

COMMENT

Internet Gaming Tax Regulation: Can Old Laws Learn New Tricks?

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I. INTRODUCTION

The tide is changing in Internet gaming law and practice. Internet gaming has been largely restricted to countries with little or no regulatory structure, whereas first-world countries such as the United States, Canada, and several in the European Union prohibit the establishment of Internet gaming facilities. However, these prohibitions have not had the intended result of restricting the growth of Internet gambling. Not only has Internet gaming in countries with lax regulation grown, but officials in countries such as Australia and Great Britain have legalized Internet gaming establishments in an effort to internalize gaming revenue.¹

A lively discussion that ensued in 1995 continues today regarding the merits of prohibition and legalization of Internet gaming in the United States. These issues are largely beyond the scope of this Comment. The focus of this Comment is analysis of regulatory schemes after legalization. Therefore, part one begins with a short discussion of current world events that point to the

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¹ See Mike Bruner, *Australia, U.S. at Odds on Net Betting*, at <http://www.msnbc.com/NEWS/287419.asp> (last visited Nov. 4, 2001) [hereinafter Bruner, *Australia, U.S. at Odds*]; Mike Bruner, *Britain Embraces Internet Gambling*, at <http://www.msnbc.com/news/540530.asp> (last visited Nov. 4, 2001) [hereinafter Bruner, *Britain Embraces*].

likelihood of legalization in the United States and the need for regulation. Part two discusses federal and state regulatory issues. Federal issues discussed include the Commerce Clause, statutes already in place that allow for the collection of wagering taxes, and federal revenue sharing. The discussion of state regulation of gaming concentrates on states' power to regulate gaming under the police power and multi-state lotteries. Finally, part three makes proposals for collection and allocation of Internet gaming tax revenues that will allow states to maintain their traditional control of gaming while exploiting a new source of revenue.

A. The Inevitability of Internet Gaming?

Internet gaming has largely been an offshore industry since its introduction in 1995.² However, a shift is occurring, and countries that once prohibited Internet gaming are looking at new possibilities for legalization and regulation.³ Two primary benefits exist for Internet gaming companies located in countries with little or no regulation. The first benefit is cost savings from the lack of regulation. Internet gaming companies receive a warm welcome from countries such as Costa Rica because the companies create high paying jobs with benefits.⁴ Companies, in turn, find Costa Rica attractive because it has loose laws regulating Internet gaming, and companies operate under municipal licenses.⁵ The licensing fees in countries such as Costa Rica and Antigua are often much less than licensing fees for casinos in the United States.⁶

² See generally Mark G. Tratos, *Gaming on the Internet III: The Politics of Internet Gaming and the Genesis of Legal Bans or Licensing*, 610 *PLI/Pat* 711, 719-22 (2000); Seth Gorman & Antony Loo, *Blackjack or Bust: Can U.S. Law Stop Internet Gambling?*, 16 *LOY. L.A. ENT. L. J.* 667-69 (1996).

³ Most notably, Australia and Great Britain recently enacted laws that allow casinos in these countries to accept bets and wagers over the Internet. See Brunner, *Australia, U.S. at Odds*, *supra* note 1; Brunner, *Britain Embraces*, *supra* note 1.

⁴ Marianela Jimenez, *Costa Rica A Paradise for Online Gambling Firms Lax Regulations and Cheap Labor Force Lure Offshore Bookies Catering to U.S. Residents*, *PRESS DEMOCRAT* (Santa Rosa, Cal.), Oct. 25, 2000, at A13, available at 2000 WL 24341002.

⁵ *Id.*

⁶ *Id.* Antigua charges a licensing fee of one hundred thousand dollars per year. *Id.* In October 2000, Costa Rica announced that it would require Internet gaming operators to undergo background checks and pay a \$150,000 licensing fee. I. Nelson Rose, *Gambling and the Law®: Understanding the Law of Internet Gambling*, *ALI-ABA COURSE OF STUDY*, SF89 ALI-ABA 175, 204 (2001) [hereinafter Rose, *Understanding the Law*]. Conversely, Nevada's Internet gaming bill proposes to charge five hundred thousand dollars every two years for licensing plus a six percent tax on all Internet gaming profits. Mike Brunner, *Net Betting Bill Signed in Nevada*, at www.msnbc.com/news/578499.asp (last visited Nov. 4, 2001) [hereinafter Brunner, *Net Betting*]. In addition to charging lower licensing fees, Antigua's flat fee is significantly less complicated to calculate than licensing fees charged by Nevada—such as \$250 per slot machine, *NEV. REV. STAT.* 463.385 (2001); a ten percent excise tax on all amounts paid for admission, food, drink, and merchandise sold in a casino, *NEV. REV. STAT.* 463.401 (2001); and up to one thousand dollars per game in an establishment, *NEV. REV. STAT.* 463.380 (2001). While these fees apply only to land based casinos, it

The second advantage to locating offshore is that Internet gaming companies do not have to worry about liability under U.S. federal or state law. No U.S. statutes specifically address Internet gaming.⁷ However, the section on transmission of wagers in the federal Wire Act⁸ prohibits the use of a “wire communication facility for the transmission in interstate or foreign commerce of bets.”⁹ The Wire Act was enacted prior to the emergence of the Internet, but because Internet communications are generally carried over wires, the statute applies.¹⁰ The Wire Act raises serious questions regarding criminal liability for operating Internet gaming sites in the United States.¹¹ Penalties for Wire Act violations may include loss of a state gaming license or seizure of property if U.S. state and federal courts are able to assert jurisdiction.¹²

The advantages of setting up Internet gaming sites offshore are outweighed by the opportunity to profit from legalized Internet gaming in the United States and other first-world countries. Estimates of Internet wagering are in the hundreds of millions of dollars, but the exact figure is unknown.¹³ These large amounts are attributed to increased Internet access, especially in the United States; improvements in software that allow for instantaneous gaming and improved sound and graphics; increased confidence in online financial transactions; and licensing measures in countries such as Australia and Antigua.¹⁴ Revenues will likely increase as the chilling effects of complicated financial transactions are removed by Internet gaming companies in countries with sophisticated regulatory systems.¹⁵ The likely reason for the anticipated increase is consumer comfort. Established and reputable casinos are more attractive to bettors because of consumer recognition of an established brand name, guaranteed paybacks, and the stability of a “brick and mortar” establish-

is likely that fees charged to Internet gaming providers in the United States will have similar complications.

⁷ I. Nelson Rose, *Gambling and the Law®: Internet Gambling: Statutes and International Law*, ALI-ABA COURSE OF STUDY, SE81 ALI-ABA 231, 234 (2000) [hereinafter Rose, *Statutes and International Law*].

⁸ 18 U.S.C. § 1084 (2000).

⁹ *Id.*

¹⁰ Gorman & Loo, *supra* note 2, at 671.

¹¹ *Id.* at 671-72.

¹² Rose, *Understanding the Law*, *supra* note 6, at 204-05.

¹³ NAT'L GAMBLING IMPACT STUDY COMM'N, FINAL REPORT, at 2-15 to 2-16 (1999) available at <http://govinfo.library.unt.edu/ngisc/index.html> [hereinafter NGISC FINAL REPORT]. The Report cites two studies that estimate Internet gaming revenues at \$300 to \$445.4 million in 1997, and \$651 to \$919.1 million in 1998. *Id.* While a dispute exists regarding the exact amounts, both studies estimate that revenue doubled from 1997 to 1998. *Id.*

¹⁴ *Id.* at 2-16.

