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TAXATION OF GAMBLERS: THE HOUSE ALWAYS WINS

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Abstract

Gambling is everywhere. Whether it takes place in a casino, on the internet, or even on a cell phone, there is no shortage of venues for the avid gambler. With the rapid expansion and geographical spread of gambling activities in the United States and abroad, gamblers must understand the tax consequences of their gaming. For the professional, expenses incurred in his or her occupation are deductible but, like losses from wagering transactions, are limited to wagering gains. Recreational gamblers can also deduct wagering losses to the extent of gains, but expenses incurred in pursuit of their pastime (or compulsion) are nondeductible personal expenses. Explored in this Article are such topics as the computation and characterization of wagering gains, the treatment of cancellation of gambling indebtedness, the deductibility and substantiation of wagering losses, the classification and taxation of professional and amateur gamblers, the use of other tax entities to maximize the wagering loss deduction, and the deductibility of the cost of charity lotteries and raffles. This survey of tax laws and procedures as they relate to gamblers is designed to inform such risk takers of the tax consequences of their wagering activities and to encourage both professional and casual gamblers to keep detailed, contemporaneous records of their wins and

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losses. If a gambler is unlucky, the Internal Revenue Service will reconstruct gambling income, disallow wagering losses, and—if the gambler is very unlucky—impose a multitude of tax penalties.

Table of Contents

I. Introduction

> Gambling is apparently as old as the human race. The practice runs back through recorded history until it is lost amid the mysteries of tradition. It affects people in all latitudes, longitudes and stages of civilization.[1]

1. Skeeles v. United States, 95 F. Supp. 242, 242 (Ct. Cl. 1951).

"Legal gambling is a multi-billion-dollar industry that has proliferated across the country and has become a major source of adult entertainment."[2] In 2016, the U.S. gaming industry generated $73.1 billion in revenue, marking the seventh consecutive year of growth for the overall industry and the second time the industry surpassed $70 billion in total gaming revenue.[3] The U.S. commercial casino gaming segment of the industry generated a record $38.7 billion in revenue with 581 casinos across twenty-four states.[4] While only three states have legalized online gaming, the iGaming segment of the industry generated $212.2 million in revenue in 2016, the third full year of gaming operations.[5] Tribal gaming generated an estimated $30.7 billion in revenue marking the seventh consecutive year of growth in that segment of the industry.[6] Limited stakes gaming, representing gaming machines at taverns, restaurants, and travel centers, generated $3.5 billion in revenue in 2016.[7]

With such dramatic growth of the gaming industry, the tax consequences to an individual, whether visited or abandoned by Lady Luck, must be examined. This Article explores the tax treatment of gamblers: professional gamblers, who are engaged in the trade or business of gambling, and recreational gamblers, who are not. Both professional gamblers and recreational gamblers must include gambling winnings in income for tax purposes, raising issues as to the methods used for the computation of wagering gains by gamblers and the reconstruction of wagering gains by the Internal Revenue Service (I.R.S. or Service). The characterization of gambling winnings and the cancellation of gambling indebtedness has recently generated conflicting results among the courts, thus warranting discussion. Penalties, both civil and criminal, which often attach to the under-inclusion of gambling income and the over-statement of gambling losses, are also examined.

Internal Revenue Code (I.R.C.) § 165(d) states that losses from "wagering transactions" are deductible only to the extent of gains from "wagering transactions." Thus, identifying the types of activity that constitute wagering transactions is a threshold question. As to both gains and losses from wagering transactions, contemporaneous documentation is

2. Libutti v. Comm'r, 71 T.C.M. (CCH) 2343, 2343 (1996).

3. *2017 Gaming Statistics*, RUBINBROWN 3 (Apr. 1, 2017), http://www.rubinbrown.com/Gaming_Stats.pdf.

4. *Id.* at 3.

5. *Id.* at 5.

6. *Id.* at 4.

7. *Id.*

unequivocally necessary. This Article reviews guidelines established by the Service and courts for keeping the necessary books and records to substantiate wagering gains and losses. Further, the successful use of other tax entities by taxpayers to maximize the deduction of wagering losses is also discussed.

The distinction between professional gamblers and recreational gamblers becomes pivotal in the computation of the gambler's taxable income. Distinguishing between professional and recreational gamblers is a factual determination, aided by court decisions and Treasury regulations. Although wagering losses are limited to wagering gains, a professional gambler can also deduct gambling-related expenses incurred in the business of gambling to the extent of wagering gains. Nonprofessional gamblers are limited to the deduction of gambling losses to the extent of gains, which are treated as itemized deductions. Finally, the Article examines whether purchasers of lottery or raffle tickets may claim a charitable contribution deduction.

II. Inclusion of Wagering Gains into Income

Gross income includes income "from whatever sources derived."[8] Thus, gains realized from wagering transactions are included in the gross income of a gambler,[9] whether the wagering activity is legal or illegal.[10] Gambling

8. I.R.C. § 61(a). The Supreme Court liberally defined income to include all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

9. I.R.C. § 61(a); Rev. Rul. 54-339, 1954-2 C.B. 89; Umstead v. Comm'r, 44 T.C.M. (CCH) 1294, 1294 (1982); Dunnock v. Comm'r, 41 T.C.M. (CCH) 146, 146 (1980). The taxpayer must include in income *all* gambling winnings, not just gambling winnings to the extent gambling winnings exceed gambling losses. McClanahan v. United States, 292 F.2d 630, 631-32 (5th Cir. 1961). A recreational gambler must report gambling income on Form 1040 as "Other Income." INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 525, TAXABLE AND NONTAXABLE INCOME 31 (Jan. 23, 2017), https://www.irs.gov/pub/irs-pdf/p525.pdf. A professional gambler must report gambling income on Form 1040, Schedule C. *See* INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 334, TAX GUIDE FOR SMALL BUSINESS (Jan. 27, 2017), https://www.irs.gov/pub/irs-pdf/p334.pdf [hereinafter IRS PUB. 334, TAX GUIDE FOR SMALL BUSINESS]. I.R.C. § 3402(q)(1) requires the withholding of taxes on certain gambling winnings at a rate equal to the "third lowest rate" under I.R.C. § 1(c), or, if not subject to withholding, I.R.C. § 6654 may require the payment of estimated taxes during the tax year prior to filing a return. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 505, TAX WITHHOLDING AND ESTIMATED TAX 14 (Mar. 1, 2017), https://www.irs.gov/pub/irs-pdf/p505.pdf. Generally, gambling winnings of more than $5000 from any wagering transaction, reduced by the amount of the wager, are subject to withholding if the amount of the proceeds is at least 300 times the amount wagered. I.R.C. § 3402(q)(3)(A), (C)(ii). Gambling winnings from the following sources are subject to

income includes winnings from lotteries, raffles, horse racing, and casinos.[11] In addition to cash winnings, gross income includes the fair market value of any prize or award received, including cars, watches, and trips.[12] If a wagering transaction occurs in an earlier tax year, deferred payments received in a subsequent year by a cash-method taxpayer constitute wagering gains during the tax year in which payment is received.[13] Wagering gains are ordinary income taxed at rates ranging from 10% to 37%.[14]

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withholding if the gambling winnings are more than $5000: (1) sweepstakes; (2) wagering pools, including payments made to winners of poker tournaments; and (3) lotteries, whether or not State-conducted. I.R.C. § 3402(q)(3)(B), (C)(i). Thus, regular gambling withholding does not apply to certain winnings from bingo, keno, or slot machines or winnings from other wagering transactions if the winnings are under specified limits. *See* Internal Revenue Serv., Form W-2G: Certain Gambling Winnings (2018), https://www. irs.gov/pub/irs-pdf/fw2g.pdf [hereinafter IRS Form W-2G] (back side of form, "Instructions to Winner"). The payer must provide a copy of Form W-2G to the payee if the payee receives: (1) $1200 or more in gambling winnings from bingo or slot machines; (2) $1500 or more in net winnings from keno; (3) more than $5000 of winnings, reduced by wager and buy-in, from a poker tournament; (4) $600 or more in gambling winnings if the payout is at least 300 times the amount of the wager; or (5) any other gambling winnings subject to withholding. Treas. Reg. §§ 1.6041-10(b)(1)(i), 1.6041-10(c) (2016); IRS Form W-2G, *supra*. Gambling winnings from bingo, keno, and slot machines are not subject to withholding, unless backup withholding is triggered by the failure of the winner to provide a taxpayer identification number. Treas. Reg. § 31.3406(g)-2(d) (2017). For purposes of information reporting, a session begins when the gambler first places a wager on a type of game at a gaming establishment and ends when that gambler places the last wager on the same type of game at the same gambling establishment before the end of a twenty-four-hour period. Treas. Reg. §§ 1.6041-10(b)(2)(i), 1.6041-10(g) (2016).

10. United States v. Sullivan, 274 U.S. 259, 263 (1927).

11. JOINT COMM. ON TAXATION, 111TH CONG., NO. JCX-28-10, OVERVIEW OF FEDERAL TAX LAWS AND REPORTING REQUIREMENTS RELATING TO GAMBLING IN THE UNITED STATES 15 (2010), https://www.jct.gov/publications.html?func=download&id=3683&chk=3683&no_html=1.

12. *Id.*

13. I.R.S. Tech. Adv. Mem. 200417004 (Apr. 23, 2004). Although payments are deferred into a subsequent tax year, the amount won is not treated as constructively received or an economic benefit in the earlier tax year. *Id.* If the option is exercised within sixty days or less, the option to receive either a single cash payment or a series of payments over a period of at least ten years is not treated as constructively received in the year the option is received. I.R.C. § 451(h)(1). The cash method of accounting requires income to be reported in the tax year in which the income is actually or constructively received and deductions to be taken in the tax year in which payments are actually made. Treas. Reg. § 1.446-1(c)(1)(i) (2011).

14. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11001, 131 Stat. 2054, 2054–56 (2017) (to be codified at I.R.C. § 1). The 10% to 37% rates are effective for tax years

A. Computation of Wagering Gains

Wagering gains are included in income, and wagering losses are deductible to the extent of wagering gains.[15] Whether a taxpayer is a professional or recreational gambler, the ability of that taxpayer to deduct wagering losses is limited to the taxpayer's wagering gains by I.R.C. § 165(d).[16] The amount of wagering gain is calculated by subtracting the amount of wager placed from the winnings produced.[17] If property is won, the amount of the wagering gain is the difference between the value of the property and the cost of the winning bet or ticket.[18]

As I.R.C. § 165(d) uses the plural term "transactions," the wagering loss limitation has been interpreted to measure wagering gains and losses on a per-session basis, calculating wagering gains and losses over a series of separate plays or wagers.[19] Thus, a series of separate plays or wagers may be combined in determining the amount of gambling winnings and losses.[20] To require that wagering gains and losses be computed on every wager separately and to treat every wager as a separate taxable event would be unduly burdensome and unreasonable.[21] Further, the fluctuating gains and

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beginning after Dec. 31, 2017, and before Jan. 1, 2026. *Id*.; *see also* Watkins v. Comm'r, 447 F.3d 1269, 1273 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179, 1183 (9th Cir. 2004); Davis v. Comm'r, 119 T.C. 1, 4 (2002).

15. JOINT COMM. ON TAXATION, *supra* note 11, at 34.

16. Offutt v. Comm'r, 16 T.C. 1214, 1215 (1951), *abrogated by* Mayo v. Comm'r, 136 T.C. 81 (2011); Skeeles v. United States, 95 F. Supp. 242, 247 (Ct. Cl. 1951).

17. Shollenberger v. Comm'r, 98 T.C.M. (CCH) 667, 669 (2009); Rev. Rul. 83-130, 1983-2 C.B. 148.

18. Rev. Rul. 83-130, 1983-2 C.B. 148.

19. I.R.C. § 165(d); Park v. Comm'r, 722 F.3d 384, 386 (D.C. Cir. 2013) (holding the per-session interpretation applied to nonresident aliens in I.R.C. § 871); *Shollenberger*, 98 T.C.M. (CCH) at 668 (quoting I.R.S. Chief Couns. Adv. A.M.2008-011 (Dec. 12, 2008)); I.R.S. Chief Couns. Adv. AM2008-011 (Dec. 12, 2008)).

20. *Shollenberger*, 98 T.C.M. (CCH) at 669. I.R.S. Notice 2015-21 discusses a proposed revenue procedure that, if finalized, will provide an optional safe harbor method for determining a "session of play" for calculating gains or losses from electronically tracked slot-machine play. I.R.S. Notice 2015-21, 2015-12 I.R.B. 765. A "session of play" would begin when a patron places the first wager on a particular type of game and end when the same patron completes the last wager on the same type of game before the end of the same calendar day. *Id.* The safe harbor would generally be effective for the tax years ending on or before the date of publication of the final revenue procedure. *Id*. For horse races, dog races, and jai alai, all wagers placed in a single parimutuel pool and represented on a single ticket are aggregated and treated as a single wager for the purposes of determining the amount of the wager for tax withholding. Treas. Reg. § 31.3402(q)-1(c)(1)(ii) (2017).

