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Memorandum**

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subject: Daily Fantasy Sports and the Excise Taxes on Wagering

This Generic Legal Advice Memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether an organization involved in the operation of daily fantasy sports (DFS or DFS operator) is liable for the excise tax on wagers under IRC § 4401.
2. Whether a DFS operator is liable for the occupational excise tax imposed under IRC § 4411 and is required to register under IRC § 4412.
3. If the answer to issues 1 and 2 are yes, whether the DFS operator is liable for the excise tax on wagers and the occupational excise tax at the authorized or unauthorized rate described in IRC §§ 4401(a) and 4411(a) and (b).

CONCLUSIONS

1. A DFS operator is liable for the excise tax on wagers under IRC § 4401.
2. A DFS operator is liable for the occupational excise tax under IRC § 4411 and is required to register under IRC § 4412.
3. The rate of tax IRC § 4401(a) imposes on wagers accepted by a DFS operator depends on whether the wager is accepted in a state in which the wager is authorized. The rate of occupational tax IRC § 4411 imposes on a DFS operator depends on whether the DFS operator accepts only state authorized wagers under IRC § 4401(a)(1).

BACKGROUND

In general, fantasy sports are games where participants assemble simulated, “fantasy” teams with rosters of actual players from the real teams in a particular sports league (such as the National Football League (NFL) or the National Basketball Association (NBA)). The participants accumulate points based on the actual game performances of the selected players. Scoring is based on the selected players’ performance statistics or measures which are converted into points. Each participant will then receive a total fantasy score that is determined by compiling the individual fantasy scores of each player in the participant’s roster or lineup. The participants compete against one another based on the total fantasy score.

Traditionally, fantasy sports have been typically played among a group of people such as family members, friends, or coworkers over the course of a league’s season. At the beginning of the season, the fantasy league holds a “draft” during which each participant selects professional sports players one-by-one to create their fantasy team. Each player may only be selected once by one fantasy participant, but throughout the season participants may trade, drop, or add players as they become available. Each week the fantasy teams match up against each other, accumulating fantasy wins and losses depending on how well each of their fantasy players did, statistically, in their real-life sports games that week. At the end of the season, the participant with the most cumulative points wins the fantasy season.

Around 2007, companies began offering a new form of fantasy sports, played exclusively on-line, that are now called daily fantasy sports. The details of these DFS games are outlined in the Facts section, below. Traditional fantasy and DFS have some similarities. In both, once a participant selects a roster or lineup and the lineup is locked, the participant has no ability to control the outcome of the simulated contests. The points a participant earns are based upon the performance of the actual players in actual sporting events. The participant has no control over the players’ performances in the actual game, no control over the outcome of the actual game, and no ability to influence the outcome of the simulated contest. How well a participant does is based on selecting the sports players with the best statistics for the duration of the contest.

DFS, however, has many key differences from traditional fantasy games. For example, DFS contests typically occur daily, and the participants tend to be a much larger group of strangers. Rather than a draft, each DFS participant is given an equal amount of fictitious money known as a “salary cap.” The DFS operator sets each player’s “salary” or “price” commensurate with the player’s perceived value, not unlike how bookmakers set wagering odds in traditional sports gambling. Participants may select the same players for their fantasy teams as other participants so long as selections do not exceed a participant’s salary cap.

Another important distinction between traditional fantasy and DFS is the treatment of the entry fee associated with each. Although participants in both types of fantasy sports

typically pay a fee to participate, this pool of money is generally given entirely to the winner or winners of the traditional fantasy league. In contrast, in DFS, a portion of the fees collected is not paid out to the winner or winners, but is retained by the DFS operator.