¹⁵ See Mark G. Tratos, *Gaming on the Internet*, 3 STAN. J.L. BUS. & FIN. 101, 111-12 (1997).

ment.¹⁶ Established gaming companies will continue to lobby for legalization and regulation of Internet gaming in the United States and other countries in order to capitalize on the will of consumers.¹⁷

The lure of increased revenue and consumer preference will likely result in federal and state governments enacting legislation to legalize and regulate Internet gaming. Federal and state governments are continually trying to collect greater amounts of much-wanted revenue.¹⁸ Taxes and licensing fees on Internet gaming offer state and federal governments a large and previously untapped source of revenue.¹⁹ Because Internet gaming is a new source of revenue, few laws govern the amount of revenue that might be realized.²⁰ Governments have the authority to enact legislation and promulgate regulations that will maximize revenues while allowing for the growth of Internet gaming. A relatively clean slate encourages governments and businesses to negotiate regulatory solutions that will benefit all parties.

B. The Need for Regulatory Models

It is in the best interests of federal and state governments to find ways of policing the industry since it appears legalization of Internet gaming would provide a valuable new source of tax revenue. The goals of regulation should be to provide stability, collect and distribute tax revenue, prevent gambling by minors and problem gamblers, prevent the influence of criminal elements, and ensure fair games with known odds.²¹ The need exists for regulations addressing collection and allocation of gaming tax revenues because federal and state governments lack an incentive to pass Internet gaming regulations without the carrot of additional tax revenue.

¹⁶ *Id.*; Stevie A. Kish, *Betting on the Net: An Analysis of the Government's Role in Addressing Internet Gambling*, 51 FED. COMM. L.J. 449, 453-54 (1999).

¹⁷ In fact, some large casino owners such as MGM Mirage, Park Place Entertainment, and Harrah's Entertainment are actively lobbying for Internet gaming and have already developed "for-fun" gaming that can be transformed into for-profit gaming in a very short time. Mike Bruner, *Online Gambling Goes Global*, at <http://www.msnbc.com/news/544764.asp> (last visited Nov. 1, 2001) [hereinafter Bruner, *Online Gambling*].

¹⁸ Tratos, *supra* note 15, at 113-14.

¹⁹ *Id.* Nevada casinos collected \$9.6 billion in winnings and paid \$561.5 million to the state in taxes in 2000. Jeff Simpson, *Experts Promote Legalization of Internet Gambling*, LAS VEGAS REV.-J., May 16, 2001, at 3D, available at 2001 WL 9534745. Current projections of worldwide Internet gaming taxed at the rate of 6.25% could generate approximately \$156 million in new tax revenue. *Id.*

²⁰ See *infra* Part II.A.2 (discussing I.R.C. § 4401).

²¹ Bradford S. Smith, *Roundtable Discussion: The Role of Regulators*, ALI-ABA COURSE OF STUDY, SC91 ALI-ABA 465 (1998). Industry stability, problem gambling prevention, crime, and fairness are beyond the scope of this comment; for a discussion on these issues see NGISC FINAL REPORT, *supra* note 13, at 5-4 to 5-6; Kish, *supra* note 16, at 453-54.

No commercial Internet gaming sites currently exist in the United States. Most sites are located in the Caribbean, Central and South America, and Australia.²² Geography is not a bar to Americans who want to use the Internet for gambling. The great appeal of the Internet is that it allows the transmission of data across large distances, including national and international borders.²³ The Internet creates a problem for legislators and courts because of the difficulty of enforcing judgments against foreign-based operations.²⁴ Federal and state governments are largely powerless to enforce penalties against foreign Internet gaming companies because of a lack of personal jurisdiction.²⁵

Legislative attempts to ban Internet gaming have been unsuccessful, and proposed legislation will also be ineffective as long as bettors are exempt from prosecution.²⁶ Arizona Senator Jon Kyl introduced the Internet Gambling Prohibition Act of 1999.²⁷ The proposed bill would have significantly amended the Internet Gambling Prohibition Act of 1997 that the Senate approved, but the full Congress did not pass.²⁸ Placing any bet on the Internet would have been a federal offense under the 1997 act.²⁹ The 1999

²² See discussion *supra* Part I.A.

²³ The Internet has been variously described as “a medium through which people in real space in one jurisdiction communicate with people in real space in another jurisdiction; . . . a collection of networks; a giant network which interconnects innumerable smaller groups of linked computer networks; and a decentralized, global medium of communications.” Tom Lundin Jr., *The Internet Gambling Prohibition Act of 1999: Congress Stacks the Deck Against Online Wagering but Deals in Traditional Gaming Industry High Rollers*, 16 GA. ST. U. L. REV. 845, 858 (2000) (internal quotation omitted) (citations omitted). The federal government defines the Internet as “[t]he international computer network of both Federal and non-Federal interoperable packet switched data networks.” *Id.* at 859 (quoting the Electronic Communications Act, 47 U.S.C. § 230(e)(1) (1998) (alteration in original)).

²⁴ Lundin, *supra* note 23, at 862. One method of dealing with the problem is through treaties. See, e.g., Rose, *Statutes and International Law*, *supra* note 7, at 250-52. The difficulty is in enforcement of prohibitions rather than in asserting jurisdiction over Internet gaming sites. In *State v. Granite Gate Resorts, Inc.*, No. C6-95-7227, 1996 WL 767431, at *1 (D. Minn. Dec. 11, 1996), the Attorney General of Minnesota successfully brought suit against an Internet sports wagering company incorporated in Nevada, with its primary place of business in Belize. Minimum contacts were established by the amount of advertising on the Internet that reached Minnesota. *Id.* at *6-7. The fact that defendants kept track of users proved they knew that computers in Minnesota were accessing the site. *Id.* at *8. Defendant purposely availed itself of Minnesota law by including a provision on its site that said the company had a right to file action against users in the user’s home forum or in Belize. *Id.* at *11.

²⁵ Conducting Internet gaming may be a criminal offense under federal and state laws, but enforcing penalties against foreign nationals is difficult. The United States has extradition treaties that allow extradition for criminal fraud, but no treaties exist for extradition for illegal gambling. Rose, *Statutes and International Law*, *supra* note 7, at 251. For a thorough discussion of the difficulties governments face in asserting personal jurisdiction over Internet gaming companies see Anthony N. Cabot & Robert D. Faiss, *Sports Gambling in the Cyberspace Era*, 5 CHAP. L. REV. 1 (2002).

²⁶ See discussion *infra* notes 27-43 and accompanying text.

²⁷ S. 692, 106th Cong. (1999).

²⁸ Internet Gambling Prohibition Act of 1997, H.R. 2380, 105th Cong. (1997).

²⁹ See Lundin, *supra* note 23, at 865.

bill would have exempted individual bettors from federal prosecution for placing wagers via the Internet.³⁰ States may still bring criminal prosecution under state law against individual bettors who place wagers on the Internet, but the federal government has yet to pass a bill specifically outlawing Internet gaming.