21. *Shollenberger*, 98 T.C.M. (CCH) at 668 (quoting I.R.S. Chief Couns. Adv. AM2008-011 (Dec. 12, 2008)). The gambler would have to calculate gain or loss separately

losses left in play are not accessions to wealth until the taxpayer terminates the play and can definitively calculate the amount above or below the initial investment.[22]

With regard to slot machine play, for example, the taxpayer recognizes wagering gain or loss at the time slot-machine tokens, which were received in exchange for cash, are redeemed.[23] Under this methodology, gambling income is reduced by the amount with which the taxpayer begins play and amounts withdrawn from any winnings for additional gambling.[24]

> **Example**: Taxpayer, who enters the casino with $100 and redeems tokens for $300 after playing slot machines, has a wagering gain of $200 ($300 - $100). This is the result even if, during the day, Taxpayer has $1000 in winning spins and $700 in losing spins. Further, if Taxpayer enters the casino with $100 and loses the entire amount after playing slot machines, Taxpayer has a wagering loss of $100, even though Taxpayer may have had winning spins of $1000 and losing spins of $1100 during the course of play.[25]
>
> **Example**: Taxpayer enters the casino with $500 and, on the same day, wins a $2000 jackpot from which $400 was taken out for additional slot-machine play. If the Taxpayer leaves the casino that day with $1600, Taxpayer has a wagering gain of $1100 ($2000 - $400 - $500).[26]
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> **Example**: Taxpayer, who plays the slot machines, buys $100 of tokens at the start of each day and redeems any remaining tokens at the end of the day. Over a ten-day period, Taxpayer loses $100 for five days, loses $30 ($100 - $70 tokens redeemed) on one day, and loses $80 ($100 - $80 tokens redeemed) on another day, for a total of $610 in losses. On three days, Taxpayer wins $50 ($150 tokens redeemed - $100), $100 ($200 tokens redeemed - $100), and $200 ($300 tokens redeemed - $100), for a total of $350 in winnings. For the ten-day period, Taxpayer has

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on every play or wager, requiring the taxpayer to trace and recompute the basis through all of the transactions to calculate the result of each play or wager. *Id.* (quoting I.R.S. Chief Couns. Adv. AM2008-011 (Dec. 12, 2008)).

22. *Id.* (quoting I.R.S. Chief Couns. Adv. AM2008-011 (Dec. 12, 2008)).
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*

> $350 of wagering gain and can deduct only $350 of the $610 of wagering losses.[27]

B. Characterization of Wagering Income

Gambling winnings are taxed as ordinary income, which is subject to tax rates ranging from 10% to 37%.[28] However, gains characterized as long-term capital gains are taxed at a preferential rate of 15%.[29] The 20% rate applies to the long-term capital gain of high-income taxpayers.[30] Unless the character of gain is statutorily provided, capital gains only result from a disposition that qualifies as a sale or exchange and property that qualifies as a capital asset.[31]

In *Prebola v. Commissioner*,[32] the taxpayer won $17.5 million in the New York State Lottery, payable in twenty-six annual installments.[33] After receiving the first three payments, which were reported as ordinary income, the taxpayer sold her right to receive the remaining payments to a third party for the lump-sum amount of $7.1 million.[34] On her tax return for the year of the sale, the taxpayer reported $7.1 million of long-term capital gain.[35] The Second Circuit Court of Appeals began its opinion by noting:

> The issue in this case is whether lump-sum proceeds received from a sale of future interest in lottery payments should be characterized for income tax purposes as a capital gain or as ordinary income. The United States Courts of Appeals for the Third, Ninth, and Tenth Circuits, along with the United States

27. I.R.S. Chief. Couns. Adv. AM2008-011 (Dec. 12, 2008).

28. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11001, 131 Stat. 2054, 2054–56 (2017) (to be codified at I.R.C. § 1). The 10% to 37% rates are effective for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026. *Id*.; *see also* Watkins v. Comm'r, 447 F.3d 1269, 1273 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179, 1183 (9th Cir. 2004); Davis v. Comm'r, 119 T.C. 1, 4 (2002)

29. I.R.C. § 1(h). Depending on the type of asset that generated the gain, generally, long-term capital gain is subject to three maximum rates of taxation: (1) 28% for collectible gain and I.R.C. § 1202 gain; (2) 25% for unrecaptured I.R.C. § 1250 gain; and (3) 15% for adjusted net capital gain. *Id.*

30. *Id*. § 1(h)(1). For 2018, the 20% breakpoint is $479,999 for joint returns and surviving spouses (half this amount for married taxpayers filing separately), $452,000 for heads of household, and $425,000 for other unmarried individuals. Tax Cuts and Jobs Act § 11001(a)(5).

31. I.R.C. § 1222(1)–(4).

32. 482 F.3d 610 (2d Cir. 2007).

33. *Id.* at 610-11.

34. *Id.*

35. *Id.*

> Tax Court in numerous rulings, have all held that such proceeds are properly characterized as ordinary income. We have no difficulty reaching the same conclusion.[36]

Although I.R.C. § 1221 defines the term "capital asset" broadly, the Second Circuit noted that the Supreme Court has limited the scope of this provision in certain contexts, "such as here, where the 'property' at issue is a right to receive ordinary income."[37] Applying the substitute-for-ordinary-income doctrine, the Second Circuit found that the $7.1 million received by the taxpayer was clearly a substitute for the remainder of the lottery payments that would have been received in the future as ordinary income.[38]

C. Reconstruction of Wagering Income

A taxpayer is under the obligation to "keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe."[39] If the taxpayer fails to file a return, files an inaccurate return, does not keep records, or keeps inaccurate records, the Service is given "great latitude" in adopting a suitable method for reconstructing the taxpayer's income.[40] The Service is not required to use any particular method of reconstructing income, but may use any method that clearly reflects the taxable income of the taxpayer.[41] Although the Service has the initial burden of proof,[42] the Service's reconstruction of taxable income is presumed correct, and the taxpayer has the burden of proving that the deficiency notice was arbitrary, capricious,

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36. *Id.* (citations omitted); *see also* Womack v. Comm'r, 510 F.3d 1295 (11th Cir. 2007); Lattera v. Comm'r, 437 F.3d 399 (3d Cir. 2006); Watkins v. Comm'r, 447 F.3d 1269 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Comm'r, 119 T.C. 1 (2002).

37. *Prebola*, 482 F.3d at 611 (citing Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 266 (1985)).

38. *Id.* at 612.

39. I.R.C. § 6001; *see* Treas. Reg. § 1.6001-1(a) (1990) (requiring taxpayers to "keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information").

40. Ramsey v. Comm'r, 39 T.C.M. (CCH) 1150, 1155 (1980).

41. *Id.* at 1155-56. The method used by the government to reconstruct income is not conclusive, allowing the taxpayer to present alternative methods that may be more accurate. Kikalos v. United States, 408 F.3d 900, 903 (7th Cir. 2005).

42. *See* Szkircsak v. Comm'r, 40 T.C.M. (CCH) 208, 211 (1980) (finding the Service did not present evidence of an increase in net worth or unexplained bank deposits to support the Service's argument that the taxpayer had unreported gambling income).

and excessive.[43] Courts do not require the Service's computation to be exact; however, the Service must employ reasonable means and be relatively exact when determining the taxpayer's taxable income.[44]

Depending on the facts and circumstances of each reconstruction, the Service may establish the taxable income of a taxpayer by direct or several indirect methods of proof.[45] The method most preferred by the Service is the direct method, referred to as the "specific item method."[46] The specific item method of reconstructing income uses books and records of the taxpayer in which transactions are contemporaneously recorded and then summarized on the tax return.[47] Generally, the special agent will gather evidence to determine the amount of income that the taxpayer should have included on the tax return and compare that amount to the income the taxpayer actually included on the return.[48] If a taxpayer fails to keep books and records or if the taxpayer's books and records are not available, inadequate, or withheld, an indirect method of reconstructing taxable income may be employed.[49]

The indirect methods of proving income that the courts have upheld are: (1) the net worth method; (2) the expenditures method; and (3) the bank deposit method.[50] Generally, the net worth method measures the increase in net worth of the taxpayer calculated at the beginning and end of each tax year.[51] The assumption is that the taxpayer's increase in net worth, plus the

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43. Elizabeth M. Rutherford, Note, *Taxation of Drug Traffickers' Income: What the Drug Trafficker Profiteth, the IRS Taketh Away*, 33 ARIZ. L. REV. 701, 716 (1991).

44. *Id.* at 713–14.

45. IRM 9.5.9.1 (Nov. 5, 2004).

46. IRM 9.5.9.2.1 (Nov. 5, 2004).

47. *Id.* The three circumstances suited for the use of the specific item method are: (1) understatement of income; (2) overstatement of expenses; and (3) fraudulent claims for credits or exemptions. IRM 9.5.9.2.1.2 (Nov. 5, 2004); *see* Durland v. Comm'r, 112 T.C.M. (CCH) 37 (2016) (holding stipulations that the taxpayer received certain payments and that he did not keep adequate records were sufficient to allow the presumption of correctness to attach to the Service's determinations and justified the use of the specific item method of reconstructing income).

48. IRM 9.5.9.2.1.1 (Nov. 5, 2004).

49. Rutherford, *supra* note 43, at 713.

50. IRM 9.5.9.2.2.3 (Nov. 5, 2004). Two additional indirect methods used by the Service to establish income are the percentage markup method and the unit and volume method. IRM 9.5.9.1.1 (Nov. 5, 2004).

51. Ray A. Knight & Lee G. Knight, *How the IRS Reconstructs Income Without Records*, TAX'N FOR ACCT., Jan. 2005, at 30; *see* Holland v. United States, 348 U.S. 121, 129 (1954) (sanctioning and detailing the use of the net worth method of reconstructing taxable income).

taxpayer's nondeductible personal expenses, must have been financed by taxable and nontaxable income.[52] The expenditures method compares the taxpayer's expenditures with the taxpayer's receipt of income.[53] The assumption is that the amount by which the taxpayer's expenditures during the tax year exceed known sources of income, if unexplained, represents unreported income.[54] The bank deposit method is a means of verifying the taxpayer's receipts and expenditures.[55] The assumption is that the taxpayer's bank deposits represent income and, if not income, the taxpayer is in the best position to explain the nature of the deposits.[56] The bank deposit method requires an analysis of the taxpayer's bank account(s), which may reveal unreported income or provide leads to unreported income by tracing the deposits to their source.[57] The most common defenses to the indirect methods of reconstruction are: cash "hoards" from previous years, funds being held for other parties, nontaxable loans, and undisclosed gifts.[58]

In *Farkas v. Commissioner*,[59] the taxpayer, a craps dealer, received an hourly wage and was permitted to keep tips (often referred to in the gaming industry as "tokes"), which were pooled and divided among the dealers according to hours worked.[60] For the tax year at issue, the taxpayer reported $4800 in toke income, but the Service determined that the taxpayer actually

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52. Knight & Knight, *supra* note 51. Generally, the difference in the taxpayer's net worth from the previous tax year is: (1) increased by the amount of personal living expenses, nondeductible losses, and gifts made; and (2) decreased by any nontaxable sources of funds, such as gifts and inheritances received. IRM 9.5.9.5.8.1 (Nov. 5, 2004).

53. Knight & Knight, *supra* note 51, at 32.

54. *Id.*; *see* United States v. Johnson, 319 U.S. 503 (1943) (sanctioning the use of the expenditures method of reconstructing taxable income). The expenditures method of proof is used if the taxpayer's net worth has not substantially changed or when significant and extravagant living expenditures are apparent during the period under investigation. IRM 9.5.9.6.2 (Nov. 5, 2004). For example, the taxpayer has spent substantial income on consumable goods and services, such as food, vacations, and gifts, as opposed to durable goods, such as stocks, bonds, and real estate. *Id.*

55. Jim Swayze & John C. Zimmerman, *IRS Steps Up Indirect Methods of Establishing Income*, TAX'N FOR ACCT., Feb. 1994, at 92.

56. Knight & Knight, *supra* note 51, at 33.

57. Rutherford, *supra* note 43, at 727. The Service does not have to prove that the bank deposits are income or establish a likely source of unreported income, as the taxpayer has the burden of proving that the deposits represent nontaxable income. Knight & Knight, *supra* note 51, at 33.

58. Holland v. United States, 348 U.S. 121, 127 (1954); Knight & Knight, *supra* note 51, at 30; Swayze & Zimmerman, *supra* note 55, at 92;.

59. 52 T.C.M. (CCH) 402, 402-03 (1986).