FACTS

DFS contests take place on a DFS operator's website and are accessed by DFS participants (also called customers, clients, etc.) via computer or mobile software applications. DFS operators' offerings cover a number of actual professional sports leagues, including the NFL, MLB, NBA, WNBA, NHL, MLS, PGA, MMA, and NASCAR, as well as college sports such as NCAA football and basketball, and some e-sports. DFS operators may offer new types of games involving other sports leagues as well. DFS operators conduct their operations (that is, accept participants) in multiple states within the United States. Many DFS operators offer various types of DFS contests on their websites, including the following:

- **Guaranteed prize pools:** Participants pay a set entry fee to compete against large fields (in some cases, hundreds of thousands of contest participants) for a share of a fixed prize pool. A participant's winnings, if any, are dependent on their respective rankings against the field upon the completion of the contest.
- **50/50:** Participants who score in the top half of the contestant field are winners. Generally, all winners are awarded the same amount regardless of their respective rankings. The bottom half of the contestant field receives nothing. One popular variation of this type of contest is called Multipliers, in which the top portion contestants (e.g., top half, top third, top quarter, etc.) win two, three, or four times the amount paid to enter the contest in accordance with a preannounced prize structure.
- **Head-to-Head:** Generally, these contests involve two participants in direct competition. The winner receives the entire prize pool (less a commission or fee paid to the operator of the contest).
- **Leagues:** Also known as Private Contests, Leagues are participant-created contests allowing participants to compete in a variety of game types while restricting participation to individuals by invitation from the participant.

For contests involving guaranteed prize pools, a typical DFS operator will set the prize pool such that it retains a commission ranging from 6% to 14%. For 50/50 and Head-to-Head contests, a typical DFS operator will take a fee ("rake") from every participant who participates. For example, in a 100 person, 50/50 contest with a \$10 entry fee, the 50 highest scoring participants would receive an average of \$18, the 50 lowest scoring participants would receive \$0, and the DFS operator would keep \$100 as a rake. Leagues, or private contests, operate in a similar fashion except that the participant that starts the league sets the payout rules (rather than the DFS operator) and only individuals invited by that participant have access to join the league. Some DFS operators may receive a percentage or flat rake on such contests.

In order to participate in a contest on a DFS operator's website, a participant must register for an account. At the time of registration, the participant provides a username and password to be used in conjunction with the account. The participant may deposit funds into a separate, segregated account held by a DFS operator (or a related entity). The funds in this segregated participant account are intended solely to be used to enter paid contests on the DFS operator's website. The funds in the segregated participant account belong to the participant (including deposits and participant winnings) and may not be used by the DFS operator to cover its operating expenses or for any other purposes.

When a participant enters a (non-free) contest, the amount of the entry fee is debited from the participant's segregated account. If a participant wins a prize as a result of a contest, the amount of the prize is added to the participant's account balance. The participant is responsible for all taxes associated with the receipt of any prize. The relationship between the participant and the DFS operator generally is governed by a terms of use document. The participant may withdraw funds from the segregated participant account at any time.

The DFS operator, upon debiting the amount of an entry fee from a participant's segregated account, deposits the amount in its own account and records the amount as cash revenue on its books. Upon the completion of a contest, the DFS operator deposits any contest winnings into the winning participants' respective segregated accounts and deducts those amounts from its own revenue for book purposes. The DFS operator uses a net contest revenue method (generally entry fees less winnings less incentives) to report gross receipts. Support for this method is found under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 605, superseded by FASB ASC 606, which provides a framework for revenue recognition used by DFS operators.

LAW

Relating to the Excise Taxes on Wagering

IRC § 4401 generally imposes a percentage tax on every wager. The tax is imposed on the person who is engaged in the business of accepting wagers, and the percentage amount depends on whether the wager is authorized by the state in which it is accepted, or whether the wager is unauthorized.

IRC § 4402 generally provides exemptions for parimutuel wagering licensed under state law, coin-operated (or similar) devices, and state-conducted lotteries.

IRC § 4411 imposes an annual occupational tax on each person who is liable for the tax imposed by IRC § 4401.

IRC § 4412 requires each person required to pay tax under IRC § 4411 to register with the Internal Revenue Service.

IRC § 4421(1) defines wager as (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.

Treas. Reg. § 44.4401-1(b)(2) of the Wagering Tax regulations provides in relevant part that the amount of the wager is the amount risked by the bettor, including any charge or fee incident to the placing of the wager rather than the amount which the bettor stands to win.

Treas. Reg. § 44.4401-2(b) provides that a person is engaged in the business of accepting wagers if the person makes it a practice to accept wagers with respect to which the person assumes the risk of profit or loss depending upon the outcome of the event or the contest with respect to which the wager is accepted.

Treas. Reg. § 44.4421-1(b)(1) provides in part that a lottery conducted for profit includes any scheme or method for the distribution of prizes among persons who have paid or promised a consideration for a chance to win such prizes.