Any law that criminalizes placing bets over the Internet will face serious enforcement difficulties. The basic problem is identification of gamblers who place bets at offshore Internet casinos.³¹ The identities of individual gamblers may be hidden from law enforcement as encryption technology becomes more prevalent.³² The second problem is that in order to bring a criminal action against bettors, law enforcement will need to intercept betting information while it is being transmitted. The nature of the Internet as a decentralized network or series of networks makes it very difficult for officials to know where to place a tap on communication lines.³³ Law enforcement will not have the evidence necessary for conviction without intercepted bets. Finally, law enforcement may be reluctant to attempt enforcement of Internet gaming prohibitions because of doubt about the success of enforcement efforts both domestically and internationally.³⁴ A complete ban on Internet gaming will not effectuate the desired goals of providing stability, preventing problem gambling, ensuring the fairness of games, and providing revenue due to these enforcement difficulties. Internet gaming will continue to exist overseas at unregulated sites because bettors will not be sufficiently discouraged from participating in illegal gambling.

Regulation of Internet gaming offers a preferred solution to the perceived problems of Internet gaming for several reasons. First, federal and state governments can obtain results through regulation that are unattainable with a ban on Internet gaming. Gambling in some form is legal and regulated in forty-eight states and the District of Columbia.³⁵ Laws that address public and legislators' concerns already exist.³⁶ Casino regulators perform background checks on companies applying for casino licenses, casino employees, and companies doing business with casinos in order to

³⁰ *Id.* at 851.

³¹ Regulation will not face the same difficulty in identifying gamblers because the gamblers will willingly provide identifying information in order to access Internet gaming sites. *See infra* notes 41-43 and accompanying text.

³² Kish, *supra* note 16, at 463.

³³ Gorman & Loo, *supra* note 2, at 691.

³⁴ Kish, *supra* note 16, at 462-63.

³⁵ *See* Ronald J. Rychlak, *The Introduction of Casino Gambling: Public Policy and the Law*, 64 *Miss. L. J.* 291, 303-04 (1995). Hawaii and Utah are the only states that prohibit all forms of gambling. *Id.* at 304. In 1994, thirty-seven states and the District of Columbia conducted lotteries; twenty-four states allowed Indian gaming; six states allowed riverboat gambling; and twenty-three states allowed casino gambling. *Id.*

³⁶ *See generally* Smith, *supra* note 21.

prevent the influence of organized crime.³⁷ Additionally, regulators set the rules of games and promote fair games by ensuring that casinos pay out the required amount to gamblers.³⁸ Operators have an interest in following regulations in states that allow gaming and abiding by laws in states that do not allow gambling in order to protect their licenses.³⁹ Finally, casinos welcome Internet gaming legislation and pledge to assist governments in regulating Internet gaming.⁴⁰ The casinos maintain that regulation of Internet gaming will be relatively easy because an electronic record of each bet will be created. These electronic records will allow for "precise auditing and control."⁴¹ With current software, prohibiting underage gambling will still be a problem.⁴² However, if casinos develop more reliable age verification procedures they may be able to accurately determine the bettor's age, monitor bets, and restrict problem gamblers.⁴³ Legalization and regulation allow legislators to accomplish the goals of limiting Internet gaming and generating revenues with the willing assistance of casinos. The regulatory solution is preferable to a ban because regulation will generate revenue and ultimately offer more control over Internet gaming than an unenforceable ban.

II. EXISTING REGULATORY MODELS: POSSIBILITIES AND PROBLEMS

The two possible sources of laws to regulate Internet gaming are the Commerce Clause⁴⁴ and the police powers retained by the states.⁴⁵ Federal laws exist or may be enacted to regulate Internet gaming under the Commerce Clause. Such laws provide a framework for collection and distribution of revenues from Internet gaming. On the other hand, states may enact laws to regulate gaming under the police power. State legislatures will determine whether their citizens can use the Internet to place bets at regulated casinos and sports books. Effective regulation of Internet gaming should incorporate elements of both state and federal law.

³⁷ *Id.* at 467.

³⁸ *Id.* at 468.

³⁹ Kish, *supra* note 16, at 464.

⁴⁰ *Internet Gambling: Hearing Before the Subcomm. on Crime of the House Comm. on the Judiciary*, 105th Cong. (1998) (testimony of Sue Schneider, Managing Editor and Chief Executive Officer of Rolling Good Times OnLine), [hereinafter Schneider testimony] available at 1998 WL 58226.

⁴¹ *Id.*

⁴² Simpson, *supra* note 19.

⁴³ *Id.*

⁴⁴ "The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. CONST. art. I, § 8, cl. 3.

⁴⁵ Police powers retained by the states are affirmed in the Tenth Amendment of the Constitution. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X.

A. Federal Regulation

1. Congress's Power to Regulate Internet Gaming Under the Commerce Clause

Congress can clearly regulate Internet gaming under the Commerce Clause. The Commerce Clause allows Congress to regulate commerce with foreign nations or among the several states.⁴⁶ Placing bets across state or international lines falls into the category of commerce among the several states or with foreign nations for several reasons. First, bets travel through channels of interstate commerce—phone lines and the Internet. Second, instrumentalities of interstate commerce—money or credit—are traveling through those channels. Furthermore, current reports on Internet gambling reveal that the amounts of money being wagered over the Internet are sizeable.⁴⁷ The amounts being wagered support the conclusion that Internet wagering has a substantial impact on interstate commerce.

However, it is not clear whether Congress can regulate Internet gaming that is restricted to intrastate systems such as closed circuit Internet gaming, purchasing state lottery tickets via the Internet, or pari-mutuel betting⁴⁸ using the Internet.⁴⁹ It may be argued that congressional regulation or a ban on purely intrastate activities may violate the Commerce Clause because intrastate activities would not satisfy the “substantially affect[ing] interstate commerce”⁵⁰ requirement for the federal government’s legislation to be constitutional.⁵¹ However, the Court in *United*

⁴⁶ U.S. CONST. art. I, § 8, cl. 3. At least one commentator questions whether Congressional regulation of Internet gaming can pass the three-part test for Commerce Clause regulation set out in *United States v. Lopez*, 514 U.S. 549 (1995). David Goodman, *Proposals for a Federal Prohibition of Internet Gambling: Are There Any Other Viable Solutions to This Perplexing Problem?*, 70 MISS. L.J. 375, 396-98 (2000). *Lopez* delineates three areas in which Congress may regulate under the Commerce Clause: 1) activities that use the channels of interstate commerce such as roads, railroads, and phone lines; 2) activities that implicate instrumentalities of interstate commerce including people and things moving in interstate commerce; and 3) activities that have a “substantial relation to interstate commerce.” *Lopez*, 514 U.S. at 559. Goodman questions whether Internet gambling has the necessary “substantial relation” in order to pass muster under *Lopez*. Goodman, *supra* note 46, at 396-98.

⁴⁷ NGISC FINAL REPORT, *supra* note 13, at 2-15 to 2-16.

⁴⁸ Pari-mutuel betting is a system commonly used for gambling on horse and dog races in which all money bet on a race is divided for payment to bettors holding tickets for first, second, or third place after a statutorily determined deduction for maintenance and profits. See generally IND. CODE § 4-31-2-12 (2002); NEV. REV. STAT. 466.028 (2001); R.I. GEN. LAWS § 41-3.1-6 (2001); *W. Flagler Amusement Co. v. Commissioner*, 21 T.C. 486 (1954).