60. *Id.* at 403.

received $18,431.90 in toke income.[61] The taxpayer testified that he kept a record of daily toke receipts on a calendar but was unable to produce the calendar at the time of trial.[62] The Service reconstructed the taxpayer's toke income by examining the daily receipts reported by several of the casino's dealers.[63] From these reports, the Service established the total daily receipts most frequently reported by the dealers for each eight-hour shift and, ultimately, the monthly average, daily average, and hourly average.[64] The $18.431.90 toke income was computed by multiplying the average hourly rate times the hours which the taxpayer worked during the tax year.[65] Since the taxpayer failed to meet his burden of proving the amount was erroneous, the Service's determination of the taxpayer's unreported toke income was sustained.[66] As the taxpayer failed to maintain accurate records of his toke income and presented no evidence to justify his failure to do so, the imposition of the accuracy-related penalty was also sustained.[67]

D. Cancellation of Gambling Indebtedness

Generally, amounts borrowed are not included in income because of the borrower's corresponding obligation to repay.[68] The receipt of the loan does not increase the borrower's net worth; hence, the borrower does not have income.[69] However, if the borrower is able to satisfy the debt for less than the amount owed, the amount discharged constitutes cancellation of indebtedness income.[70] In 1954, I.R.C. § 61, defining the term "gross income," was amended to explicitly include "[i]ncome from discharge of indebtedness."[71] In the same year, I.R.C. § 108 was enacted to provide for the exclusion of cancellation of indebtedness in limited circumstances.[72]

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61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.* at 404. The civil negligence penalty is now included in I.R.C. § 6662 and the civil fraud penalty is currently codified in I.R.C. § 6663. Omnibus Budget Reconciliation Act, Pub. L. No. 101-239, 103 Stat. 2106 (1989). *See infra* text accompanying notes 111-128 (describing and discussing I.R.C. §§ 6662 and 6663).
68. BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.05[1] (3d ed. 2002) [hereinafter BITTKER ET AL.].
69. *Id.*
70. *Id.*
71. I.R.C. § 61(a)(12); BITTKER ET AL., *supra* note 68, ¶ 4.05[2].
72. I.R.C. § 108(a)(1)(A)-(D); BITTKER ET AL., *supra* note 68, ¶ 4.05[2]. I.R.C. § 108 excludes from income discharge of indebtedness if the discharge involves: bankruptcy,

In *Zarin v. Commissioner*,[73] the taxpayer was a compulsive gambler who lost $3,435,000 in chips furnished to him by the casino while playing craps.[74] The taxpayer denied liability on the ground that the casino's claim was unenforceable under a state law intended to protect compulsive gamblers.[75] The taxpayer and the casino settled their dispute for a total of $500,000.[76] The Service argued that settlement of a $3,435,000 debt for $500,000 caused the taxpayer to recognize $2,935,000 of cancellation of indebtedness income.[77] The casino advanced the taxpayer $3,435,000 worth of chips, which were the functional equivalent of cash and, on receipt, were not treated as income because of the taxpayer's recognized obligation to repay.[78] The cancellation of a tax-free loan, in whole or in part, "fits neatly into the cancellation of indebtedness provisions in the Code."[79]

The taxpayer contended that the settlement agreement with the casino did not give rise to cancellation of indebtedness income because the debt instruments were unenforceable under state law.[80] "[H]is debt was unenforceable and thus there was no debt to be discharged and no resulting freeing up of assets because his assets were never encumbered."[81] Further, because the credit extended was in the form of chips (which were a nonnegotiable medium of exchange useable only in the casino), the taxpayer maintained that the settlement should be treated as a purchase price adjustment and not cancellation of indebtedness.[82] Finally, relying on the contested-liability exception to cancellation of indebtedness income, the taxpayer argued that settlement of disputed debt did not give rise to income.[83]

The Tax Court found that the taxpayer received value in the form of an opportunity to gamble and other benefits at the time the debt was incurred and only the promise to repay prevented the taxation of the value

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insolvency, qualified farm indebtedness, or qualified real property business indebtedness. I.R.C. § 108(a)(1)(A)-(D).

73. 916 F.2d 110 (3d Cir. 1990).

74. *Id.* at 112.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 113.

79. *Id.*

80. Zarin v. Comm'r, 92 T.C. 1084, 1090 (1989), *rev'd* 916 F. 2nd 110 (3d Cir. 1990).

81. *Id.*

82. *Id.* at 1097. The taxpayer argued that the settlement constituted a purchase price adjustment under I.R.C. § 108(e)(5). *Id.*

83. *Id.* at 1096.

received.[84] "When, in the subsequent year, a portion of the obligation to repay was forgiven, the general rule that income results from forgiveness of indebtedness, section 61(a)(12), should apply."[85] Further, the legal enforceability of the taxpayer's debt did not determine whether discharge of indebtedness income was recognized,[86] and the settlement of the claim with the casino could not be interpreted as a purchase price adjustment.[87] Finally, the principle that the settlement of a disputed debt does not result in income was inapplicable because the taxpayer's gambling debt to the casino was a liquidated amount, and the parties disputed only legal enforceability and not the amount of the debt.[88]

The Third Circuit Court of Appeals reversed the Tax Court, finding that the term "indebtedness of the taxpayer," as defined in I.R.C. § 108(d)(1), was not applicable to the taxpayer's settlement with the casino.[89] I.R.C. § 108(d)(1) requires an indebtedness: "(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property."[90] The taxpayer was not indebted to the casino because the casino's claim against the taxpayer was unenforceable, and the gambling chips were not property held by the taxpayer subject to the debt, but instead were only a medium of exchange for gambling within the casino.[91] The Third Circuit also relied on the disputed debt or contested liability exception in holding that the taxpayer did not have income from cancellation of indebtedness.[92] As the debt was unenforceable under state law, the parties merely settled the amount of the dispute at $500,000, which the taxpayer paid.[93]

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84. *Id.* at 1094.

85. *Id.*

86. *Id.* at 1094-95.

87. *Id.* at 1098. For a debt reduction to be treated as a purchase price adjustment under I.R.C. § 108(e)(5), the following conditions must be satisfied: (1) the indebtedness must be between the purchaser and seller of property and must have arisen out of the purchase of the property; (2) the purchaser must be solvent and not in bankruptcy; and (3) except for this provision, the indebtedness reduction would have given rise to discharge of indebtedness income. *Id.* at 1097-98.

88. *Id.* at 1104 (Tannewald, J., dissenting).

89. Zarin v. Comm'r, 916 F.2d 110, 113 (3d Cir. 1990). The Third Circuit applied the definition of "indebtedness of the taxpayer," as provided in I.R.C. § 108(d)(1), for the purpose of defining cancellation of indebtedness income under I.R.C. § 61(a)(12). *Id.*

90. I.R.C. § 108(d)(1)(A)-(B).

91. *Zarin*, 916 F.2d at 116.

92. *Id.* at 115.

93. *Id.* The Third Circuit noted that if the taxpayer had not paid the $500,000 settlement, the taxpayer would have cancellation of indebtedness income. *Id.* at 115 n.10.

In *Preslar v. Commissioner*,[94] the Tenth Circuit Court of Appeals rejected the reasoning in *Zarin*, limiting the application of the disputed liability doctrine to unliquidated debts.[95]

> The problem with the Third Circuit's holding is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the *amount* of the debt be disputed before the contested liability exception can be triggered is that only in the context of disputed debts is the Internal Revenue Service (IRS) unaware of the exact consideration initially exchanged in a transaction. The mere fact that the taxpayer challenges the enforceability of the debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated. Total denial of liability is not a dispute touching upon the amount of the underlying debt.[96]

E. Civil and Criminal Penalties

Taxpayers engaged in gambling activities are often liable for both unpaid taxes and civil and criminal penalties as the result of the under-inclusion of income, the overstatement of deductions, or both. In addition to any supplementary tax and interest, civil penalties are assessed, collected, and subject to the same interest rate and statute of limitations as the regular tax liability.[97] The Service may also assert criminal penalties.[98] Unlike civil penalties, however, criminal penalties are not collected through the assessment procedures but are imposed in criminal proceedings and may result in fines and/or terms of imprisonment.[99] The major difference between civil and criminal penalties is the degree of proof required by the government.[100] In civil cases, the government must introduce sufficient evidence to prove the imposition of the penalty by "clear and convincing

94. 167 F.3d 1323 (10th Cir. 1999).

95. *Id.* at 1325.

96. *Id.* at 1328 (citation omitted); *see* BITTKER ET AL., *supra* note 68, ¶ 4.05[3][c]. (discussing the law and cases establishing the disputed liabilities exception to inclusion of cancellation of indebtedness income).

97. BITTKER ET AL., *supra* note 68, ¶ 50.03.

98. *Id.*

99. Spies v. United States, 317 U.S. 492, 495 (1943).

100. IRM 25.1.1.2.2.2 (Jan. 23, 2014).

evidence," while in criminal cases, guilt must be proven by the more rigorous "beyond a reasonable doubt" standard.[101]

1. Civil Penalties

It has been stated that the Internal Revenue Code contains "a mind-numbing assortment of civil penalties."[102] Civil penalties are imposed in addition to any underpayment of tax and are assessed and collected along with any underpayment.[103] While the normal burden of proof rules apply to evidence of a deficiency, the "IRS bears the burden of proof with respect to penalties and additions to tax."[104] The Service must initially demonstrate the appropriateness of imposing a particular penalty or addition to tax.[105] In response, the taxpayer may introduce evidence of reasonable cause, substantial authority, or other defenses to negate the application of the penalty provision.[106] To avoid a penalty, reliance on professional advice does not necessarily constitute reasonable cause and good faith.[107]

a) I.R.C. § 6651—Failure to File a Tax Return or Pay Tax

If a taxpayer fails to file a tax return or fails to pay the tax shown (or required to have been shown) on a tax return, a penalty is imposed unless the taxpayer shows that the delay resulted from reasonable cause and not from willful neglect.[108] Reasonable cause for failure to pay tax is shown if the taxpayer exercised ordinary business care and prudence, but was unable to pay or would suffer undue hardship if payment was made on the due date.[109] Special circumstances that warrant relief include the following: (1) the inability to comply with the tax law due to circumstances beyond the

101. *Id.*

102. Michael Asimow, *Civil Penalties for Inaccurate and Delinquent Tax Returns*, 23 UCLA L. REV. 637, 637 (1976).

103. BITTKER ET AL., *supra* note 68, ¶ 50.03.

104. *Id.*

105. *Id.*

106. *Id.*

107. Tollis v. Comm'r, 65 T.C.M. (CCH) 1951, 1960 (1993) (citing United States v. Boyle, 469 U.S. 241, 251-52 (1985)).

108. I.R.C. § 6651(a). The penalty for failure to file a return is 5% of the amount the taxpayer was required to show for the first month, plus an additional 5% for each month thereafter, not to exceed 25%. *Id.* § 6651(a)(1). The penalty for failure to pay the tax in a timely manner is 0.5% of the amount shown on the tax return for the first month, plus an additional 0.5% for each month thereafter, not to exceed 25%. *Id.* § 6651(a)(2), (3). If the failure to file is due to fraudulent intent, the penalty for failure to file a timely tax return increases to 15% per month with a maximum of 75%. *Id.* § 6651(f).

109. Treas. Reg. § 301.6651-1(c)(1) (1996).

taxpayer's control; (2) the death, serious illness, or unavoidable absence of the taxpayer or a member of the taxpayer's immediate family; (3) an event such as fire, casualty, natural disaster, or other disturbance; (4) the unobtainability of records necessary to comply with a tax obligation; and (5) the receipt of, and reliance on, erroneous tax advice.[110]

b) I.R.C. § 6662—Accuracy Related Penalty on Underpayments

The accuracy related penalty on underpayments attaches to specified, proscribed conduct, including: (1) negligence or disregard of tax rules and regulations,[111] and (2) a substantial underpayment of tax.[112] The penalty is 20% of the underpayment attributable to the proscribed conduct.[113] Generally, the accuracy related penalty will not be imposed on any portion of an underpayment if the taxpayer shows a reasonable and good faith effort to comply with the tax laws.[114]

With regard to the penalty for "negligence or disregard of rule or regulations," the term "negligence" includes any failure to make a reasonable attempt to comply with the tax laws, exercise ordinary care in tax return preparation, or keep adequate books and records.[115] The penalty for negligence will not apply if the taxpayer's position has a reasonable basis.[116] "Disregard" includes any careless, reckless, or intentional disregard of tax statutes and regulations.[117] The penalty for the disregard of tax statutes and regulations does not apply if the taxpayer adequately discloses the position, and the position represents a good faith challenge to the regulations.[118]

A "substantial understatement" of tax occurs if the amount of the understatement exceeds the greater of: (1) 10% of the tax required to be shown on the return or (2) $5000.[119] The accuracy related penalty will not

110. IRM 20.1.1.3.2.2 (Feb. 22, 2008); IRM 20.1.1.3.2.2.1 (Nov. 25, 2011); IRM 20.1.1.3.2.2.2 (Aug. 5, 2014); IRM 20.1.1.3.2.2.3 (Dec. 11, 2009); IRM 20.1.1.3.2.2.5 (Nov. 25, 2011).

111. I.R.C. § 6662(b)(1), (c).

112. *Id.* § 6662(b)(2), (d).

113. *Id.* § 6662(a); *see id.* § 6662(b) (listing additional proscribed conduct for which the accuracy-related penalty is imposed).

114. *Id.* § 6664(c)(1).

115. *Id.* § 6662(c); *see also* IRM 20.1.5.7.1 (Dec. 13, 2016); Treas. Reg. § 1.6662-3(b)(1) (2003) (defining the term "negligence" for the purpose of the accuracy-related penalty).

