

# **Taxing Gambling**

Michael Roeseler

May 23, 2014

Final Draft

Directed Research – Professor Francine Lipman

Boyd School of Law  
University of Nevada, Las Vegas

## Abstract

Gambling winnings are taxable under the Internal Revenue Code of 1986, as amended (the “Code”). There are many individuals, in Las Vegas particularly, that derive a substantial portion of their income from gambling activities such as playing poker. Unfortunately, anecdotally it appears that many individuals fail to properly report their gambling winnings as income on their tax return. Perhaps some of the failure to report is due to the complexity of the process. All gambling winnings, from the \$50 someone might win one night at a slot machine to the yearly tournament earnings of a professional poker player are required to be included in gross income. While gambling losses are allowable only to the extent of gambling winnings, there is generally no netting of losses against winnings allowed unless an individual’s gambling activity is such that it qualifies as a trade or business. Alternatively, gambling losses can only be claimed as itemized deductions. Unfortunately, many gamblers cannot enjoy the benefit of these gambling losses because they do not itemize their deductions and instead take the greater standard deduction. For taxpayers with high levels of gambling income and losses, it is possible to accrue additional tax liability under the alternative minimum tax (AMT) without being afforded the benefit of deducting gambling losses for the purpose of the AMT calculation.

This Article describes the tax treatment for several types of professional gamblers, including the restrictive nature of certain Code sections. Many taxpayers find the treatment of gambling losses confusing and this emboldens some to inaccurately report their taxable income. Several potential changes could be made to the tax formula regarding the treatment of gambling activities with the intent of fostering greater and more accurate tax reporting.

# Contents

<b>I</b>	<b>Introduction</b>	<b>3</b>
<b>II</b>	<b>How Gambling Tax Reporting Works</b>	<b>8</b>
	(a) Types of Gamblers.....	12
	(b) Netting Calculations.....	15
<b>III</b>	<b>Gambling Within a Trade or Business Context</b>	<b>21</b>
	(a) Difficulties Obtaining Trade or Business Status.....	23
<b>IV</b>	<b>Problems in the Sphere of Gambling Taxation</b>	<b>27</b>
	(a) AMT Considerations.....	27
	(b) Phase-Outs.....	30
	(c) Timing Concerns.....	31
<b>V</b>	<b>Potential Improvements</b>	<b>32</b>
	(a) Fixing the AMT Problem.....	33
	(b) Proactively Withholding.....	33
	(c) Reevaluating the Netting Process.....	35
	(d) Hobby Loss Application.....	38
<b>VI</b>	<b>Conclusion</b>	<b>41</b>

# Section I

## Introduction

The Internal Revenue Code of 1986, as amended (the Code), was enacted by Congress as Title 26 of the United States Code.<sup>1</sup> It contains a comprehensive set of tax laws including many Code sections and subsections that are administered by the Internal Revenue Service. Individual taxpayers are required to self-report and pay a personal income tax that is based on an adjusted gross income calculation. The Code defines gross income as: all income from whatever source derived, unless otherwise excluded.<sup>2</sup> The Treasury Regulations state that gross income includes income realized in any form, whether in money, property, or services from all sources unless the taxpayer can point to an express exclusion.<sup>3</sup>

The US Supreme Court has defined gross income to include “gains, profits, ... or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, ... or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.”<sup>4</sup> In fact, there is no requirement that you affirmatively seek profits, there are tax consequences for the fortunate

---

<sup>1</sup> 26 U.S.C.A. Subt. A, Ch. 1, Subch. A, Pt. I, Refs & Annos

<sup>2</sup> *Id.* at 61

<sup>3</sup> 26 C.F.R. § 1.61-1(a)

<sup>4</sup> C.I.R. v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955)

wanderer who discovers a treasure (similar to being given gambling winnings in a casino).<sup>5</sup> Treasure Trove, to the extent of its value in US currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.<sup>6</sup>