⁴⁹ Kish, *supra* note 16, at 458.

⁵⁰ *Lopez*, 514 U.S. at 559.

⁵¹ Kish, *supra* note 16, at 457. A question arises as to whether placing purely intrastate wagers violates the Federal Wire Act since the same lines of communication are used for both intrastate and interstate wire communications. Federal fraud statutes may be instructive. Fraud by wire, radio, or television are unlike mail fraud in that the criminal activity must cross state lines in order to give rise to a federal offense. 18 U.S.C. § 1343

States v. Lopez stated, “we have upheld a wide variety of congressional Acts regulating intrastate economic activity where we have concluded that the activity substantially affected interstate commerce.”⁵² Federal regulation of purely intrastate gaming activity would also place Congress in the awkward position of regulating the same types of gaming that are traditionally regulated by the states under the police power.⁵³ Commerce Clause jurisprudence leaves open the question of whether Congress can prevent states from developing their own strictly intrastate Internet gaming systems.

While questions remain about Congress’s ability to regulate intrastate Internet gaming, the Commerce Clause clearly gives Congress the power to regulate interstate gaming via the Internet. The breadth of Congress’s power under the Commerce Clause and the fact that Congress already has the power to tax wagers leave little room to question Congress’s power to make laws that regulate Internet gaming.⁵⁴

2. The Federal Wager Tax

The federal government currently has the ability to collect taxes on wagers regardless of whether the wagers are authorized under state law. The Federal Excise Wagering Tax allows the federal government to collect a tax equal to 0.25 percent of the amount of any state authorized wager.⁵⁵ The federal government collects a tax of two percent on any wager not authorized by state law.⁵⁶ The tax applies to any person, or corporation, engaged in

(2001) (“Whoever . . . transmits . . . by means of wire, radio, or television communication in interstate or foreign commerce, any writings . . . for the purpose of executing such scheme or artifice.”) (emphasis added). This is in contradiction to the rule for mail fraud, which dictates that any use of the mails for fraudulent activity, whether interstate or intrastate, gives rise to a federal offense. *Id.* § 341; *Annulli v. Panikkar*, 200 F.3d 189, 200 n.9 (3rd Cir. 1999) (“There are two elements of a mail or wire fraud charge: ‘. . . a scheme to defraud, and . . . a mailing or wire in furtherance of that scheme.’ Wholly intrastate use of the mails for fraud violates the mail fraud statute. In contrast, the federal wire fraud statute requires interstate use of the wire.”) (citations omitted); *Smith v. Ayres*, 845 F.2d 1360, 1366 (5th Cir. 1988) (stating wire communications must cross state lines in order to satisfy the statute and purely intrastate communications are beyond the reach of the statute).

⁵² *Lopez*, 514 U.S. at 559.

⁵³ Goodman, *supra* note 46, at 398.

⁵⁴ See discussion *infra* Part II.A.2 (discussing federal wagering tax).

⁵⁵ I.R.C. § 4401(a)(1) (West 2002).

⁵⁶ *Id.* § 4401(a)(2). The use of the dual rate structure is not considered an improper penalty on unauthorized wagers because of the likelihood of a higher rate of return on such unauthorized wagers. *United States v. Hallmark*, 911 F.2d 399, 401 (10th Cir. 1990) (citing *United States v. Constantine*, 296 U.S. 287, 297 (1935)). The dual structure does not violate tax uniformity requirements because the distinction between legal and illegal wagering is geographically neutral. *Hallmark*, 911 F.2d at 402. However, the wagering tax has been successfully challenged on Fifth Amendment prohibition of self-incrimination grounds. See *Marchetti v. United States*, 390 U.S. 39 (1968) (reversing petitioner’s conviction for tax evasion on the grounds that public registration for occupational Wagering Tax Stamp would constitute self incrimination since local Internal Revenue Service offices

the business of accepting wagers.⁵⁷ The tax also applies to any wager placed in a wagering pool or lottery.⁵⁸

The wagering excise tax may appear to be an easy fix for the collection of Internet gaming revenue. However, the definition of what is covered under the statute and exceptions to the tax may cause problems in applying it to Internet gaming. Wagers covered by the tax may not be broad enough to include Internet gaming. The definition of “wager” under the statute is limited to:

- (A) any wager with respect to a sports event or a contest placed with a person engaged in the business of accepting such wagers,
- (B) any wager placed in a wagering pool with respect to a sports event or a contest, if such pool is conducted for profit, and
- (C) any wager placed in a lottery conducted for profit.⁵⁹

The clear language of the statute includes sports books within its scope, but not necessarily casino type games.

No cases have decided the issue of whether “contest” in the Federal Wagering Excise Tax Act may be expanded to include casino games. However, the statute has been broadly construed thus far to exclude only bets that are purely social or friendly.⁶⁰ In *United States v. Simon*, the court upheld the appellant’s tax evasion conviction for accepting bets on sporting events.⁶¹ He argued on appeal that he was not in the business of taking wagers because he did not derive most of his living from the wagering business or engage in the business for profit.⁶² The court disagreed stating, “The purpose of the language engaged in the business of accepting wagers was to exclude from coverage of the Act only bets of the purely social or friendly type.”⁶³

In another case, the statute was construed to cover betting that provided intangible benefits such as increased publicity and goodwill instead of direct profit.⁶⁴ The district court held that the application of I.R.C. § 4421 was overbroad in cases where only an indirect profit is realized.⁶⁵ The Court of Appeals reversed, holding, “There is nothing in the word ‘profit’ . . . which indicates that the gain referred to must be derived from the wagering pool it-

shared registration information with state law enforcement authority); *see also* *Grosso v. United States*, 390 U.S. 62 (1968) (expanding holding of *Marchetti* to include monthly payments of Wager Tax since reporting was regularly shared with state prosecuting authorities).

⁵⁷ I.R.C. § 4401(c).

⁵⁸ *Id.*

⁵⁹ *Id.* § 4421(1) (2000).

⁶⁰ *United States v. Simon*, 241 F.2d 308, 310 (7th Cir. 1957).

⁶¹ *Id.* at 312.

⁶² *Id.* at 309.

⁶³ *Id.* at 310 (internal quotation omitted).

⁶⁴ *United States v. D.I. Operating Co.*, 362 F.2d 305 (9th Cir. 1966).

⁶⁵ *Id.* at 306.

self.”⁶⁶ More important for the current discussion, the court examined the legislative intent of the statute and found, “The committee reports . . . reveal that [the excise tax] was intended to make ‘commercialized gambling’ help meet ‘the present need for increased revenue’”⁶⁷

If the language of the wagering tax is interpreted in the same way as language in the Wire Act, the tax will not apply to Internet casino games. The federal Wire Act⁶⁸ contains a similar definition of wager,⁶⁹ and a federal district court in *In re MasterCard* recently held that the Wire Act does not apply to casino style Internet gambling.⁷⁰ Plaintiffs alleged that credit card companies and issuing banks violated the Wire Act by engaging in “a worldwide gambling enterprise” when they assisted Internet casinos in transmission of Internet casino and sports wagers and gambling debt collection.⁷¹ The court held that defendants’ business relationship with Internet casinos did not violate the Wire Act prohibition against transmission of gambling information because the Wire Act prohibition does not include casino gambling or other games of chance.⁷² According to the court, the plain language of the Wire Act treats “event” and “contests” as both being modified by “sporting.”⁷³

The definition of “lottery” in the wagering excise tax statute may also be problematic in applying the wagering tax to Internet gaming. Under the statute, lotteries do not include games in which “the distribution of prizes or other property is made, in the presence of all persons placing wagers in such game.”⁷⁴ This definition excludes any table game or slot machine in a “brick and

⁶⁶ *Id.* at 308.