116. IRM 20.1.5.7.1(3) (Dec. 13, 2016).

117. I.R.C. § 6662(c).

118. IRM 20.1.5.7.2.1(3) (Jan. 24, 2012).

119. I.R.C. § 6662(d)(1)(A).

be imposed on any portion of an underpayment if the taxpayer shows a reasonable and good faith effort to comply with the tax laws.[120] The amount of the understatement is reduced if: (1) substantial authority exists for the position taken or (2) relevant facts are adequately disclosed on the tax return and there is a reasonable basis for the tax treatment of the item.[121]

c) I.R.C. § 6663—Imposition of Civil Fraud Penalty

If any part of a tax deficiency is due to fraud with the intent to evade tax, the amount of the civil fraud penalty is 75% of the portion of the underpayment attributable to fraud.[122] The Service must prove by clear and convincing evidence that the taxpayer is guilty of fraudulent intent to evade taxes.[123] As distinguished from negligence, fraud is always an intentional act.[124] Generally, fraud involves one or more of the following elements: deception, misrepresentation of material facts, false or altered documents, or evasion.[125] The fraud penalty is not imposed on any portion of the underpayment if the taxpayer shows a reasonable and good faith effort to comply with the tax laws.[126]

Since direct proof of fraud is rarely available, the Service may prove fraud by circumstantial evidence and reasonable inferences.[127] Although a determination of fraud is based on a taxpayer's entire course of action, some of the common indicators considered by the Service in evidencing an "intent to evade tax" are: (1) understatement of income (for example, omission of specific items or sources of income or substantial income); (2) fictitious or improper deductions (for example, overstatement of expenses); (3) accounting irregularities (for example, two sets of books and false entries); (4) obstructive actions of the taxpayer (for example, false statements, destruction of records, transfer or concealment of assets, and failure to cooperate with the examiner); (5) a consistent pattern of underreporting income; (6) implausible or inconsistent explanations; (7) engaging in illegal activities or attempting to conceal illegal activities; (8)

120. *Id.* § 6664(c)(1).

121. *Id.* § 6662(d)(2)(B).

122. *Id.* § 6663(a).

123. DiLeo v. Comm'r, 96 T.C. 858, 873 (1991), *aff'd*, 959 F.2d 16 (2d Cir. 1992).

124. BITTKER ET AL., *supra* note 68, ¶ 50.06. Tax fraud is an intentional wrongdoing with the specific purpose of evading a tax owed, requiring both a tax due and fraudulent intent. IRM 25.1.1.2 (Jan. 23, 2014).

125. IRM 25.1.6.3(1) (Nov. 5, 2014).

126. I.R.C. § 6664(c)(1).

127. IRM 25.1.6.3(1) (Nov. 5, 2014).

keeping inadequate records; (9) dealing in cash; (10) failing to file returns; or (11) education and experience.[128]

d) Tschetschot v. Commissioner

In *Tschetschot v. Commissioner*,[129] the taxpayers, professional gamblers, contended that tournament poker was not a wagering transaction and was therefore not subject to the wagering loss limitation under I.R.C. § 165(d).[130] The taxpayers argued, similar to other professional sporting tournaments, participants in tournament poker pay an entry fee and compete to win prizes through good fortune and superior skill.[131] The taxpayers contended that poker tournaments are different than live-action poker because the participants pay a "buy-in," a portion of which funds the prize "pot."[132] Because of the buy-in system, the only monetary loss a participant may incur is the amount of the buy-in and any re-buys.[133] Although the participant is out of the game once out of chips, the amount of the chips received may not correlate to the buy-in or prizes, and the chips themselves have no intrinsic value.[134] Finding betting is intrinsic to the game of poker, the Tax Court held that tournament poker was a wagering activity similar to other types of poker.[135] Akin to live-action poker, success in tournament poker depends on a combination of both luck and skill.[136] "Bets are placed on each hand, and each round of betting has consequences."[137]

The Tax Court in *Tschetschot* sustained the 20% accuracy related penalty for substantial understatement of tax pursuant to I.R.C. § 6662.[138] Although the penalty is not imposed if the taxpayer demonstrates a reasonable and good faith effort to comply with the tax laws, the Tax Court found that the taxpayers demonstrated neither reasonable cause nor good faith efforts to comply with the tax laws.[139] The Tax Court found that no substantial

128. IRM 25.1.6.3(2).
129. 93 T.C.M. (CCH) 914 (2007).
130. *Id.* at 915.
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.* at 916.
136. *Id.* at 915.
137. *Id.* at 916.
138. *Id.* at 917.
139. *Id.* ("[P]etitioners were clearly aware of the mandate of section 165(d); their wish that it be inapplicable to tournament poker does not constitute the type of misunderstanding contemplated by the statutes or the regulations.").

authority existed as to the inapplicability of I.R.C. § 165(d) and, whether or not disclosed, no reasonable basis existed in support of the taxpayers' position.[140]

2. Criminal Penalties

Criminal tax penalties, which impose fines and/or terms of imprisonment, may also be asserted by the Service. Unlike civil penalties, criminal penalties are not collected through the assessment procedures but are instead imposed in criminal proceedings.[141] Although the criminal fraud provisions often encompass the same conduct as the civil fraud penalty, the government must prove criminal fraud by the higher standard of beyond a reasonable doubt.[142] The elements of the various criminal penalties may overlap, but all require the element of willfulness.[143] Willfulness may be refuted by the demonstration of a good faith reliance on a tax advisor if all relevant facts were disclosed by the taxpayer.[144]

a) I.R.C. § 7201—Attempt to Evade Tax

A taxpayer who willfully attempts to evade or defeat any tax is guilty of a felony and, upon conviction, will be fined not more than $100,000 or imprisoned not more than five years, or both, together with the costs of prosecution.[145] The term "willfulness" requires "a voluntary, intentional violation of a known legal duty;"[146] thus, willfulness does not include a "frank difference of opinion or innocent errors made despite the exercise of reasonable care."[147] The element of willfulness can be inferred from facts and circumstances such as evidence of a consistent pattern of underreporting large amounts of income or the failure to include all income in books and records.[148] Although the mere failure to file a tax return does not constitute an affirmative act of tax evasion,[149] the requirement of an affirmative act of evasion of tax, or attempted evasion of tax, can be

140. *Id.*
141. Spies v. United States, 317 U.S. 492, 495 (1943).
142. *Id.* A civil penalty may be imposed after an acquittal in a criminal prosecution as the Service's burden of proof in the former is clear and convincing evidence and in the latter is beyond a reasonable doubt. BITTKER ET AL., *supra* note 68, ¶ 50.06.
143. United States v. Bishop, 412 U.S. 346, 361 (1973).
144. BITTKER ET AL., *supra* note 68, ¶ 50.08[2].
145. I.R.C. § 7201.
146. *Bishop*, 412 U.S. at 360.
147. Spies v. United States, 317 U.S. 492, 496 (1943).
148. Holland v. United States, 348 U.S. 121, 139 (1954).
149. *Spies*, 317 U.S. at 497-98.

inferred from conduct, including keeping a double set of books, making false entries or alterations, creating false invoices or documents, destroying books or records, concealing assets or covering up sources of income, handling one's affairs to avoid making the usual books and records, and any conduct whose purpose is to mislead or to conceal.[150]

b) I.R.C. § 7203—Willful Failure to File a Return, Supply Information, or Pay Tax

A willful failure to file a tax return, keep records, supply information, or pay tax at the time required constitutes a misdemeanor subject to a fine of not more than $25,000 or imprisonment of not more than one year, or both, plus the costs of prosecution.[151] This penalty is imposed even though the intent was not to defraud the government if the intention resulted in a failure to discharge a known legal duty.[152] Failure to file a return and pay tax, if the taxpayer knows the tax is due, is a willful omission and, as such, a misdemeanor.[153] However, a good faith belief that a tax return is not required is a defense to the charge of willful failure to file even if the belief is objectively unreasonable.[154] Additionally, a good faith belief that the filing of a tax return violates the taxpayer's privilege against self-incrimination is a defense to the charge of willful failure to file.[155]

c) I.R.C. §§ 7206—Fraudulent and False Statements

Each of the following offenses constitutes a felony, punishable with a fine of not more than $100,000 or imprisonment of not more than three years, or both, plus the costs of prosecution: (1) willfully making a false declaration under penalty of perjury; (2) willfully aiding or assisting in the preparation of any return or other document that is fraudulent or false as to any material matter; (3) willfully falsifying or fraudulently executing or signing any bond, permit, entry, or other document required by the tax laws; (4) willfully removing, depositing, or concealing property upon which tax is imposed or levied, with intent to evade or defeat the assessment or collection of any tax; and (5) willfully concealing property or withholding, falsifying, or destroying records, or making any false statement in

150. *Id.* at 499.
151. I.R.C. § 7203.
152. BITTKER ET AL., *supra* note 68, ¶ 50.08[5].
153. *Spies*, 317 U.S. at 493.
154. BITTKER ET AL., *supra* note 68, ¶ 50.08[5].
155. *Id.*

connection with any compromise or closing agreement.[156] The Supreme Court has interpreted the term "willfully" to connote "a voluntary, intentional violation of a known legal duty."[157] A conviction can be based on a willful omission of a material fact as well as on an affirmative false statement.[158] Although the defect must be material, the government need not prove that the Service relied on the false statement[159] nor that there was a tax deficiency.[160]

d) McClanahan v. United States

In *McClanahan v. United States*,[161] the Service contended and supported with sufficient evidence that the taxpayer made approximately $50,000 in gambling winnings, which he did not report on his tax return and took considerable effort to conceal.[162] At trial, a witness testified that the taxpayer had put his gambling winnings into a safety deposit box instead of a bank because, in an earlier prosecution, the Service was able to prove gambling winnings through bank deposits.[163] The taxpayer conceded he had gambling winnings but argued he suffered gambling losses in excess of his winnings and therefore had no duty to report his gambling winnings.[164]

The Fifth Circuit Court of Appeals upheld the conviction of the taxpayer for willfully attempting to evade and defeat income tax.[165] The Fifth Circuit found that the taxpayer had a duty to report gambling winnings, despite the taxpayer's claim that gambling losses exceeded gambling winnings, and that the taxpayer knowingly and willfully failed to report his winnings with the intent to defeat the payment of tax.[166] It was sufficient that the Service established, and the taxpayer admitted, that he had gambling winnings.[167] Further, the Service was under no duty to explore leads to substantiate the

156. I.R.C. § 7206. The willful delivery or disclosure to the Service of fraudulent lists, records, accounts, statements, or other documents is a misdemeanor, punishable by a fine of not more than $10,000 or imprisonment for not more than one year, or both. *Id.* § 7207.

157. United States v. Bishop, 412 U.S. 346, 360 (1973). "Willfully" has the same meaning for I.R.C. §§ 7206 and 7207 with the distinction between the two provisions being the additional misconduct essential to the violation of a felony. *Id.* at 361.

158. United States v. Tager, 479 F.2d 120, 122 (10th Cir. 1973).

159. United States v. Romanow, 509 F.2d 26, 28 (1st Cir. 1975).

160. United States v. Jernigan, 411 F.2d 471, 473 (5th Cir. 1969).

161. 292 F. 2d 630 (5th Cir. 1961).

162. *Id.* at 631.

163. *Id.* at 635.

164. *Id.* at 631.

165. *Id.*

166. *Id.* at 631-32.

167. *Id.* at 631.

taxpayer's claim that his gambling losses excessed his gambling winnings.[168] The taxpayer must include gambling winnings in income and has the burden to substantiate any gambling losses.[169]

III. Deduction of Wagering Losses

Generally, I.R.C. § 165 allows taxpayers a deduction for losses not compensated for by insurance or otherwise.[170] With regard to gambling losses, I.R.C. § 165(d) provides that losses arising from "wagering transactions shall be allowed only to the extent of gains from such transactions."[171] Several additional limitations apply to the deduction of wagering losses: (1) the losses claimed can only offset winnings from wagering activities during the same tax year;[172] (2) gambling losses cannot reduce income from non-gambling sources;[173] and (3) excess gambling losses cannot be used as a carryover or a carryback to reduce gambling income in other tax years.[174] Married taxpayers who file joint returns may pool their gambling gains and losses in applying I.R.C. § 165(d).[175]

The predecessor to I.R.C. § 165(d) first appeared in the Revenue Act of 1934.[176] Prior to the legislation, the ability to deduct losses from legal gambling activities was not limited to winnings,[177] but if the gambling

168. *Id.*

169. *Id.*

170. I.R.C. § 165(a). The amount of a deductible loss cannot exceed the adjusted basis of the property to which the loss is attributable. *Id.* § 165(b). As to individuals, loss deductions are limited to: (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit; and (3) losses arising from fire, storm, shipwreck, or other casualty, or from theft. *Id.* § 165(c). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the personal casualty and theft loss deduction is suspended, except for personal casualty losses incurred in a Federally-declared disaster; however, where a taxpayer has personal casualty gains, the loss suspension does not apply to the extent that such loss does not exceed such gain. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11044, 131 Stat. 2054, 2087 (2017) (to be codified at I.R.C. § 165(h)(5)).

171. I.R.C. § 165(d). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling gains. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11050, 131 Stat. 2054, 2089 (2017) (to be codified at I.R.C. § 165(d)).

172. Treas. Reg. § 1.165-10 (1960).

173. Boyd v. United States, 762 F.2d 1369, 1373 (9th Cir. 1985).

174. Skeeles v. United States, 95 F. Supp. 242, 244 (1951).

175. Treas. Reg. § 1.165-10 (1960).

176. *Skeeles*, 95 F. Supp. at 245.

