sup>

## Taxability of Online Gaming

State gaming taxes on casino-style online games generally consist of taxes on gross revenue or adjusted gross proceeds (generally, gross revenue less payouts) and licensing fees. However, from a sales tax perspective, the taxation of online gaming generally depends on the method of delivery (electronically downloaded software, SaaS, *etc.*) and game features (in-play buy-ins, virtual currency, *etc.*).

As the commercial online gaming industry continues to grow, it is important for operators and suppliers to remember that approximately 35 states impose sales tax on electronically delivered software, such as an app downloaded onto a computer or phone. Over 30 states impose sales tax on various digital products, including in-game purchases. For instance, access to fee-based prewritten software that extends or enhances the purchaser's online gaming experience (such as the ability to access additional levels and interactions) is subject to sales tax.<sup>15</sup> Approximately half of the U.S. states impose sales tax on SaaS, and around 12 states impose sales tax on data

processing or information access services.<sup>16</sup> Around 14 states impose sales tax on IaaS<sup>17</sup> and 18 states impose sales tax on PaaS.<sup>18</sup> Thus, vendors of online games or platforms must be cognizant of their delivery models (free download, pay to download, access online, *etc.*) and in-app purchases that may be subject to sales tax, regardless of whether real or virtual currency is used.

## Taxability of Online Sports Betting

The taxation of online sports betting is complex and generally includes a federal excise tax of 25 basis points on the amount of each wager, a state-based tax on gross gaming revenue or modified gross profit, and licensing fees.<sup>19</sup> Gaming taxation can generate significant revenue for a state. For instance, New York recently announced that, in its first year of taxing mobile sports wagering, it collected more than \$709.2 million in taxes and an additional \$200 million in licensing fees.<sup>20</sup>

Technology companies, sportsbooks, and operators should determine whether sales tax applies to their products and services. For instance, some states that impose sales tax on data processing, access to information services, data monitoring, streaming, and security services may consider specific functions of the sportsbook offering, depending on the method of delivery, to be subject to sales tax.

If a company combines the sale of taxable and nontaxable products and services into one fee on customer invoices, states may consider those bundled transactions of separately identifiable services that are combined with taxable components and sold at a single price as taxable in their entirety. It is therefore important to review contracts and invoicing methodologies to identify and mitigate bundling risk.

Access to software, data, or other services—often combined in a service offering—may be purchased by a casino or sportsbook operator but is used by players. As part of the taxability analysis, when a transaction involves taxable (*e.g.*, software) and nontaxable (*e.g.*, potentially select services) components that are not separable, it is important to analyze the true object of (or principal purpose or essence of) the transaction to determine if the taxable items are merely incidental to the overall transaction and who the ultimate user is, thus not subjecting the entire transaction to sales tax. While the application of the true object test to determine the taxability of a transaction varies among states, “each relies on the concept that services must be taxed, not by what they are named, but instead by the function of the service, as characterized by the provider and customer.”<sup>21</sup>

To illustrate the benefit of this analysis, one can look at a recent New York Advisory Opinion that considered whether receipts from sales of online courses of study provided *via* a software platform are subject to state and local sales tax.<sup>22</sup> The Department of Taxation and Finance determined that free software downloads are not subject to sales tax because there is no charge for downloading the software. The fee charged for course certificate videos streamed through the app and software platform are not subject to sales tax, because the “primary function” of the service is to provide education programs and not a sale of taxable products.<sup>23</sup>

In determining the taxability of gaming or sportsbook offering, it is important to identify and analyze whether a transaction’s true object is a sale of software, SaaS, IaaS, or PaaS or whether the transaction involves a nontaxable service (*e.g.*, sports betting service) that is accessed not by the operator but by the players placing bets. Some states (*e.g.*, Texas) have attempted to enact legislation imposing taxes on consumers placing wagers on sporting events,<sup>24</sup> perhaps realizing that players are the ultimate users of the service.