⁶⁷ *Id.*

⁶⁸ 18 U.S.C. § 1084 (2000).

⁶⁹ The Federal Excise Wagering Tax places a tax on “any wager with respect to a *sports event or a contest.*” I.R.C. § 4421(1) (emphasis added). Similarly, the Wire Act includes within its scope persons who use wire communication facilities to place “bets or wagers on any *sporting event or contest.*” 18 U.S.C. 1084(a) (emphasis added).

⁷⁰ *In re MasterCard Int’l, Inc. Internet Gambling Litig.*, 132 F. Supp. 2d 468 (E.D. La. 2001).

⁷¹ *Id.* at 475 (internal quotation omitted).

⁷² *Id.* at 481.

⁷³ *Id.* at 480. The court also cited case law to support its conclusion. Specifically, the court cited *United States v. Sellers*, 483 F.2d 37, 45 (5th Cir. 1973) (*overruled* on other grounds by *United States v. McKeever*, 905 F.2d 829 (5th Cir. 1990)) (“The statute deals with bookmakers”); *United States v. Marder*, 474 F.2d 1192, 1194 (5th Cir. 1973) (stating the government satisfied the first element of the statute when it proved defendant provided information relative to sporting events); and *United States v. Kaczowski*, 114 F. Supp. 2d 143, 153 (W.D.N.Y. 2000) (finding that plain reading of the statute demonstrates the criminality of placing bets or wagers on any sporting event or contest using interstate or foreign communication). The *in re MasterCard* court went on to discuss recent legislative attempts to amend the Wire Act to include games of chance, and prohibit Internet gambling entirely through the passage of the Internet Gambling Prohibition Act of 1999. *In re MasterCard*, 132 F. Supp. 2d at 480-81.

⁷⁴ I.R.C. § 4421(2)(A)(iii) (2001).

mortar" casino because people are physically present when wagering and when winnings are distributed. However, the statute is still applicable for two reasons. First, lotteries are not the only form of wagering covered under the statute. Wagering on sporting events and contests also falls under the statute. Second, Internet gamblers are not physically present when wagering or when accepting winnings. Therefore, even if Internet gaming is considered a lottery or other similar type of wager, the statute does not preclude collection of the tax because people wagering are only present on the Internet and not physically in the casino.⁷⁵

Several statutory exceptions exist to the § 4401 wager tax.⁷⁶ First, pari-mutuel betting is exempted from the tax.⁷⁷ This exemption is inapplicable to Internet gaming if the bettor is betting against the house and not in a pool with other bettors. The second exemption is for coin-operated devices.⁷⁸ This exemption also does not apply to Internet gaming because the bettor would necessarily be using digital cash, a credit card, or a separate bank account. The final exemption is for state-conducted lotteries and other sweepstakes or wagering pools conducted by an agency of the state acting under state law.⁷⁹ This exemption will not apply to Internet gaming run by private parties like casinos. If states run their own Internet gaming sites, then these sites would be exempt from the § 4401 wagering tax. Such a system would presumably obviate the need for federal intervention provided states allow only their own citizens to play and exclude those who are not permitted.⁸⁰

The wagering excise tax provides an effective means for the federal government to collect revenue from Internet gaming providers. The statute has been tested in the courts and has passed constitutional muster to date.⁸¹ While the definition of activities covered under the wagering tax may need to be expanded to encompass Internet casino gaming, none of the exemptions preclude its application to Internet gaming. However, the states must be able to share in the revenue collected by the federal government in order to make application of § 4401 attractive to the states.

⁷⁵ *Id.* § 4421(2).

⁷⁶ *Id.* § 4402.

⁷⁷ *Id.* § 4402(1).

⁷⁸ *Id.* § 4402 (2).

⁷⁹ *Id.* § 4402 (3).

⁸⁰ See *infra* Part II.B.1 (discussing state police power). Nevada recently enacted a bill to allow Internet gaming by its own citizens provided casinos can exclude minors and people in jurisdictions that do not allow gambling. Bruner, *Net Betting*, *supra* note 6.

⁸¹ See discussion *supra* note 56.

3. Federal Revenue Sharing With the States

Distribution of revenue to the states after collection by the federal government is the next hurdle to a federal regulatory system.⁸² Federal revenue sharing with the states is not a new concept. States receive a large part of their revenues through federal revenue sharing programs initiated in the early part of the twentieth century.⁸³ Revenue sharing programs were developed in response to federal retention of land that had previously been transferred to private use.⁸⁴ Since state and local governments are prohibited from taxing federal land, states were deprived of property tax revenue when the federal government retained lands for national parks and forests.⁸⁵ Congress enacted laws to share national forest timber production and user fees,⁸⁶ onshore mineral production,⁸⁷ federal lands grazing fees,⁸⁸ and payments in lieu of taxes for certain lands held by the federal government⁸⁹ in order to decrease the burden of federal lands on the states.⁹⁰ Some of the revenue sharing laws have been curtailed in recent years because of the federal government's desire to retain revenue and encourage development through preferential leases; however, federal land use revenue sharing remains an important part of state budgets.⁹¹

Congress has also approved revenue sharing among the states where no federal lands were involved. Such sharing of revenues was approved when Congress allowed the formation of the Port Authority of New York and New Jersey.⁹² The Port Authority compact was formed by New York and New Jersey in 1834, and approved by Congress as required under Article 1, § 10 of the Constitution.⁹³ The agreement between New York and New Jersey allows the two states to share "toll revenues to various facilities within the Port Authority's network."⁹⁴

⁸² See discussion *infra* note 130 and accompanying text regarding the tax "nexus" required in order for states to impose a direct tax on out-of-state casinos.

⁸³ Michael E. Shapiro, *Sagebrush and Seaweed Robbery: State Revenue Losses from Onshore and Offshore Federal Lands*, 12 *ECOLOGY L.Q.* 481, 485-87 (1985).

⁸⁴ *Id.* at 485-86.

⁸⁵ *Id.*

⁸⁶ 16 U.S.C. § 500 (2000).

⁸⁷ 30 U.S.C. § 191 (2001).

⁸⁸ 43 U.S.C. § 315 (1986).

⁸⁹ 31 U.S.C. §§ 6901-06 (1983).

⁹⁰ Shapiro, *supra* note 83, at 485-86.

⁹¹ *Id.* at 482-83. The federal government contributed almost \$500 million to states from onshore mineral leasing programs in 1983; approximately \$225 million from forestry leases in 1984; and "over \$100 million as payments in lieu of taxes in 1984." *Id.* at 482.

⁹² N.Y. UNCONSOL. LAW § 6401 n.1 (McKinney 2000) (1834 agreement between New York and New Jersey "consented to by Congress, Act June 28, 1834, c. 126, 4 Stat. 798").