177. Lakhani v. Commissioner, 142 T.C. 151, 162 (2014).

activity was illegal, the ability to deduct gambling losses was so limited.[178] The congressional intent of the new legislation was to eliminate the difference in treatment between legal and illegal gambling losses.[179] Further, many taxpayers were taking deductions for gambling losses but failing to report gambling gains.[180] The gambling loss limitation forced taxpayers to report gambling winnings in order to deduct their gambling losses.[181] Although the question was left open, the courts ultimately interpreted the new gambling loss limitation provision as applicable to all gamblers, not just recreational gamblers.[182] Thus, wagering losses are deductible only to the extent of wagering gains—regardless of whether the gambler is a professional or a recreational gambler or whether the gambling activity is legal or illegal.[183]

A. Wagering Transactions Defined

As I.R.C. § 165(d) allows a gambler to deduct wagering losses only to the extent of wagering gains, the determination of what constitutes a wagering transaction is a threshold question.[184] The term "wagering transactions" is not defined in the Internal Revenue Code or Treasury regulations.[185] For a transaction to be a wager, the Service maintains that the following three elements must be present: (1) prize, (2) chance, and (3) consideration.[186] Within the meaning of I.R.C. § 165(d), gains and losses from wagering transactions are the direct result of a wager entered into by the taxpayer and do not included gains and losses merely arising in connection with the conduct of wagering activities.[187] Thus, the term "wagering loss" is used in the transactional sense, as the amount of wager (basis) minus the amount returned.[188] For instance, the Service and the

178. *Id.*

179. *Skeeles*, 95 F. Supp. at 246.

180. *Lakhani*, 142 T.C. at 162.

181. *Id.*

182. Stephen A. Zorn, *The Federal Tax Treatment of Gambling: Fairness or Obsolete Moralism?*, 49 TAX LAW 1, 22 (1995).

183. *Skeeles*, 95 F. Supp. at 247.

184. Although the term "wagering" has a different meaning depending on the context in which the term is used, generally, the term is synonymous with "gambling." Tschetschot v. Comm'r, 93 T.C.M. (CCH) 914, 916 (2007).

185. I.R.S. Tech. Adv. Mem. 200417004 (Apr. 23, 2004).

186. *Id.* A wager is "money or other consideration risked on an uncertain event; a bet or gamble." *Id.*

187. Mayo v. Comm'r, 136 T.C. 81, 93 (2001).

188. I.R.S. Chief Couns. Adv. AM2008-013 (Dec. 10, 2008).

courts have considered whether the following activities constitute wagering transactions.

1. Sweepstakes, Raffles, and Lotteries

A sweepstake, raffle, or lottery is a wagering transaction if the contestant is required to furnish consideration (a wager) in exchange for a chance to win.[189] The chance to win prizes as part of a merchandising plan is not a wagering transaction if the customer is not required to pay more for the merchandise in order to obtain a chance.[190] A no-purchase-necessary marketing sweepstake, which requires a contestant to submit a stamped, self-addressed envelope, does not have the requisite "consideration" element to be a wagering transaction.[191] Thus, the Service held that the taxpayer's winnings from a no-purchase-necessary sweepstake were not wagering gains for the purpose of offsetting the taxpayer's wagering losses sustained in other wagering activities.[192]

2. Comps

A casino transferred complimentary goods and services to certain players to induce the players to patronize the casino.[193] The type and amount of these "comps" would be determined by senior management through either the management's discretion or a formula that allowed each player to receive comps of approximately fifty percent of the players anticipated loss.[194] The taxpayer, who gambled extensively at the casino, received automobiles and accessories, including five Rolls Royces, three Ferraris, one Bentley Corniche, five European vacations, diamond jewelry, Rolex watches, and tickets to numerous theater and sporting events.[195] The Fifth Circuit Court of Appeals held that the comps constituted gains from wagering transactions, allowing the taxpayer to deduct his gambling losses to the extent of the value of the comps.[196] The Fifth Circuit found that taxpayer's receipt of the comps bore a close nexus to his gambling

189. I.R.S. Tech. Adv. Mem. 200417004.

190. *Id.* The purchase of a single lottery or raffle ticket for relatively little consideration constitutes a wager. Rev. Rul. 83-130, 1983-2 C.B. 148.

191. I.R.S. Tech. Adv. Mem. 200417004.

192. *Id.*

193. Libutti v. Comm'r, 71 T.C.M. (CCH) 2343, 2344 (1996).

194. *Id.*

195. *Id.*

196. *Id.*

transactions.[197] "The relationship between [the] petitioner's comps and his wagering is close, direct, evident, and strong."[198]

3. Tokes

Craps dealers in casinos often receive tokes from players at their tables that take the form of bets placed by the player for the dealer's benefit.[199] Unlike other service providers, casino policy prohibits dealers from performing favors of any kind for players, regardless of gratuities given or expected.[200] The Tax Court held that the tokes were received in exchange for services performed for the players and were the direct result of employment as a dealer.[201] The dealers receiving tokes could not have elected cash in lieu of the wager, participated in making the wager, or lost as a result of the wager.[202] The taxpayer, the dealer who received the tokes, did not enter into a wagering transaction and therefore could not offset the amount of the tokes against his wagering losses.[203]

4. Game-Show Expenses

Expenses incurred by the taxpayer in attending and participating in the television game show, "Wheel of Fortune," were not wagering losses deductible against wagering gains, but rather were nondeductible personal expenses.[204] After being selected to appear on the program, the taxpayer and his family flew from Illinois to California for the taping of the game show.[205] The taxpayer won three consecutive games and was awarded $14,850 cash and an automobile.[206] The taxpayer included his cash winnings and the value of the automobile into income and deducted the expenses incurred by his family and himself for transportation, meals, and lodging.[207] Admittedly the taxpayer was not a professional gambler; as such, the expenses incurred were not deductible business expenses under

197. *Id.* at 2346.
198. *Id.*
199. Allen v. United States, 976 F.2d 975 (5th Cir. 1992). Typically, dealers pool and split the tokes received during each shift. *Id.* at 975-76.
200. *Id.* at 976.
201. *Id.* at 975.
202. *Id.* at 976.
203. *Id.* at 976–77.
204. Whitten v. Comm'r, 70 T.C.M. (CCH) 1064, 1067 (1995).
205. *Id.* at 1065.
206. *Id.*
207. *Id.*

I.R.C. § 162(a).[208] The Tax Court held the expenses involved were paid for specific goods and services and not losses from a wager or bet and, as a result, were not deductible to the extent of wagering gains under I.R.C. § 165(d).[209]

5. Shills

A gaming club employed shills, who were provided with chips to play in card games when an insufficient number of gamblers were playing.[210] If a shill lost, the club absorbed the loss; however, if a shill won, the shill would split the winnings evenly with the club.[211] The retention of fifty percent of their winnings was the shills' sole compensation.[212] The shills as a group lost more than fifty percent of their winnings, and the club deducted the losses as a business expense under I.R.C. § 162(a).[213] Because the shills were betting with the club's money and the club shared in each win and loss, the Ninth Circuit Court of Appeals held the club was engaged in wagering transactions.[214] The Ninth Circuit characterized the relationship between the shills and the club as the shills acting on behalf of the club in placing bets.[215] Consequently, the club's wagering loss deduction was limited to wagering gains, and the net loss was not deductible as a business expense.[216]

6. Thefts

The taxpayer, a ticket seller at an off-track betting parlor, "punched up" tickets for himself on his computer terminal without paying for them.[217] The tickets placed bets on nine horse races with a total value of $80,280, resulting in winnings of $42,175 and a net loss of $38,105.[218] Later that year, the taxpayer pled guilty to grand larceny in the third degree.[219] The Tax Court determined that the taxpayer had reportable income equal to the value of the tickets minus the winnings he transferred back to his

208. *Id.* at 1066.
209. *Id.* at 1068.
210. Nitzberg v. Comm'r, 580 F.2d 357, 358 (9th Cir. 1978).
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.*
216. *Id.*
217. Collins v. Comm'r, 64 T.C.M. (CHH) 557, 558 (1992).
218. *Id.* at 558–59.
219. *Id.* at 559.

employer.[220] The Tax Court held that the taxpayer could not offset his theft income with the $38,105 net loss because the loss was not the result of a wagering transaction or a loss incurred in a transaction entered into for profit.[221] The taxpayer-realized income was from the theft of "the opportunity to gamble."[222] Thus, the income realized by the taxpayer was ordinary theft income, and his losses were not deductible.[223]

B. Necessary Documentation

Under I.R.C. § 165(d), losses incurred in wagering transactions are deductible only to the extent of gains from wagering transactions.[224] Wagering gains and losses must be evidenced by adequate documentation to take full advantage of the wagering loss limitation.[225] The question is a factual one and is decided on the basis of all the evidence.[226] The taxpayer has the burden of proving that wagering gains and losses were in fact sustained.[227] Generally, neither self-serving assertions nor subsequently created documents are sufficient to substantiate wagering gains and losses.[228]

In Revenue Procedure 77-29, the Service provides guidelines for keeping adequate records of wagering winnings and losses.[229] Taxpayers should maintain an accurate diary or similar record supplemented by verifiable documentation to substantiate wagering winnings and losses.[230] Generally, the diary should include the date and type of wager or wagering activity, the name, address, and location of the gambling establishment, the names of other persons, if any, present with the taxpayer at the gambling

220. *Id.* at 564.
221. *Id.* at 568.
222. *Id.* at 562.
223. *Id.* at 567–68.
224. I.R.C. § 165(d).
225. *See* Plisco v. United States, 306 F. 2d 784, 787 (1962).
226. Schooler v. Comm'r, 68 T.C. 867, 869 (1977).
227. *Id.*
228. Stein v. Comm'r, 322 F.2d 78, 82 (5th Cir. 1963); Showell v. Comm'r, 16 T.C.M. (CCH) 103, 105 (1957).
229. Rev. Proc. 77-29, 1977-2 C.B. 538; *see* INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 529, MISCELLANEOUS DEDUCTIONS 18 (Dec. 23, 2016), https://www.irs.gov/pub/irs-pdf/p529.pdf [hereinafter IRS PUB. 529, MISCELLANEOUS DEDUCTIONS] (requiring recreational gamblers to keep an accurate diary or similar record of winnings and losses, including the date and type of the specific wager or wagering activity, the name and location of the gambling establishment, the names of other persons present at the gambling establishment, and amounts won or lost).
230. Rev. Proc. 77-29, 1977-2 C.B. 538.

establishment, and the amounts won or lost.[231] Verifiable documentation to establish gambling transactions includes wagering tickets, cancelled checks, credit records, bank withdrawals, and statements of winnings or payment slips provided by the gambling establishments.[232] Further support of the taxpayer's wagering activities or visits to gambling establishments includes hotel bills, airline tickets, gasoline receipts, credit card statements, cancelled checks, credit records, bank deposits, and bank withdrawals.[233] Affidavits or testimony from responsible gaming officials regarding wagering activities provide additional supporting evidence.[234]

With regard to specific wagering transactions, winnings and losses may be further supported by the following items:[235]

- Keno: Copies of keno tickets purchased by the taxpayer and validated by the gambling establishment, copies of the taxpayer's casino credit records, and copies of the taxpayer's casino check cashing records.
- Slot Machines: A record of all winning by date and time that the machine was played, including the number of the slot machine played.
- Table Games (Twenty One, Craps, Poker, Baccarat, Roulette, Wheel of Fortune, etc.): The number of the table at which the game was played, the number of people at the table while playing, and casino credit card data, indicating whether the credit was issued in the pit or at the cashier's cage.
- Bingo: A record of the number of games played, the cost of tickets purchased, and the amounts collected in winnings.
- Horse Racing, Harness Racing, Dog Racing, etc.: A record of the races, entries, amounts of wagers, and amounts collected on winning tickets and lost on losing tickets.
- Lotteries: A record of ticket purchases, dates, winnings, and losses.

Notwithstanding insufficient substantiation, the courts have allowed wagering loss deductions based on estimates pursuant to the Cohan Rule,

231. *Id.*

232. *Id.* Form W-2G ("Certain Gambling Winnings") and Form 5754 ("Statement by Person Receiving Gambling Winnings") also provide verifiable documentation.