Treas. Reg. § 44.4421-1(c)(1) provides that a wagering pool conducted for profit includes any scheme or method for the distribution of prizes to one or more winning bettors based upon the outcome of a sports event or contest, or a combination or series of such events or contests, provided that such wagering pool is managed and conducted for the purpose of making a profit.

Edgewood Am Legion Post No. 448 v. United States, 246 F.2d 1 (7th Cir. 1957), considered wagering taxes paid by an organization operating a lottery and a baseball pool. The taxpayer argued the proceeds relating to the baseball pool were not subject to tax because the operation did not constitute a wager placed in a wagering pool under the definition of IRC § 3285 (the predecessor to IRC § 4401). The court stated:

[The taxpayer's] argument is based on the theory that the winner was determined by the number of runs scored in baseball games during the season rather than on the result of any particular game; that during the non-baseball season the winner depended upon the result of certain games played during the previous season, the games used being determined with reference to bank clearings, and that on Saturdays and Sundays, when no bank clearings were available, a pea-shake was employed to determine the day of the previous baseball season to be used. This argument is little more than an exercise in semantics and in our view is without merit. The operation constituted a wagering pool, the winner of which was determined

by reference to the happenings of a sports event. The particular manner in which such event was used in determining the winner is beside the point.

Rev. Rul. 69-21, 1969-1 C.B. 290, describes a “baseball pool.” During baseball season, the winner of the pool is determined by the result of the baseball games played each day, and during the off-season period, the winner is determined by the daily bank clearings used in conjunction with the results of the prior season’s games. Rev. Rul. 69-21 does not give any additional detail on how participants place wagers, how winners are selected, and whether or how the baseball pool operator retains a rake, or commission, on the wagers. The ruling concluded that the baseball pool constituted a lottery for profit.

Rev. Rul. 57-521, 1957-2 C.B. 779, describes a puzzle game with entry fees and guaranteed payments to winners. The ruling stated that contesting for a prize offered by another in a contest of mental or physical skill of the contestant, which the one offering the prize must award in any event, is not gaming; and, the fact that each contestant is required to pay an entrance fee does not make the payment a bet or gaming transaction unless the entrance fees alone comprise the prize to be won by the successful contestant. Additionally, the operator has obligated itself to pay a sum certain in prizes which is not contingent on the number or amount of entrance fees. The ruling concluded that the puzzle game was not a wagering pool or lottery within the meaning of IRC § 4421.

Relating to Gambling Generally

The Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA), 31 USC §§ 5361-5367, generally prohibits gambling businesses from knowingly accepting payments in connection with the participation of another person in a bet or wager that involves the use of the internet and that is unlawful under any federal or state law. The UIGEA defines the term wager to include risking something of value on the outcome of a sporting event but it has a specific carve-out for fantasy sports in 31 USC § 5362(1)(E)(ix). The UIGEA carve-out provides that the term “bet or wager” does not include participation in any fantasy or simulation sports game or educational game or contest in which (if the game or contest involves a team or teams) no fantasy or simulation sports team is based on the current membership of an actual team that is a member of an amateur or professional sports organization. In order to meet this definition, fantasy sports games must also comply with the following conditions: (I) All prizes and awards offered to winning participants are established and made known to the participants in advance of the game or contest and their value is not determined by the number of participants or the amount of any fees paid by those participants, (II) All winning outcomes reflect the relative knowledge and skill of the participants and are determined predominantly by accumulated statistical results of the performance of individuals (athletes in the case of sports events) in multiple real-world sporting or other events, (III) No winning outcome is based--(aa) on the score, point-spread, or any performance or performances of any single real-world team or any combination of such

teams; or (bb) solely on any single performance of an individual athlete in any single real-world sporting or other event.

Individual states vary in their regulation of DFS. Some states have determined that DFS is illegal gambling under state law. Other states have enacted legislation stating that DFS is a game of skill, not gambling, often to decriminalize the activity under state law. Still other states enacted legislation simply stating that DFS is not gambling (without opining on whether DFS is a game of skill). Some states have taken no position specifically relating to DFS.

ANALYSIS

Issue 1: Whether a DFS operator is liable for the excise tax on wagers under IRC § 4401.