⁹³ *Fort Lee v. Port Auth.*, No. CIV.A.87-1238, 1988 WL 24146, at *3 (D.N.J. Mar. 14, 1988).

⁹⁴ *Id.* at *1.

Congress could act under either federal revenue sharing laws or allow states to pass their own laws regulating Internet gaming. Federal revenue sharing has the advantage of centralized tax collection. Tax statutes, such as the Federal Wagering Excise Tax, would be employed to collect taxes. Gaming taxes could then be distributed to states that allow Internet gaming by their citizens. Federal collection and distribution provides a fairly efficient means of accomplishing the goals of Internet gaming regulation. Federal revenue sharing would also avoid some of the bureaucratic problems that would arise under cooperative agreements among the states.⁹⁵

B. State Regulation

1. The Police Power

States traditionally regulate gambling under their police powers.⁹⁶ The police power allows states to regulate in the interest of the health, safety, morals, and welfare of citizens.⁹⁷ Gambling has historically been regulated by the states under the police power because gambling is considered a vice activity that affects the morality of citizens.⁹⁸ The police power gives states the authority to regulate gaming to the point of completely banning all gaming activity within the borders of the state.⁹⁹

Federal gaming regulation has been designed and used to assist states in enforcing gambling regulations. The federal government yields to the wishes of the states in determining gambling policy because states are better able to determine the will of the people.¹⁰⁰ The federal Wire Act prohibits people in the business of betting and wagering from using wire communications to take bets in interstate or foreign commerce on any sporting event or contest.¹⁰¹ However, the Wire Act has an important exception for the use of wire communication facilities to transmit information to be used for news reporting or to assist bettors in placing bets on

⁹⁵ See discussion *infra* Part III.

⁹⁶ See *supra* note 45.

⁹⁷ See *Berman v. Parker*, 348 U.S. 26, 32 (1954) ("Public safety, public health, morality, peace and quiet, law and order—these are some of the more conspicuous examples of the traditional application of the police power to municipal affairs. Yet they merely illustrate the scope of the power and do not delimit it.")

⁹⁸ See *Thomas v. Bible*, 694 F. Supp. 750, 759-60 (D. Nev. 1988) ("Licensed gaming is a privilege conferred by the state and does not carry with it the rights inherent in useful trades and occupations. . . . Licensed gaming is a matter reserved to the states within the meaning of the Tenth Amendment to the United States Constitution.") (citations omitted); Rose, *Understanding the Law*, *supra* note 6, at 181.

⁹⁹ Peter Brown, *Regulation of Cybercasinos and Internet Gambling*, 547 PLI/Pat 9, 14 (2000). Most states currently allow some form of gambling whether casinos, lotteries, Indian gaming, or, more recently, riverboat casinos. Only two states, Utah and Hawaii, have complete bans on all gambling activities. *Id.*

¹⁰⁰ Goodman, *supra* note 46, at 379.

¹⁰¹ 18 U.S.C. § 1084 (2000).

sporting events between states where such bets are legal.¹⁰² States determine the legality of placing wagers while the Wire Act assists “prohibitionist states in keeping their citizens free from operators based in foreign jurisdictions.”¹⁰³ The Wire Act and other federal statutes do not determine the legality of gambling in any particular state or for the nation as a whole. Rather, federal statutes assist states in effectively enforcing their own laws by providing a federal cause of action against violators whom states would otherwise have difficulty prosecuting.

Several issues arise for states applying the police power to Internet gaming. First, states have a problem with inconsistency. For example, if a state passed a law that criminalized acceptance of wagers by parties located outside the state but allowed acceptance of wagers by casinos inside the state, the effect of the law would be to create a double standard in which the type of activity allowed in the legislating state is prohibited in other states.¹⁰⁴

Such a law would also violate the Dormant Commerce Clause, which prevents states from enforcing laws that facially discriminate against commerce in other states in areas where Congress has not acted.¹⁰⁵ When states pass legislation that facially discriminates against commerce in areas that Congress has not acted, courts will apply strict scrutiny to hold the legislation “virtually per se invalid . . . unless the state can show that [the legislation] advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives.”¹⁰⁶ A state law that allows acceptance of bets by casinos within the state while prohibiting acceptance of bets by casinos outside the state discriminates by restricting commercial activity outside the state while allowing—and possibly encouraging—the same type of activity by casinos located within the legislating state. A law of this type would clearly impact interstate and foreign commerce

¹⁰² *Id.* § 1084(b).

¹⁰³ Rose, *Statutes and International Law*, *supra* note 7, at 237; *see also* United States v. Southard, 700 F.2d 1, 20 (1st Cir. 1983) (“Section 1084 (a) was not passed to protect bettors from their gambling proclivities. Its stated purpose was to assist the states in enforcing their own laws against gambling.”); H.R. REP. NO. 87-967, at 2633 (1961):

The purpose of this legislation is to assist the various States, territories, and possessions of the United States and the District of Columbia in the enforcement of their laws pertaining to gambling, bookmaking, and like offenses and to aid in the suppression of organized gambling activities by prohibiting the use of or the leasing, furnishing, or maintaining of wire communication facilities which are or will be used for the transmission of certain gambling information in interstate and foreign commerce.

Id. (statement of Robert F. Kennedy, Attorney General of the United States).

¹⁰⁴ Rose, *Understanding the Law*, *supra* note 6, at 201.

¹⁰⁵ *Pharmaceutical Research & Mfrs. of Am. v. Concannon*, 249 F.3d 66, 79 (1st Cir. 2001).

¹⁰⁶ *Id.* (internal quotation omitted).

since it would cut off the flow of money from the legislating state to other jurisdictions.

Finally, the police power only gives states the authority to regulate gaming within their borders. It does not provide a workable model that allows states to benefit from the revenues that can be generated by Internet gaming. For such a model, states will have to turn to existing cooperative ventures or build a workable system from the ground up.

2. Multi-State Lotteries

Multi-state lotteries such as Powerball provide a possible model for states to regulate Internet gaming. Multi-state lotteries have become popular in the past ten years because of their promise to provide much needed state funding.¹⁰⁷ The lure of Internet gaming for states is similar, provided states can actually realize revenue from Internet gaming. While multi-state lotteries appear to be an obvious parallel to Internet gaming, important differences preclude using a multi-state lottery type system as a regulatory model for Internet gaming.

a. Structure

Multi-state lotteries are cooperative ventures between states' independent lottery commissions. State lottery associations run multi-state lotteries in their home states, and any revenue generated by the sale of multi-state lottery tickets stays within the state where the ticket is sold.¹⁰⁸ The Multi-State Lottery Association is a non-profit organization owned and operated by the various state lotteries.¹⁰⁹ Powerball, which is run by the Multi-State Lottery Association, is a fifty percent payout game; therefore, states must pay back fifty cents in prize money for every dollar spent on tickets.¹¹⁰ Individual states are responsible for paying small cash prizes, and all of the states contribute to a common prize pool for jackpots.¹¹¹ This arrangement allows states with smaller populations such as Rhode Island and South Dakota to participate in a lottery with a much larger prize pool than can be

¹⁰⁷ Powerball is the largest of the multi-state lotteries. Currently twenty-two states participate in Powerball or other games administered by the Multi-State Lottery Association. States currently participating in the Multi-State Lottery Association are Arizona, Colorado, Connecticut, District of Columbia, Delaware, Indiana, Idaho, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Mexico, Oregon, Rhode Island, South Dakota, Wisconsin, and West Virginia. Multi-State Lottery Association, About MUSL, at <http://www.musl.com/muslabout.shtm> (last visited Mar. 26, 2002).