233. *Id.*

234. *Id.*

235. *Id.*

which allows for an approximation of the taxpayer's wagering losses if the court is convinced that a loss was sustained.[236]

In *Doffin v. Commissioner*,[237] the taxpayer was heavily engaged in "pulltab" gambling at several charitable gambling establishments located in Fargo, North Dakota.[238] Pulltab gambling involves purchasing tickets contained in a large, old-fashioned cookie jar and immediately pulling tabs to determine whether the player won or lost.[239] If the player wins, the player receives cash; if the player loses, the player commonly throws the losing ticket on the floor.[240] The taxpayer admitted he had unreported winnings but contended his gambling losses exceeded his gambling winnings.[241] In sustaining a portion of his claimed wagering losses, the Tax Court found sufficient evidence to apply the Cohan Rule.[242] The taxpayer's testimony was honest and credible; the taxpayer's modest lifestyle and financial position did not indicate the increase in income as asserted by the Service; and, based on the time spent and amounts wagered, statistically, the taxpayer would have incurred losses.[243]

In a Summary Opinion, the Tax Court recently denied "house players" gambling loss deductions because of a lack of substantiation.[244] In *Pham v. Commissioner*,[245] the taxpayers, professional gamblers, were employed by a casino to ensure enough players to start and maintain card games.[246] The taxpayers received an hourly wage but were required to use their own funds for betting in the poker games.[247] The taxpayers maintained that they did not include their winnings into income because their gambling losses

236. In determining the amount of his travel and entertainment deduction, the Second Circuit Court of Appeals allowed George M. Cohan, an American entertainer, playwright, composer, lyricist, actor, singer, dancer, and producer, a deduction in close approximation of the amount expended. Cohan v. Comm'r, 39 F.2d 540, 544 (2d Cir. 1930). Although no longer applicable to travel and entertainment expenses, the Cohan Rule is now applicable to virtually all areas of tax law. BITTKER ET AL., *supra* note 68, ¶ 11.09. Taxpayers relying on the Cohan Rule must make a threshold showing that the expenditure was larger than the amount acknowledged by the Service. *Id.*

237. 61 T.C.M. (CCH) 2157 (1991).

238. *Id.* at 2159.

239. *Id.*

240. *Id.*

241. *Id.* at 2161.

242. *See* Norgaard v. Comm'r, 939 F.2d 874, 877 (1991).

243. *Doffin*, 61 T.C.M. (CCH) at 2161.

244. Pham v. Comm'r, T.C. Summary Op. 2016-73, at 2 (Nov. 8, 2016).

245. *Id.*

246. *Id.*

247. *Id.* at 3.

exceeded their gambling winnings.[248] However, the taxpayers did not provide any documentation or other proof to evidence their losses.[249] The taxpayers stated that they initially tried to keep track of their poker winnings and losses by documenting amounts won or lost daily, "but after a while they gave up that practice because it was 'bad for their psyche . . . you need to be strong mentally when playing cards.'"[250] The Tax Court stated that if a taxpayer establishes that a deductible expense has been paid or incurred, the amount allowable as a deduction can be estimated in some circumstances under the Cohan Rule.[251] "In order for the Court to estimate the amount of the expense, it must have some basis upon which an estimate can be made."[252]

C. Involvement of Other Tax Entities

Taxpayers have enjoyed mixed success in avoiding the I.R.C. § 165(d) wagering loss limitation by employing other tax entities. In *Brown v. Commissioner*,[253] the taxpayer formed a corporation, Gold Pot, Inc., and acquired all of the common stock issued by the corporation for $21,600.[254] Immediately, the taxpayer withdrew $20,000 from the corporation's bank account and gave the $20,000 to an individual named Reppert, who used the funds to bet on horseraces.[255] Reppert claimed to have devised a system for betting on horseraces, and the taxpayer was convinced that the system was sound.[256] Pursuant to an agreement with the corporation, Reppert placed wagers on horseraces on behalf of the corporation, ultimately losing a total of $56,000.[257] As a consequence of the wagering losses, the taxpayer claimed an ordinary loss deduction of $20,600 for the worthlessness of his stock.[258] The Tax Court found that the "corporation was merely a sham set up to transmit funds to Reppert for wagering."[259] Accordingly, the Tax

248. *Id.* at 6.
249. *Id.*
250. *Id.* at 4.
251. *Id.* at 10.
252. *Id.*
253. 38 T.C.M. (CCH) 91 (1979).
254. *Id.* at 92.
255. *Id.*
256. *Id.*
257. *Id.*
258. *Id.*
259. *Id.* at 93. The taxpayer incurred a travelling expense of $600 in order to consummate the corporation's agreement with Reppert, which the Tax Court found was a nondeductible personal expense of the taxpayer. *Id.*

Court held that the $20,000 loss was a wagering loss subject to I.R.C. § 165(d).[260]

In Chief Counsel Advice 200725036,[261] the taxpayer had an ownership interest in a partnership, which provided entertainment in the form of gambling and related activities and, as part of its operation, engaged in wagering activities.[262] In its first year of operation, the partnership sustained an overall operating loss, primarily due to significant startup expenditures, but realized a gain on its wagering transactions.[263] That same year, the taxpayer lost substantial amounts in personal wagering transactions. The Service found that wagering gains and losses realized by the partnership are separately stated and pass through the partners as separate items.[264] As a result, the partner's proportionate share of the partnership's wagering gains and losses may be combined with personal gains and losses in calculating the partner's wagering loss deduction under I.R.C. § 165(d).[265] The Service concluded that I.R.C. § 165(d) is applied at the partner level and not the partnership level.[266]

IV. Deduction of Gambling Expenses and Losses

The tax treatment of professional gamblers varies greatly from the tax treatment of recreational gamblers. In order to determine whether a gambler is a professional gambler, the facts and circumstances of each case must be examined.[267] Generally, the professional gambler must be involved in the activity with sufficient continuity and regularity, and the primary purpose for being involved in the activity must be for income or profit.[268] In

260. *Id.* The corporation adopted a plan to issue I.R.C. § 1244 stock, which would have produced an ordinary loss upon the worthlessness, but the Tax Court found that the corporation failed to meet the "operating company" requirement as it was merely a "paper company." *Id.* I.R.C. § 1244 allows a shareholder to treat a limited amount of loss recognized from the sale or worthlessness of stock in certain small business corporations as ordinary loss instead of capital loss. I.R.C. § 1244(a)–(c).

261. I.R.S. Chief Couns. Adv. 200725036 (June 22, 2007).

262. *Id.*

263. *Id.*

264. *Id.*

265. *Id.*; *see also* Jennings v. Comm'r, 110 F.2d 945, 946 (5th Cir. 1940); Joseph v. Comm'r, 43 B.T.A. 273, 275 (1941) (holding that the partners in a partnership engaged in the business of entering into wagering transactions may deduct their individual losses from wagering transactions against their distributive share of the partnership's wagering gains).

266. I.R.S. Chief Couns. Adv. 200725036.

267. Higgins v. Comm'r, 312 U.S. 212, 217 (1941).

268. Dreicer v. Comm'r, 78 T.C. 642, 643 (1982).

addition to the ability to deduct losses from wagering transactions to the extent of gains from wagering transactions, professional gamblers can deduct the ordinary and necessary expenses incurred in their gambling enterprises.[269] However, the definition of the term "losses from wagering transactions" includes any deduction incurred in carrying on a wagering transaction; thus, business-related expenses are also subject to the wagering gain limitation.[270] Although recreational gamblers can deduct gambling losses to the extent of winnings,[271] they cannot deduct expenses incurred in gambling activities as such expenses are nondeductible personal expenses.[272] Finally, if professional gamblers sustain losses, such gambling losses are deductible from gross income in computing adjusted gross income.[273] However, gambling losses are deductible as itemized deductions of recreational gamblers.[274]

A. Business of Gambling

In addition to being entitled to deduct gambling losses,[275] a professional gambler is entitled to deduct the "ordinary and necessary expenses" incurred in the business of gambling.[276] Pursuant to I.R.C. § 162, the gambler can deduct expenses incurred to generate gambling income, such as traveling expenses and meals and lodging.[277]

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269. I.R.C. § 162(a). Professional gamblers report gambling losses to the extent of gambling income and other deductible expenses on Form 1040, Schedule C. IRS PUB. 334, TAX GUIDE FOR SMALL BUSINESS, *supra* note 9; INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 535, BUSINESS EXPENSES (Jan. 19, 2017), https://www.irs.gov/pub/irs-pdf/p535.pdf [hereinafter IRS PUB. 535, BUSINESS EXPENSES].

270. I.R.C. § 165(d). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11050, 131 Stat. 2054, 2089 (2017) (to be codified at I.R.C. § 165(d)).

271. I.R.C. § 165(d).

272. I.R.C. § 262(a).

273. Shollenberger v. Comm'r, 98 T.C.M. (CCH) 667, 669 (2009).

274. *Id.* A recreational gambler claims gambling losses, to the extent of gambling income, as an itemized deduction on Form 1040, Schedule A. IRS PUB. 529, MISCELLANEOUS DEDUCTIONS, *supra* note 229, at 12.

275. I.R.C. § 165(d).

276. I.R.C. § 162(a). Trade or business classification subjects a gambler to self-employment tax. I.R.C. § 1401; IRS PUB. 334, TAX GUIDE FOR SMALL BUSINESS, *supra* note 9; IRS PUB. 535, BUSINESS EXPENSES, *supra* note 269.

277. I.R.C. § 162(a); *see* I.R.C. § 274 (restricting the deductibility and requiring substantiation of expenses incurred in business or for-profit activities with elements of personal pleasure).

In *Commissioner v. Groetzinger*,[278] the Supreme Court addressed the issue of whether the taxpayer was engaged in a "trade or business" within the meaning of I.R.C. §§ 162(a) and 62(a)(1).[279] After terminating his employment, the taxpayer devoted sixty to eighty hours per week to parimutuel wagering, primarily dog races, with intent to earn a living from such activities.[280] The taxpayer gambled solely for his own account and had no other profession or employment.[281] For the tax year at issue, the taxpayer bet $72,032 and won $70,000, for a net gambling loss of $2032.[282] Other than his gambling winnings, the taxpayer's only sources of income were interest, dividends, and sales of investments, totaling $6498.[283]

The Supreme Court observed that the determination of what constitutes a trade or business has "proven to be most difficult and troublesome."[284] Although the term "trade or business" appears frequently, the Internal Revenue Code, the Treasury regulations, and judicial decisions have not provided a definitive and generally applicable definition of the term.[285] Reviewing prior decisions, the Supreme Court in *Groetzinger* acknowledged that holding oneself out to others as engaged in the selling of goods and services usually results in being considered as engaged in a trade or business; however, the Court found that such activities are not an absolute prerequisite.[286] The inquiry is whether certain activities of the taxpayer can be characterized as a livelihood, occupation, or means of earning a living.[287] The primary considerations are (1) the continuity and extensiveness of the activities, and (2) the good faith intent of the taxpayer to make a profit.[288] The Supreme Court observed that a purely personal activity, no matter how continuous or extensive, does not constitute a trade

278. 480 U.S. 23 (1987).

279. *Id.* at 24. Although the specific issue in the case was the application of I.R.C. § 62(a)(1), the Service conceded that the meaning of the term "trade or business" is the same for both sections. *Id.* at 25. I.R.C. § 62(a)(1) allows an individual to deduct trade or business expenses, other than the trade or business of the performing services as an employee, from gross income in arriving at adjusted gross income.

280. *Id.* at 24.

281. *Id.*

282. *Id.* at 25.

283. *Id.*

284. *Id.* at 33 (quoting Groetzinger v. Comm'r, 771 F.2d 269, 271 (7th Cir. 1985)).

285. *Id.* at 27.

286. *Id.* at 34.

287. *Id.* at 28.

288. *Id.* at 35.

or business.[289] Applying a common sense concept of a trade or business to the facts of the case,[290] the Supreme Court held that the taxpayer was engaged in the trade or business of gambling, stating "if one's gambling activity is pursued full-time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business."[291]

As to whether a gambler has a good-faith intent to make a profit, the factors relevant to the determination of a profit motive under I.R.C. § 183 are often applied when distinguishing between a professional gambler and a recreational gambler.[292] "It should be noted here, however, that [the rules of I.R.C. § 183] are considered guideposts for determining whether an activity is a business or profit seeking activity for purposes of §§ 162 and 212."[293] The Treasury regulations, promulgated under I.R.C. § 183, are applied by courts to establish whether wagering activities are engaged in for profit.[294] The relevant factors are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or the taxpayer's advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any; (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation.[295] The Treasury regulations state that no single factor is conclusive, and the nine listed factors are not exclusive.[296] The Treasury regulations and the courts often

289. *Id.* at 29.

290. *Id.* at 35.

291. *Id.*

292. Chow v. Comm'r, 99 T.C.M. (CCH) 1193, 1195 (2010); *see infra* text accompanying notes 364-367 (discussing whether the income limitation of I.R.C. § 183 applies to recreational gamblers).

293. BITTKER ET AL., *supra* note 68, ¶ 11.02[2]. I.R.C. § 183(c) defines the term "activity not engaged in for profit" as any activity other than one to which deductions are allowable under I.R.C. §§ 162 and 212. Treas. Reg. § 1.183-2 (1972). I.R.C. § 162 allows a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business. I.R.C. § 162(a). I.R.C. § 212 allows a deduction for all ordinary and necessary expenses incurred in the production of income. I.R.C. § 212(1).

294. Chow v. Comm'r, 99 T.C.M. (CCH) 1193, 1196. Activities carried on primarily as a sport or hobby, or for recreation, do not have the requisite profit motive. Treas. Reg. § 1.183-2(a) (1972).