However, the high courts of a limited number of states, including Pennsylvania, which imposes sales tax on most software offerings, have not adopted the application of the true object test.<sup>25</sup> In those states, the nontaxable offerings of transactions may be unbundled to prevent them from becoming subject to sales tax.<sup>26</sup>

## Exemptions and Reduced Sales Tax Rates

The availability of any exemptions and reduced sales tax rates must also be considered. Some states (*e.g.*, New Jersey) exempt the sale of software when it is electronically delivered and used exclusively in the customer’s trade or business.<sup>27</sup> Other states (*e.g.*, Iowa and Maryland) may exempt SaaS from sales tax if it is furnished for exclusive use by another commercial enterprise.<sup>28</sup>

Some states that impose sales tax on SaaS provide reduced preferential sales tax rates. For instance, Connecticut imposes a reduced one-percent rate on business-to-business sales of SaaS, but the full rate of 6.35 percent on sales to individuals.<sup>29</sup>

For PaaS transactions, Indiana provides preferential tax treatment for PaaS if the purchase of hardware is incidental—that is, less than 10 percent of the purchase price—to the purchase of SaaS, which is not subject to Indiana sales tax.<sup>30</sup>

Companies should also monitor whether they are purchasing software or services for resale, as sales tax should not be paid on the purchase but instead charged on the sale to the end consumer, unless the purchase is not taxable, or another exemption applies. Similarly, companies should know where purchased software or services are used, because a “bill to” location may impose sales tax on the purchase, while the location of shipment or use may not impose tax on the purchase.

## Recommended Action Items

Because of the imposition of federal- and state-specific gaming taxes and stringent licensing requirements, the potential application of sales tax to sportsbooks and commercial online gaming platforms operated *via* software may be an afterthought for many companies in the gaming industry. To stay compliant with sales tax rules in such a highly regulated industry, it is imperative that technology companies in the commercial gaming or sportsbook industry and operators evaluate how sales tax may affect their processes.

To accomplish that, a review of the company supplying the operators with products and services and its physical

and economic presence based on the volume of sales and transactions should be conducted at least annually. Both the operators and suppliers must pay particular attention to the characterization of products, contractual language, method of delivery, and invoicing methodology to properly identify revenue streams for sales tax purposes, analyze the true object of the transaction, identify the applicable tax rate and potential exemptions, and mitigate possible bundling issues. If suppliers do not charge sales tax on taxable transactions, operators should carefully review their purchases to identify whether use tax should be self-accrued and remitted.

Companies should understand their total state tax liabilities including sales taxes, in addition to other applicable federal and international taxes. To determine their total state tax liabilities and identify additional tax savings opportunities, companies should review their income, franchise, gross receipts, payroll, and personal and real property taxes, as well as any unclaimed property. Inbound companies should also consider whether U.S. treaty protection may apply for state income tax purposes. Following these recommendations and working with a competent tax advisor with industry knowledge will improve tax compliance and mitigate financial risk.