¹⁰⁸ Multi-State Lottery Association, Frequently Asked Questions, at <http://www.musl.com/faq.shtm> (last visited Mar. 26, 2002) [hereinafter Frequently Asked Questions].

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

generated by the states' residents alone. The payoff for the states is that each state can use the revenue generated by the multi-state lottery in any way its legislature deems appropriate.¹¹²

Despite the fact that multi-state lotteries are obvious cooperative ventures between the states, the lotteries do not appear to be in violation of the Interstate Compacts Clause.¹¹³ No federal courts have ruled on this issue, but in *Tichenor v. Missouri State Lottery Commission*,¹¹⁴ the Supreme Court of Missouri held that Missouri's participation in the Multi-State Lottery Association did not violate the Interstate Compacts Clause because the multi-state lottery was not a threat to the federal government's sovereignty.¹¹⁵ The court reasoned, "The purpose of the federal constitutional provision is to protect the federal government against threats to its sovereignty by reason of combinations of states."¹¹⁶ The multi-state lottery cooperative agreement is not a threat to sovereignty because the agreement exists "to foster a gambling enterprise designed to benefit the treasuries of participating states . . . [but] Congress retains its power to regulate lotteries to the full extent of its delegated powers."¹¹⁷ Congress has not asserted its power to regulate or prohibit multi-state lotteries to date. While questions remain about the constitutionality of multi-state lotteries because of the lack of congressional activity and federal litigation, the states have decided the issue in favor of retaining the lotteries.

b. Applicability: Physical v. Internet Presence and Public v. Private Control

Despite their apparent legality and success in generating revenue, multi-state lotteries do not provide a workable model for Internet gaming revenue collection and allocation. Two problems arise with applying the multi-state lottery model to Internet gaming. First, lottery laws prohibit the purchase of lottery tickets across state lines, while interstate Internet gaming by definition requires the transmission of money and bets across state lines. Second, multi-state lotteries are state run while Internet gaming will be conducted by privately held casinos and bookmakers.

¹¹² Examples of lottery revenue use include "mass transportation in Arizona; economic development in Kansas; natural resources in Minnesota; school aid and crime control in Montana; senior citizens and state parks in West Virginia; [and] property tax relief in Wisconsin." *Id.*

¹¹³ U.S. CONST. art. I, § 10, cl. 3. ("No State shall, without consent of Congress . . . enter into any Agreement or Compact with another State")

¹¹⁴ 742 S.W.2d 170 (Mo. 1988).

¹¹⁵ *Id.* at 176.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

Multi-state lottery tickets must be purchased in a state sponsoring the lottery; the sale of tickets is not permitted over the Internet.¹¹⁸ Lottery tickets may be purchased through the mail or on a subscription basis, but the person ordering the tickets or subscription must live within a state sponsoring the lottery.¹¹⁹ The Multi-State Lottery Association carefully spells out rules regarding transportation of lottery tickets across state or international lines. The Association rules cite 18 U.S.C. § 1301, which provides:

Whoever brings into the United States for the purpose of disposing of the same, or knowingly deposits with any express company or other common carrier for carriage, or carries in interstate or foreign commerce any paper, certificate, or instrument purporting to be or to represent a ticket, chance, share, or interest in or dependent upon the event of a lottery . . . or, being engaged in the business of procuring for a person in 1 State such a ticket, chance, share, or interest in a lottery, gift, enterprise or similar scheme conducted by another State (unless that business is permitted under an agreement between the States in question or appropriate authorities of those States), knowingly transmits in interstate or foreign commerce information to be used for the purpose of procuring such a ticket, chance, share, or interest; or knowingly takes or receives any such paper, certificate, instrument, advertisement, or list so brought, deposited, or transported, shall be fined under this title or imprisoned not more than two years, or both.¹²⁰

The statute is interpreted to include only those who are in the business of selling lottery tickets outside the tickets' state of origin.¹²¹ Therefore, a person who lives in a state that is not part of the Multi-State Lottery Association may purchase a Powerball ticket so long as: it is purchased in a state while physically present in that state;¹²² the purchaser is not purchasing the ticket with the intent to dispose of the ticket in another state; and the entire transaction is completed in the state permitting the lottery.¹²³

Internet gaming, on the other hand, assumes that players will place bets across state lines. In fact, it is the ability of the Internet to communicate rapidly across large distances and jurisdictional lines that makes it such an attractive medium for gaming. Internet technology allows gamblers to place bets in their own homes; whether the state in which the gambler lives has "brick and mortar" casinos or sports books is immaterial. The Internet gambler does not have to physically cross state lines in order to

118 Frequently Asked Questions, *supra* note 108.

119 *Id.*

120 18 U.S.C. § 1301 (2000).

121 Frequently Asked Questions, *supra* note 108.

122 *Id.*

123 *Id.*

place a wager as a lottery player would do if his or her home state did not have a lottery. If an Internet gaming company accepts bets from out of state residents, it is guilty of the very conduct the Multi-State Lottery Association seeks to avoid by restricting sales of lottery tickets to physical purchases within states that license or sponsor lottery games.

The second major difference between multi-state lotteries and Internet gaming is that the lotteries are owned and administered by state governments,¹²⁴ while Internet gaming sites are generally owned and operated by privately held corporations. For example, Rupert Murdoch is heavily invested in Sports Internet Group PLC, an Australian company that takes wagers from people in the United States;¹²⁵ Ladbroke's, Coral, Stanley Leisure, and William Hill are Britain's largest bookmakers, and all plan to close their offshore Internet operations and open sites in Britain as soon as a regulatory system is in place,¹²⁶ and casinos in the United States support regulation of Internet gaming so they can open sites and capitalize on additional revenues.¹²⁷ No current plans exist for state run casinos or Internet gaming sites.

The fact that Internet gaming will be a private enterprise complicates any regulatory scheme and makes imposing a system similar to the multi-state lottery difficult. States that allow multi-state lotteries have direct control over the lottery in their own state, and each state owns a share in administrative bodies such as the Multi-State Lottery Association.¹²⁸ States will not have the same type of direct control over for-profit Internet casinos or sports books in other states. At the very least, Internet gaming will force states to impose one more level of regulation such as a compact for collection of revenues between a state that allows casino gaming and a state that allows its residents to place wagers in another state via the Internet.

An illustration of the differences and complications may be helpful. Under the multi-state lottery system, Rhode Island sells Powerball tickets and keeps the revenue from those tickets with the exception of money that must be paid into the common jackpot prize pool.¹²⁹ Rhode Island does not have to depend on any other state for collection of lottery revenue. Conversely, if Rhode Island allowed Internet gaming but did not allow physical full service casinos, it would have to contract for collection of revenue with a state that allows physical casinos such as Nevada. Rhode Island

¹²⁴ See generally KAN. STAT. ANN. § 74-8731 (2000); Louisiana Lottery Corporation, at <http://www.lalottery.com/about.html> (last visited Mar. 26, 2002).