295. Treas. Reg. § 1.183-2(b).

296. *Id.*

look to the primary purpose of the taxpayer in the weighing process,[297] with greater weight given to objective facts than the taxpayer's statement of intent.[298] Finally, a small chance of making a large profit may be sufficient to indicate a profit objective, similar to "an investor in a wildcat oil well."[299]

In *Boneparte v. Commissioner*,[300] the taxpayer was employed full-time by the Port Authority of New York and New Jersey and regularly gambled in casinos and at racetracks.[301] Keeping his personal belongings in a locker in New Jersey, the taxpayer did not maintain a permanent residence, instead staying in the casino hotels where he gambled.[302] The taxpayer gambled primarily in Atlantic City, New Jersey, but also gambled in other venues across the United States.[303] He did not keep a contemporaneous written log of his gambling winnings and losses but testified that he kept a running ledger in his head.[304] On his tax return, the taxpayer did not report any gambling winnings, reported $25,000 in gambling losses, and took $90,000 of deductions for gambling-related expenses.[305] The Service contended that the taxpayer engaged in gambling as a hobby, not as a business.[306]

The Tax Court noted that a professional gambler must engage in gambling activities with the objective of making a profit.[307] Although a reasonable expectation of a profit is not necessary, the relevant facts and circumstances must establish that the taxpayer had an actual and honest profit objective.[308] The Tax Court then discussed the I.R.C. § 183 factors and determined that the taxpayer failed to satisfy any of the relevant factors: (1) the taxpayer did not carry on his gambling activities in a business-like manner, as he did not maintain complete and accurate records, only kept a

297. J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 483 (10th ed. 2012).

298. Dreicer v. Comm'r, 78 T.C. 642, 645 (1982), *aff'd without opinion*, Dreicer v. Comm'r, 702 F.2d 1205 (D.C. Cir. 1983); Treas. Reg. § 1.183-2(a).

299. Treas. Reg. § 1.183-2(a).

300. T.C. Memo. 2015-128 (July 3, 2015); *see also* Boneparte v. Comm'r, T.C. Memo. 2017-193 (Oct. 2, 2017) (holding that the taxpayer, based on the same facts but in later taxable years, was not a professional gambler).

301. *Boneparte. v. Comm'r*, T.C. Memo. 2015-128, at 2.

302. *Id.* at 3.

303. *Id.*

304. *Id.*

305. *Id.* at 5.

306. *Id.* at 8.

307. *Id.* at 9.

308. *Id.*

running total of gains and losses in his head, and did not spend time honing or adjusting his system for gambling to improve his profitability; (2) although the taxpayer testified that he created a system for gambling on the game of baccarat, the court was not persuaded that he achieved any level of expertise and noted that his only preparation and consultation with experts was the time he spent discussing some aspects of gambling with a friend who frequently gambled; (3) the taxpayer provided no evidence of a history of success with business activities, other than working as an employee, and no evidence that his success as an employee of the Port Authority paved a way for success as a gambler; (4) the taxpayer provided no evidence regarding his history of income or losses from gambling; (5) the financial status of the taxpayer did not indicate a profit motive, since he derived the bulk of his income from his employment; and (6) the taxpayer testified that he enjoyed gambling.[309]

Considering all the facts and circumstances, the Tax Court held that the taxpayer did not conduct his gambling activity in a businesslike manner and did not engage in that activity with the necessary profit objective; therefore, the taxpayer could not deduct his gambling-related expenses under I.R.C. § 162(a).[310] Further, the taxpayer was not entitled to deduct his "purported" $25,000 of gambling losses as he did not report any gambling winnings and did not keep contemporaneous records of his gambling losses.[311] Finally, as the taxpayer did not show reasonable cause for failing to keep adequate books and records, the taxpayer was liable for the accuracy related penalty pursuant to I.R.C. § 6662.[312]

B. Tax Treatment of Professional Gamblers

Despite the characterization of the activities of a gambler as a business, the wagering losses and business-related expenses of a professional gambler are deductible only to the extent of wagering gains.[313] The asymmetrical treatment of taxing net gambling winnings while disallowing

309. *Id.* at 10.

310. *Id.* at 11.

311. *Id.* at 19.

312. *Id.* at 23; *see supra* text accompanying notes 111-121 (discussing the application and consequences of the imposition of the accuracy-related penalty).

313. Mayo v. Comm'r, 136 T.C. 81, 90 (2011), *acq.* 2012-3 I.R.B. 285. For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11050, 131 Stat. 2054, 2089 (2017) (to be codified at I.R.C. § 165(d)).

a deduction for net gambling losses is theoretically justified for gamblers who gamble for recreation.[314] As with other expenses incurred for personal enjoyment, net gambling losses can be viewed as nondeductible personal expenses.[315] Although harder to justify for professional gamblers, the disallowance of a deduction for excess gambling losses has been defended by the difficulty of distinguishing between the casual and the professional gambler.[316] Nevertheless, the wagering loss limitation results in professional gamblers being treated differently than other types of businesses that can fully deduct all expenses and losses incurred in generating income.[317]

In *Lakhani v. Commissioner*,[318] the taxpayer was a certified public accountant who maintained an accounting practice and was also a professional gambler who experienced horseracing gambling losses in excess of gains.[319] The taxpayer argued that "gamblers should be allowed the same protection as any other profession when the activity is legal and conducted as a profession."[320] Congress enacted the predecessor to I.R.C. § 165(d) decades ago because, at the time, "gambling was taboo," but now gambling is legal in most states and gamblers are recognized in society.[321] The taxpayer's position was that treating the business of gambling differently than other businesses "constitutes a discriminatory, unconstitutional deprivation of professional gamblers' right to equal protection of the laws."[322] The Tax Court noted that the lessening of the historic moral opposition to gambling does not undermine the rational basis for treating professional gambling losses differently from other business-related losses.[323] The original intent of Congress, to treat losses from legal

314. BITTKER ET AL., *supra* note 68, ¶ 4.06.

315. *Id.* Except as otherwise provide, I.R.C. § 262 disallows a deduction for personal, living, or family expenses. I.R.C. § 262(a).

316. BITTKER ET AL., *supra* note 68, ¶ 4.06.

317. Zorn, *supra* note 182, at 20. *See generally id.* at 1 (arguing that the tax treatment of gambling includes restrictions that reflect a "moralistic anti-gambling bias").

318. 142 T.C. 151 (2014).

319. *Id.* at 153.

320. *Id.* at 158.

321. *Id.*

322. *Id.* The taxpayer also argued that a pro rata share of the "takeout" extracted from the parimutuel betting pool by the race track to cover purse money, expenses, fees, etc. was a business expense and not a reduction of his gambling winnings. *Id.* The Tax Court held that the expenses paid by the race track from the takeout were expenses imposed on the race track, not the bettors; therefore, they were not deductible by the taxpayer as a business expense. *Id.*

323. *Id.* at 162.

and illegal gambling the same and to force gamblers to report wagering gains, still pertains to taxpayer reporting of gambling gains and losses.[324]

In addition to wagering losses, professional gamblers often incur business-related expenses.[325] If an expense can be considered either a gambling loss or a business expense, the more specific wagering loss limitation under I.R.C. § 165(d) controls over the more general business expense deduction allowance under I.R.C. § 162.[326] Nevertheless, both business-related expenses and wagering losses are deductible from the gross income of the professional gambler in computing adjusted gross income.[327] Generally, expenditures are eligible for a business deduction if the expense is (1) ordinary and necessary and (2) incurred in carrying out a business activity or purpose.[328] Traveling expenses must be reasonable and necessary, including transportation expenses and meals and lodging, and incurred while away from home in pursuit of business.[329] In order to deduct the cost of meals, the "sleep and rest rule" must be satisfied, requiring the gambler to be away from home for a period of sufficient duration to necessitate the securing of lodging.[330] Except for payments of certain fines and penalties, which are not deductible under I.R.C. § 162(f), business expenses from legal as well as illegal gambling activities are deductible under I.R.C. § 162(a).[331]

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324. *Id.* The taxpayer was found liable for the I.R.C. § 6662(a) accuracy-related penalty for the years at issue. *Id.* at 163.

325. I.R.C. § 162..

326. Pham v. Comm'r, T.C. Summary Op. 2016-73 (Nov. 8, 2016). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11050, 131 Stat. 2054, 2089 (2017) (to be codified at I.R.C. § 165(d)).

327. I.R.C. § 61(a)(1); Comm'r v. Groetzinger, 480 U.S. 23, 37 (1987) (White, J., dissenting).

328. I.R.C. § 162(a). "The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." Welch v. Helvering, 290 U.S. 111, 115 (1933).

329. Comm'r v. Flowers, 326 U.S. 465, 470 (1946). Traveling expenses cannot be lavish or extravagant under the circumstances. I.R.C. § 162(a)(2). *See generally* BITTKER ET AL., *supra* note 68, ¶ 13.01[1] (discussing the requirement that the travelling expenses be incurred while away from home).

330. Strohmaier v. Comm'r, 113 T.C. 106, 115 (1999).

331. 7 MERTENS LAW OF FEDERAL INCOME TAXATION § 28:157 (Westlaw, Oct. 2017 update). I.R.C. § 162(f) disallows a business deduction for any fine or penalty paid to a government for violation of any law. I.R.C. § 162(f).

In *Mayo v. Commissioner*,[332] the taxpayer was engaged in the business of horserace gambling.[333] During the tax year at issue, he wagered $131,760 on the outcome of horse races and won $120,463 as a result of those wagers.[334] He also incurred $10,968 of business-related expenses, including travel, meals and entertainment, telephone and internet, admission and entry fees, subscriptions, and handicapping data.[335] In *Mayo*, the Tax Court confirmed that the wagering loss limitation of I.R.C. § 165(d) applied to both professional and recreational gamblers.[336] The more difficult issue was whether "losses from wagering transactions," as used in I.R.C. § 165(d), included the cost of the losing wagers as well as more general business-related expenses.[337] Declining to follow an earlier Tax Court decision that included business expenses in the definition of "losses from wagering transactions," the Tax Court held that, under I.R.C. § 162, the taxpayer was entitled to deduct the $10,968 in business expenses claimed in connection with carrying on his gambling business.[338]

If a professional gambler sustains gambling-related expense deductions in excess of net gambling winnings, the net operating loss (NOL) provisions may apply to the excess; however, gambling losses in excess of gambling winnings do not generate an NOL.[339] For the NOL provisions to apply, an individual must be engaged in a business, and the expenses incurred must relate to that business.[340] The primary purpose of I.R.C. § 172 is to treat businesses with fluctuating income in the same manner as businesses with a steady flow of income by allowing an NOL to be carried forward to subsequent tax years.[341] Generally, an NOL is the excess of business deductions over the taxpayer's gross income for the tax year.[342] However, until 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering

332. 136 T.C. 81 (2011).
333. *Id.* at 83.
334. *Id.*
335. *Id.*
336. *Id.* at 85-86.
337. *Id.* at 82.
338. *Id.* at 97.
339. I.R.S. Chief Couns. Adv. AM2008-013 (Dec. 10, 2008).
340. BITTKER ET AL., *supra* note 68, ¶ 19.02[1].
341. *Id.* Generally, an NOL is carried forward and deducted against taxable income for up to twenty subsequent tax years. I.R.C. § 172(b). Generally, the two-year carryback and the special carryback provisions have been repealed. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13302, 131 Stat. 2054, 2121–24 (2017) (to be codified at I.R.C. § 170).
342. I.R.C. § 172(c), (d); BITTKER ET AL., *supra* note 68, ¶ 19.02[2].

transactions are limited to the amount of gambling gains; therefore, business deductions in excess of gambling gains are not allowable, thus, not contributing towards an NOL.[343]

The Office of the Chief Counsel provides a formula for determining the business income or loss of a professional gambler as follows: wagering gains minus wagering losses, as limited by I.R.C. § 165(d), equals wagering income; wagering income minus business-related expenses equals business income or loss.[344] The memorandum also contains several situations as examples:[345]

> **Situation 1**: A is a professional gambler engaged in the trade or business of playing poker. Gambling is A's sole occupation; A is not employed and has no other income. Throughout the year, A traveled to various casinos and other venues where gambling is legal to participate in poker tournaments. At the end of the year,

343. Tax Cuts and Jobs Act § 11050 (to be codified at I.R.C. § 165(d)).

344. I.R.S. Chief Couns. Adv. AM2008-013. For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings. Tax Cuts and Jobs Act § 11050 (to be codified at I.R.C. § 165(d)).

345. I.R.S. Chief Couns. Adv. AM2008-013. The third situation provided in I.R.S. Chief Couns. Adv. AM2008-013 is as follows:

> Situation 3: C is a professional gambler engaged in the trade or business of playing poker. Gambling is C's sole occupation; C is not employed and has no other income. Throughout the year, C traveled to various casinos and other venues where gambling is legal to participate in poker tournaments. At the end of the year, C had total wagering gains of $75,000, total wagering losses of $100,000, and incurred $15,000 in business expenses for transportation, meals and lodging.
>
> C must report the $75,000 of wagering gains as gross receipts. Under § 165(d), C may deduct wagering loss to the extent of wagering gains. Therefore, C may subtract only $75,000 of his $100,000 of wagering losses from gross receipts, completely offsetting his $75,000 of gross receipts. C may not carry over the excess $25,000 of (unused) wagering losses to offset wagering gains or other (non-wagering) income in another taxable year. Under § 162(a)(2), C may then deduct the $15,000 business expense without regard to § 165(d), resulting in a net operating loss of $15,000. C may carry that $15,000 net operating loss over or back to another year under § 172(b).

Id. Nevertheless, for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings. Tax Cuts and Jobs Act § 11050 (to be codified at I.R.C. § 165(d)).