## ENDNOTES

- <sup>1</sup> Scott Eden, “From the Archives: How Former Ref Tim Donaghy Conspired to Fix NBA Games,” ESPN (Jul. 9, 2020).
- <sup>2</sup> Eric Meer, *The Professional and Amateur Sports Protection Act (PASPA): A Bad Bet for the States*, 2 UNLV GAMING L. J. 281 (Jan. 2012).
- <sup>3</sup> National Gambling Impact Study Commission final report (1999), at 2–14.
- <sup>4</sup> *Murphy v. Nat’l Collegiate Athletic Assn*, S Ct, 138 S Ct 1461 (2018).
- <sup>5</sup> American Gaming Association, “Interactive U.S. Map: Sports Betting” (undated).
- <sup>6</sup> *Id.*
- <sup>7</sup> Betting USA, “States With Legal Betting: Which States Allow Online Gambling?” (undated).
- <sup>8</sup> S. Keith Lowe and Benjamin B. Boozer, Jr., “Gambling or Skill: Taxation Issues Surrounding the Daily Fantasy Sports Industry” (undated), at 10 (“If a material element does depend on chance, the contest would be classified as illegal”).
- <sup>9</sup> *Id.* at 10 and 11.
- <sup>10</sup> Iowa Admin. Code 701-211.53 (423).
- <sup>11</sup> *South Dakota v. Wayfair, Inc.*, S Ct, 138 S Ct 2080 (2018).
- <sup>12</sup> Ariz. Admin. Code Section 19-4-116.
- <sup>13</sup> N.J. Rev. Stat. Sections 5:12A-10 and 5:12-95.21.
- <sup>14</sup> N.J. Rev. Stat. Section 5:12-95.22.
- <sup>15</sup> New York State Department of Taxation and Finance, Office of Counsel Advisory Opinion Unit, Advisory Opinion TSB-A-15(25)S, (Jun. 3, 2015).
- <sup>16</sup> Bruce M. Nelson, James T. Collins, and John C. Healy, *Sales and Use Tax Answer Book*, question 23:17 (2022) (“The following states impose tax upon SaaS: Arizona, Connecticut, District of Columbia, Hawaii, Iowa (effective January 1, 2019), Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Mexico, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island (effective October 1, 2018), South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, and West Virginia”).
- <sup>17</sup> *Id.* (“The following states impose tax upon IaaS: Connecticut, District of Columbia, Hawaii, Louisiana, Missouri, New Mexico, Ohio, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, and West Virginia”).
- <sup>18</sup> *Id.* (“The following states impose tax upon PaaS: Arizona, Connecticut, District of Columbia, Hawaii, Louisiana, Massachusetts, New Mexico, North Dakota, Ohio, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, and West Virginia”).
- <sup>19</sup> Jeffrey A. Friedman and Sebastian Iagrossi, *A Review of State Taxation of Sports Betting*, STATE TAX NOTES (Jan. 2, 2023).
- <sup>20</sup> New York State press release, “Governor Hochul Announces Mobile Sports Wagering Generated \$909 Million for New York State in First Year of Operation” (Jan. 13, 2023).
- <sup>21</sup> Martin I. Eisenstein and Matthew Pick, *Taxonomy of Services: The Object Test?* STATE TAX NOTES (Jan. 9, 2023).
- <sup>22</sup> New York Advisory Opinion No. TSB-A-20(33)S (Jul. 14, 2020).
- <sup>23</sup> *Id.*
- <sup>24</sup> See H.B. 1121, Section 2005.108 (2021).
- <sup>25</sup> *Downs Racing v. Commonwealth*, 196 A3d 603 (Pa. 2018) (“This Court has never endorsed the test, notwithstanding that the Commonwealth Court has used it on multiple occasions”); *Dechert LLP v. Commonwealth*, 998 A2d 575 (Pa. 2010). See also Pennsylvania Sales and Use Tax Letter Ruling No. SUT-20-001 (Jan. 31, 2020) (“This office will not apply the ‘essence of the transaction’ test in determining whether a charge for a membership fee that includes the transfer of taxable tangible personal property is taxable”).
- <sup>26</sup> Eisenstein and Pick, *supra* note 21 (“Pennsylvania: Understand what services should be unbundled. If the subscription also included a heart monitor, the heart monitor should be separately priced from the subscription itself”).
- <sup>27</sup> N.J.S. Section 54:32B-8.56; and N.J. Admin. Code Section 18:24-25.5(b)(1).
- <sup>28</sup> Md. Code Ann. Tax-Gen. Section 11-101(c-4)(3)(vi) (effective July 1, 2022); Maryland Tax Tip 29 (revised July 1, 2022); Iowa Code Ann. Sections 423.2(6)(bu) and 423.3(104); and Iowa Admin. Code r. 701-225.8.
- <sup>29</sup> Conn. Gen. Stat. Sections 12-407(a)(13) and 12-408(1)(D)(i); Connecticut Special Notice SN 2019(8) (Sep. 4, 2019).
- <sup>30</sup> Indiana Tax Information Sales Tax Bulletin 8.

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