¹²⁵ Rose, *Understanding the Law*, *supra* note 6, at 205.

¹²⁶ Brunner, *Britain Embraces*, *supra* note 1.

¹²⁷ Brunner, *Online Gambling*, *supra* note 17.

¹²⁸ See discussion *supra* Part II.B.2.

¹²⁹ Frequently Asked Questions, *supra* note 108.

cannot impose a direct tax on Nevada casinos since Rhode Island does not have a sufficient “tax nexus” with Nevada casinos.¹³⁰ Rhode Island would also have difficulty determining the amount of Internet gaming by its citizens in Nevada. Therefore, Rhode Island would have to depend on Nevada to regulate casinos and turn over revenue generated by Rhode Island bettors. Such a system is complicated for states whose citizens place bets and for states taking bets over the Internet since those states will have a reporting responsibility to other states.

III. PROPOSALS FOR INTERNET GAMING TAX REGULATION

Most scholarship on Internet gaming to date has focused on the merits of prohibition versus regulation or the difficulty of enforcing a ban on Internet gaming; little attention has been given to the positive impacts of workable regulation and what might constitute workable regulation. Articles that focus on regulatory models do not provide sufficient incentive for states to adopt regulation.¹³¹ In order for well regulated Internet gaming to become a reality in the United States, states must be able to realize some benefit from allowing their citizens to place wagers via the Internet. Each of the following proposals would allow state and federal governments to realize revenue from Internet gaming, while maintaining states’ traditional authority to regulate gaming under the police power.

A. Opt In Provisions for the States

Congress could amend the Federal Wager Excise Tax¹³² to include a provision for states to “opt in” to a federal tax collection program on Internet gaming sites. At the same time, Congress

¹³⁰ See Tom W. Bell, *All's Not Fair in Internet Tax Wars: Those Buying Over the Web Shouldn't Pay for Unused Infrastructure*, L.A. DAILY J., Feb. 1, 2001, at 6, available at <http://www.tomwbell.com/writings/TaxWars.html>. Bell argues that a long standing Supreme Court precedent prohibiting states from collecting taxes on purchases made by consumers in states where retailers do not have a physical presence should be applied to Internet purchases because purchases over the Internet consume fewer public services than purchases made in traditional malls and shopping centers. Similarly, Internet casinos do not place the same strain on public services as physical casinos, and states that only allow gaming over the Internet will not have sufficient contacts with gaming providers to enforce tax laws. *Id.*

¹³¹ See Michael P. Kailus, *Do Not Bet on Unilateral Prohibition of Internet Gambling to Eliminate Cyber-Casinos*, 1999 U. ILL. L. REV. 1045, 1068 (1999). Kailus proposes a “Seal of Approval” regulatory model for Internet casinos. *Id.* at 1080. Under this model, Internet casinos that meet licensing requirements would receive a “Seal of Approval” from the regulatory body. *Id.* In order to obtain a license, operators would have to “demonstrat[e] a clear ability to provide major prizes as promised to players” and undergo background checks. *Id.* The problem with this model is that there is no incentive for states to adopt regulation as opposed to an outright ban. The model provides some protection for consumers, but states can achieve the same protection through a ban.

¹³² I.R.C. § 4401 (West 2002).

could amend the statute to allocate a percentage of the tax to states that allow their citizens to gamble on the Internet. Under this regulatory model, the Internal Revenue Service would collect taxes from Internet gaming providers. Providers would be under an obligation to report all Internet wagers and pay taxes on those wagers much as casinos currently report income and pay taxes. Electronic records of all wagers placed over the Internet would facilitate reporting.¹³³

A federal “opt in” program has two primary advantages. First, much of the legal and bureaucratic infrastructure needed to collect and distribute tax revenue is already in place; the modification should not impose significant new costs. The Federal Wager Excise Tax, with minor modification, is applicable to Internet gaming, and the federal government already has sophisticated revenue sharing programs with the states. The method of taxation and distribution of funds from Internet gaming would not be significantly different from methods employed for collection and distribution of mineral, timber, and grazing fees. The second advantage to an “opt in” program is that states maintain their police powers by having the choice of whether to allow citizens to gamble on the Internet. By using registration software, casinos will be able to determine the origin of wagers to make sure people are not placing wagers from states that do not wish to participate in the program. Of course, citizens of those states will still be able to access offshore Internet gaming sites, but they will not enjoy the protections of highly regulated American casinos.

B. State Distribution Under Federal Supervision

Another possible regulatory model would be to have states with casinos collect and distribute taxes to states that allow Internet gaming. The primary advantage to this model is that it leaves the majority of regulation in the hands of the states. States would decide whether to allow Internet gaming, and they would negotiate with provider states for the best possible deal. As with the “opt in” model, casinos would have electronic records that facilitate accounting.

The problem with this model is that transaction costs to the states will be higher. Provider states will have to account for wagers placed by citizens of non-provider states, and non-provider states will have to make sure provider states are being honest in their accounting. Mistrust between the states could lead to increased litigation among the states over gaming revenues. State-run regulation will also increase transaction costs by forcing states to enter and administer multiple compacts between pro-

¹³³ Schneider testimony, *supra* note 40.

vider and non-provider states. Not only would provider states have compacts with each non-provider state that allowed its citizens to gamble on the Internet, non-provider states would also enter multiple compacts with provider states. This may lead to a sort of forum shopping wherein one provider state would promise higher returns than another and non-provider states would use existing compacts to coerce better returns. A state-run system would likely prove to be too complicated and too contentious to help states effectively achieve their regulatory goals.

IV. CONCLUSION

Internet gaming is not an issue that will simply go away. Internet casinos have emerged as the newest form of gambling, and there is no indication that the number of sites offering gambling will decrease. Americans are unlikely to curtail their gaming activities on the Internet.¹³⁴ The likelihood of legalization of Internet gaming gives rise to the need for regulation. Congress and the states must change their attitude toward Internet gaming in order to prevent underage and problem gambling and insure fair games on the Internet. However, lawmakers will not be willing to make these changes unless they have some incentive.

Existing laws allow the federal government to collect and distribute revenue from Internet gaming. Employing the Federal Wager Excise Tax and revenue sharing statutes is the most efficient means of providing legislatures with the incentive they need. States will maintain their traditional police power to regulate gambling within their borders by choosing whether they wish to "opt in" to the federal program. States could also expect the assistance of gaming providers who have an interest in keeping their licenses and realizing additional profits. This incentive will encourage providers to develop better software that will curtail underage and problem gambling.

Cooperation by private, federal, and state entities is the best, and possibly only, way to control burgeoning Internet gaming. Regulation by state and federal governments would allow reliable operators to open gaming sites in the United States that offer greater consumer protection and encourage bettors to place wagers at domestic casinos. Federal and state governments could then tax operators and realize revenue from an otherwise untapped source. Now is the time to take the necessary steps to keep more revenue from going to offshore sites.

¹³⁴ See generally NGISC FINAL REPORT, *supra* note 13, at 2-15 to 2-16; Jon Baumgarten et al., *Washington Watch*, CYBERSPACE LAW, vol. 6 No. 6, at 13 (2001).