> A had total wagering gains of $100,000, total wagering losses of $75,000, and incurred $15,000 in business expenses for transportation, meals and lodging.
>
> A must report the $100,000 of wagering gains as gross receipts. Under § 165(d), A may subtract $75,000 of wagering losses from the $100,000 of gross receipts, resulting in $25,000 of wagering income. Under § 162(a)(2), A may then deduct $15,000 in business expenses from the $25,000 of wagering income, resulting in $10,000 of business income.
>
> **Situation 2**: Assume the same facts as Situation 1, except that B also had $10,000 of (taxable) investment income. B must report the $100,000 of wagering gain as gross receipts. Under § 165(d), B may subtract $75,000 of wagering losses from the $100,000 of gross receipts, resulting in $25,000 of wagering income. Under § 162(a)(2), B may then deduct $15,000 in business expenses from the $25,000 of wagering income, resulting in $10,000 of business income. B also must report the $10,000 of investment income as gross income under § 61. B therefore has $20,000 of total income ($10,000 business income + $10,000 investment income).

C. Tax Treatment of Recreational Gamblers

Like professional gamblers, recreational gamblers are required to include gambling winnings into income and are subject to the gambling loss limitation of I.R.C. § 165(d).[346] However, unlike professional gamblers, recreational gamblers cannot deduct gambling-related expenses, as such expenses are nondeductible personal expenses.[347] The deductible wagering losses of the casual gambler are itemized deductions,[348] which reduce the adjusted gross income of the gambler in computing taxable income.[349] As a consequence, if the gambler does not elect to itemize deductions but

346. Professional gamblers report gambling losses to the extent of gambling income and other deductible expenses on Form 1040, Schedule A. IRS PUB. 529, MISCELLANEOUS DEDUCTIONS, *supra* note 229, at 12.

347. I.R.C. § 262(a); I.R.S. Tech. Adv. Mem. 9808002 (Oct. 24, 1997); Boneparte v. Comm'r, T.C. Memo. 2015-128, at 15 (July 3, 2015).

348. I.R.C. § 63(d); Shollenberger v. Comm'r, 98 T.C.M. (CCH) 667, 668 (2009).

349. I.R.C. § 63(a).

deducts the standard deduction,[350] the gambler effectively cannot deduct gambling losses and, thereby, offset gambling winnings.[351]

With gambling losses being itemized deductions, gambling losses are potentially subject to provisions that limit the amount of itemized deductions otherwise allowable.[352] I.R.C. § 67 allows the deduction of miscellaneous itemized deductions only to the extent the taxpayer's total miscellaneous itemized deductions exceed 2% of adjusted gross income for the tax year.[353] Fortunately for the recreational gambler, the definition of "miscellaneous itemized deduction" does not include the deduction of gambling losses.[354] Since gambling losses are not a miscellaneous itemized deduction, gambling losses are also not adjustments to taxable income for the purpose of the alternative minimum tax.[355] Pursuant to I.R.C. § 68, if the taxpayer's adjusted gross income exceeds a threshold amount, the taxpayer must reduce allowable itemized deductions by the lesser of (1) 3% of the excess over a threshold amount or (2) 80% of the otherwise allowable itemized deductions.[356] Only deductions for medical expenses, investment interest, losses arising from casualty and theft, and wagering losses are not subject to this limitation.[357]

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350. *Id.* § 63(b), (e). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of household filers, and $12,000 for all other taxpayers, adjusted for inflation in tax years beginning after 2018. Tax Cuts and Jobs Act § 11021(a) (to be codified at I.R.C. § 63).

351. *Shollenberger*, 98 T.C.M. (CCH) at 669; Rev. Rul. 83-130, 1983-2 C.B. 148.

352. I.R.C. §§ 67–68.

353. *Id.* § 67(a).

354. *Id.* § 67(b)(3). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is suspended. Tax Cuts and Jobs Act § 11045 (to be codified at I.R.C. § 67(g)).

355. I.R.C. § 56(b)(1)(A)(i). The alternative minimum tax (AMT) was enacted to prevent taxpayers from avoiding tax liability on substantial incomes through the excessive use of preferential provisions of the Internal Revenue Code. BITTKER ET AL., *supra* note 68, ¶ 45.01. Generally, the AMT provisions, I.R.C. §§ 55-58, require a redetermination of taxable income that adds back into the tax base many items that normally reduce taxable income for regular tax purposes. *Id.*

356. I.R.C. § 68(a). For 2013, the threshold amounts were $300,000 for a joint return, $275,000 in the case of head of household, and $250,000 for a single taxpayer who is not a surviving spouse or head of household. *Id.* § 68(b)(1). After 2013, the threshold amounts were adjusted for inflation. *Id.* § 68(b)(2).

357. *Id.* § 68(c). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the further limitation on the otherwise allowable itemized deductions of higher-income taxpayers is suspended. Tax Cuts and Jobs Act § 11046 (to be codified at I.R.C. § 68(f)).

Although not engaged in a business, a recreational gambler arguably can deduct gambling-related expenses under I.R.C. § 212(1), which allows a deduction for all ordinary and necessary expenses incurred for the production of income.[358] In *Shiosaki v. Commissioner*,[359] the taxpayer, an electrical engineer, was denied a deduction for amount expended for travel, meals, and lodging incurred in pursuit of his gambling activities. The taxpayer became fascinated with the game of craps and began reading books on the subject and attempting to devise a system to win at the craps tables.[360] Unable to develop a winning formula, the taxpayer experienced a "long history of enormous, unceasing gambling losses."[361] In denying a deduction for his gambling-related expenses, the Tax Court concluded the taxpayer's gambling activities were not motivated by a profit-seeking purpose as required by I.R.C. § 212(1).[362] With regard to the possible application of I.R.C. § 212(1) to the facts in *Shiosaki*, the Service, in Technical Advice Memorandum (TAM) 9808002, noted "that wagering on one's own account in games in which skill and judgement have no influence on the outcome and where the odds are against success is not an activity engaged in for the production of income, even if such wagering is continuous, dedicated, and systematic."[363]

In TAM 9808002, the taxpayers won a state lottery, with payments to be received annually. The taxpayers, who often engaged in various wagering activities, claimed as deductions expenses for legal fees, mileage, business meetings, meals and entertainment, and travel expenses incurred incident to their wagering activities.[364] After holding that these expenses are not deductible under I.R.C. § 212(1) because the taxpayers did not produce meaningful evidence that they engaged in wagering activities with a bona fide expectation of profit, the Service held that the expenses could not be deducted to the extent of income under I.R.C. § 183.[365] Generally, if it is determined that an activity is not engaged in for profit, I.R.C. § 183 allows a taxpayer to deduct expenses attributable to the activity to the extent of

358. I.R.C. § 212(1). For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is suspended. Tax Cuts and Jobs Act § 11045 (to be codified at I.R.C. § 67(g)).

359. 34 T.C.M. (CCH) 127, 128 (1975); *see also* Shiosaki v. Comm'r, 30 T.C.M. (CCH) 110, 111 (1971), *aff'd*, 475 F.2d 770 (9th Cir. 1973).

360. *Shiosaki*, 34 T.C.M. (CCH) at 127.

361. *Id.* at 128.

362. *Id.*

363. I.R.S. Tech. Adv. Mem. 9808002 (Oct. 24, 1997).

364. *Id.*

365. *Id.*

income generated by the activity.[366] The Service did not find any precedent to support the deduction and held the expenses claimed as typically considered personal, living, or family expenses, which are expressly nondeductible under I.R.C. § 262.[367]

D. Deduction of Charitable Contributions

I.R.C. § 170 allows taxpayers to deduct contributions to religious, educational, and similar nonprofit organizations.[368] To qualify for a charitable contribution deduction, the transfer must be a "contribution or gift" and not payment for goods or services.[369] A common form of charitable fundraising is the charity raffle, requiring supporters of the charity to make payments in exchange for tickets evidencing a chance to win prizes. The position of the Service is that the amounts paid to charities to participate in raffles, lotteries, or similar drawings for valuable prizes are not charitable gifts; therefore, they do not qualify as charitable contributions under I.R.C. § 170. "The purchase of raffle tickets is not a charitable contribution, but merely is the price paid for the chance to obtain a valuable prize."[370]

In Revenue Ruling 83-130,[371] the taxpayer purchased for $100 a winning raffle ticket, entitling him to participate in a drawing to win a house.[372] The charitable organization raised $200,000 from the sale of raffle tickets.[373]

366. I.R.C. § 183(b). I.R.C. § 183 allows a deduction for expenses incurred in a not-for-profit activity to the extent the income from the activity exceeds deductions allowable without regard to a profit motive. *Id.* The Treasury Regulations provide describe nine "relevant factors" that should be taken into account in determining whether an activity is engaged in for profit. Treas. Reg. § 1.183-2(b) (1972). I.R.C. § 183 contains a rebuttable presumption that the activity is engaged in for profit if the activity was profitable for three of the five preceding years. I.R.C. § 183(d); *see supra* text accompanying note 294-299 (listing and applying the factors useful in determining the existence of a profit motive).

367. I.R.S. Tech. Adv. Mem. 9808002. Treasury Regulation 1.262-1(b)(5) provides that traveling expenses incurred while away from home are nondeductible personal expenses unless they qualify as expenses deductible under I.R.C. § 162 (relating to trade or business expenses); I.R.C. § 170 (relating to charitable contributions); I.R.C. § 212 (relating to expenses for the production of income); I.R.C. § 213(e) (relating to medical expenses); or I.R.C. § 217(a) (relating to moving expenses). *Id.*

368. I.R.C. § 170(a), (c).

369. BITTKER ET AL., *supra* note 68, ¶ 25.01[2].

370. Patterson v. Comm'r, 53 T.C.M. (CCH) 847, 849 (1987); Rev. Rul. 67-246, 1967-2 C.B. 104.

371. Rev. Rul. 83-130, 1983-2 C.B. 148.

372. *Id.*

373. *Id.*

The Service held that the taxpayer was not allowed a charitable contribution deduction for the amount paid for the raffle ticket as the taxpayer received a chance to win a valuable prize; thus, the taxpayer received full consideration for the payment to the charitable organization.[374] Further, the Service held that "[a] raffle is a disposal by chance of a single prize among purchasers of separate chances, and an individual buying a raffle ticket makes a wager through such purchase."[375] The value of the house won by the taxpayer could be included in the taxpayer's income as a wagering gain.[376] Since the taxpayer was not a professional gambler, the cost of the winning raffle ticket constituted a wagering loss and, as such, was deductible as an itemized deduction pursuant to I.R.C. § 165(d).[377]

In *Goldman v. Commissioner*,[378] the taxpayer purchased raffle tickets from various charitable organizations, testifying that he would have received a prize if his number had been drawn but, in making the purchase, he did not intend to gamble but to make a gift to the charitable organization.[379] The Sixth Circuit Court of Appeals denied the charitable contribution deduction, stating:

> Petitioner was not a contributor to a charitable organization when he bought his raffle ticket. He was merely purchasing that which the charitable organization had to sell, namely, chances for a valuable prize. . . . [Petitioner] received full consideration and he got just what he paid for. He was not making a charitable contribution within the meaning of the statute.[380]

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374. *Id.*

375. *Id.*

376. *Id.* Annual lottery payments received in subsequent years are considered gains from wagering transactions in the tax year of receipt. *Id.*

377. *Id.; see* INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. 526, CHARITABLE CONTRIBUTIONS 6 (Jan. 19, 2017), https://www.irs.gov/pub/irs-pdf/p526.pdf (considering the cost of raffles, bingo, lottery, etc. as contributions from which taxpayers receive a benefit and referring taxpayers to IRS Publication 529 for information on how to report gambling winnings and losses).

378. 388 F.2d 476 (6th Cir. 1961).

379. *Id.* at 479.

380. *Id.* at 480. The Sixth Circuit suggested that, if the value of the chances was "infinitesimal," a charitable deduction might result, but the taxpayer did not sustain his burden of establishing the value of the chances purchased. *Id.* The Sixth Circuit also considered the treatment of the lottery ticket as a bargain sale not "theoretically unsound" but practically unfeasible. *Id.*

V. Conclusion

"Gambling is big business. From a barely tolerated vice . . . the gambling industry has become an integral part of the American economy, and a major source of financial support for revenue starved state and local governments."[381] Because of the growing acceptance of gambling and the proliferation of gambling opportunities, the tax treatment of both professional and recreational gamblers should be reevaluated. The business of gambling receives less favorable tax treatment than other types of business activities. With the clarity provided by the Supreme Court as to the definition of a professional gambler, the wagering loss limitation should be lifted, as losses and expenses incurred in other types of business are fully deductible. The recreational gambler should be able to deduct all gambling-related expenses, including wagering losses, to the extent of wagering income because such treatment is afforded to other activities entered into without a profit motive. Nevertheless, whether professionals or recreational gamblers, taxpayers must understand the tax laws and procedures and follow the substantiation requirements applicable to their wagering transactions before incurring any gambling winnings and losses. If forsaken by Lady Luck, a gambler may be liable for additional tax and, if completely abandoned by her, may be subject to civil and criminal penalties.

381. Zorn, *supra* note 182, at 1.