In order for DFS activities to be considered taxable wagers, the entry fee must fall into the definition of a “wager” under IRC § 4421(1). The term wager means any wager with respect to a sports event or a contest placed with a person engaged in the business of accepting such wagers, any wager placed in a wagering pool with respect to a sports event or a contest if such pool is conducted for profit, and any wager placed in a lottery conducted for profit.

All three definitions of “wager” in IRC § 4421 start with “the term wager means any wager.” When a term is not defined, we must apply the term’s “plain, obvious, and rational meaning.” *Tschetschot v. Comm’r*, T.C. Memo 2007-38 (2007) (citing *Liddle v. Comm’r* 103 T.C. 285 (1994)). The *Tschetschot* court said, “According to the dictionary, a ‘wager’ is defined as ‘something risked or staked on an uncertain event’ or ‘a bet.’ Random House College Dictionary (1968). Similarly, ‘to wager’ is defined as: (1) Something risked or staked on an uncertain event; bet; (2) the act of betting. Random House College Dictionary (1973).” *Id.*

A DFS entry fee fits into the definition of wager under both IRC § 4421(1)(A) and (B). A DFS entry fee is a wager of money by the participant with respect to a sports event or contest placed with a person engaged in the business of accepting such wagers (the DFS operator) as described in IRC § 4421(1)(A).

A DFS entry fee is also a wager placed in a wagering pool as described in IRC § 4421(1)(B) and Treas. Reg. § 44.4421-1(c)(1). The DFS entry fee is the wager. The entry fees are placed in a common fund with the other participants’ DFS entry fees – this is the wagering pool. The successful bettor (or bettors) receive the pool proceeds, subject to the DFS operator’s commission. The game involves each selected fantasy player’s performance in a real sports event. Finally, the DFS operators derive profit from their operation of DFS by retaining a commission or taking a fee (the rake) from every participant who participates, meaning the wagering pool is conducted for profit.

The Seventh Circuit's decision in *Edgewood Am Legion Post No. 448 v. United States* supports this conclusion. It determined that even though the result of any particular baseball game was irrelevant to the baseball pool, the fact that the winner was determined by reference to a sports event was enough to make the baseball pool into a wagering pool within the meaning of the wagering tax rules. Similarly, in Rev. Rul. 69-21, entries into a baseball pool were considered taxable wagers placed in a lottery conducted for profit.

A DFS operator may try to differentiate taxable wagers from non-taxable entry fees into skill-based contests. In state courts and state legislature discussions of DFS, the issue of DFS's legality within each state typically turns on whether DFS is a game of skill or a game of chance (that is, gambling) under the state's laws. While these state rules are helpful context, the statutory language in IRC §§ 4401 and 4421 does not differentiate whether an activity involves skill, chance, or some combination of the two. Most importantly, whether DFS is a game of skill for state gambling statute purposes is not relevant for determining whether DFS is wagering for federal excise tax purposes.

Still, the presence or absence of skill in a contest may help determine whether an entry fee constitutes a taxable wager, or not. In Rev. Rul. 57-521 a puzzle contest, in which the element of skill rather than that of chance determined the winners, was not a wagering pool or lottery. The ruling noted that skill is a component of determining whether a contest is a "gaming transaction."

In the puzzle contest described by Rev. Rul. 57-521, there was only one correct answer to each puzzle. Additionally, the contest participant solved the puzzles. This is not like DFS. If the puzzle in the revenue ruling was similar to DFS, the contestant would choose a person or persons from a field of puzzle solvers who the contestant believed had the greatest chance of solving the most puzzles and would be wagering based on that person or persons' expected performance. In the revenue ruling, the contest participant's own skill was the only factor involved in winning the puzzle game and there was no chance element at all. In contrast, DFS participants merely select a lineup for their simulated teams and have no ability to exercise control or influence over the actions of the players participating in the game and who earn the participants their fantasy points. DFS participants may be educated on the sports games, players, expected weather conditions, and other factors. Regardless of how educated a DFS participant is, their chosen player(s) may perform poorly that day, become injured, not play in a given game, or be affected by uncontrollable circumstances such as weather and officiating. The existence of chance indicates that DFS contests are distinguishable from the type of contest described in Rev. Rul. 57-521. We conclude that the "skill" involved in selecting fantasy players is similar to the skill involved in selecting winners of individual professional sports games, horse races, or other traditional sports gambling activities.

A DFS operator may argue that the UIGEA legalized fantasy sports and exempted DFS from the definition of wagering within the United States. For purposes of UIGEA, the

term “bet or wager” does not include participation in any fantasy or simulation sports game or educational game or contest in which (if the game or contest involves a team or teams) no fantasy or simulation sports team is based on the current membership of an actual team that is a member of an amateur or professional sports organization and that meets certain conditions. UIGEA was enacted in 2006, prior to the proliferation of DFS, and referred to traditional fantasy sports. Further, in its introductory section, UIGEA states: “No provision of this subchapter shall be construed as altering, limiting, or extending any Federal or State law or Tribal-State compact prohibiting, permitting, or regulating gambling within the United States.” 31 USC § 5361(b). Thus, UIGEA neither renders legal nor illegal any form of gambling within the United States; UIGEA simply provides “[n]ew mechanisms for enforcing gambling laws on the Internet [that] are necessary” because “traditional law enforcement mechanisms [were] often inadequate for enforcing gambling prohibitions or regulations on the Internet, especially where such gambling crosses State or national borders.” 31 USC § 5361(a)(4).

Based on the foregoing, we conclude that any entry fee for a DFS contest constitutes a taxable wager under IRC § 4421. Any DFS operator in the business of accepting taxable wagers is liable to pay the wagering excise taxes on entry fees/wagers it receives.

Issue 2: Whether a DFS operator is liable for the occupational excise tax imposed by IRC § 4411 and is required to register under IRC § 4412.

IRC § 4411(a) imposes an occupational excise tax of \$500 per year to be paid by each person who is liable for the tax imposed under IRC § 4401, or who is engaged in receiving wagers for or on behalf of any person so liable. IRC § 4411(b), however, substitutes “\$50” for “\$500” in the case of any person whose liability for tax is determined only under IRC § 4401(a)(1) (that is, for wagers authorized under state law).

IRC § 4412(a) provides that each person required to pay the occupational excise tax under IRC § 4411(a) shall register with the Service: (1) his name and place of residence; (2) if he is liable for the excise tax on wagers, each place of business where the activity is carried on, and the name and place of residence of each person who is engaged in receiving wagers for him or on his behalf, and (3) if he is engaged in receiving wagers for or on behalf of any person liable for the excise tax on wagers, the name and place of residence of each such person.

Because a DFS operator is liable to pay excise taxes on wagers, we conclude that each DFS operator is liable to pay the occupational excise tax imposed under IRC § 4411 and is required to register under IRC § 4412 as a person liable for the tax imposed under IRC § 4401.

Issue 3: Whether a DFS operator is liable for the excise tax on wagers and the occupational excise tax at the authorized or unauthorized rate described in IRC §§ 4401(a) and 4411(a) and (b).

Because we have determined that DFS entry fees are taxable wagers under IRC §§ 4401 and 4421, we must evaluate whether the authorized or unauthorized rate of tax applies. IRC § 4401(a)(1) imposes an excise tax of 0.25 percent of the amount of the wager on any wager authorized under the law of the state in which accepted. IRC § 4401(a)(2) imposes an excise tax of 2 percent of the amount of any other wager (any unauthorized wager). Generally, the person who is engaged in the business of accepting wagers is liable for the tax. We conclude that any DFS operator that accepts wagers is subject to the authorized rate under IRC § 4401(a)(1) for each wager that is accepted in a state in which DFS is authorized under state law. If DFS is not authorized under state law and a DFS operator accepts a wager in such a state, such wager is subject to the unauthorized rate under IRC § 4401(a)(2).

IRC § 4411 imposes an annual occupational tax on each person who is liable for the tax imposed by IRC § 4401 or who is engaged in receiving wagers for or on behalf of any such person. Like in IRC § 4401, the rate of tax depends on whether the wagers received are authorized under the law of the state in which accepted, or not. We conclude that any DFS operator that accepts only authorized wagers under IRC § 4401(a)(1) is an authorized person subject to the occupational tax at the rate described in IRC § 4411(b) (\$50). Any other DFS operator accepting taxable wagers is subject to the occupational tax at the rate described in IRC § 4411(a) (\$500).

Please call (202) 317-6855 if you have any further questions.