Many types of gambling winnings are includable in gross income and there is a duty for a taxpayer to report his or her gambling winnings.<sup>7</sup> Whether or not something is includable in gross income is a different question from whether the item was actually reported. Therefore it is not permissible for a taxpayer to omit an income item such as the proceeds won from a wagering pool from his or her tax returns.<sup>8</sup> If a taxpayer believes a source of income is not taxable then the appropriate procedure is to declare the disputed income and the burden of proof rests with her to show that the item is not includable in gross income by submitting a statement and supporting documentation.<sup>9</sup>

If Congress wanted to implement a policy that strongly deterred gambling activities, a system could be created where an individual is taxed for every wager she made and won, and no allowance is made for losses. Notably, Congress has not taken this approach, but rather the Code provides an itemized deduction for gambling losses up to the amount of gambling income.<sup>10</sup>

---

<sup>5</sup> The treasure trove doctrine recently manifested in Northern California where a couple discovered gold coins on their property worth millions of dollars. See Vives, Ruben. “California couple finds \$10 million in gold coins buried in backyard.” *Los Angeles Times*. 25 Feb 2014. <http://touch.latimes.com/#section/-1/article/p2p-79440593/>

<sup>6</sup> 26 C.F.R. § 1.61–14(a)

<sup>7</sup> McClanahan v. U.S., 292 F.2d 630, 632 (5th Cir. 1961).

<sup>8</sup> *Id.*

<sup>9</sup> Welch v. Helvering, 290 U.S. 111, 115 (1933)

<sup>10</sup> Shollenberger v. C.I.R., 98 T.C.M. (CCH) 667 (Tax 2009)

Unless the individual is a trade or business, the taxpayer is not allowed an above the line deduction to adjusted gross income (AGI) for his gambling losses.<sup>11</sup> Instead, AGI is increased by the total of all of the gambling income and then a taxpayer may elect to itemize her deductions and claim deductible gambling losses in lieu of taking the standard deduction.<sup>12</sup> Miscellaneous itemized deductions are generally subject to a 2% floor of AGI before they can be applied, however, gambling losses up to the amount of gambling winnings are specifically listed as not subject to the 2% limit.<sup>13</sup>

An example of this computation demonstrates the effect of gambling income and losses on two comparable individual income tax returns. Let's assume that taxpayers A and B both file individual income tax returns qualifying for head of household filing status.<sup>14</sup> Assume they each have \$50,000 in earned income from wages for the tax year of 2013 and no other income aside from winnings they receive as a result of playing in a weekly bingo tournament. A and B both pay \$100 to enter the bingo event each week for a total yearly expense of \$5,200 (\$100 x 52 weeks a year). This amount would be characterized as a gambling loss and could potentially be used as a miscellaneous itemized deduction against gambling winnings that are received during the same tax year.<sup>15</sup>

---

<sup>11</sup> 26 U.S.C.A. § 62

<sup>12</sup> *Id.* at 63

<sup>13</sup> Publication 529 Misc. Deductions, 2013 WL 6243738 (I.R.S. 2013)

<sup>14</sup> 26 U.S.C.A. § 2(b)

<sup>15</sup> *Id.* at 165(d)

Let's assume the respective value of bingo winnings for A and B in 2013 amounted to \$3,000 in cash and prizes each.<sup>16</sup> Both are required to declare the \$3,000 gambling winnings as income, raising their AGI to \$53,000 for the 2013 tax year. The maximum allowed miscellaneous itemized deduction that A or B could take as a result of their gambling loss would be \$3,000 because this was the extent of their gambling income.<sup>17</sup>

A and B each qualify for the \$3,900 personal exemption which is subtracted from AGI.<sup>18</sup> A has very little in the way of miscellaneous deductions and will elect the standard deduction as head of household for a fully sighted individual giving her an additional \$8,950 deduction.<sup>19</sup> For the sake of comparison, let us assume B has state and local income and property tax expenses as well as a home mortgage interest deduction that provide her with \$8,950 of itemized deductions.<sup>20</sup> Because B has enough expenses to elect to itemize, she will be able to benefit from her \$3,000 gambling loss giving her an itemized deduction total of \$11,950 in this example.

If we compute the taxable income of both individuals, we see that A has a taxable income of  $(53,000 - 3,900 - 8,950) = \$40,150$ ; where B has a taxable income of  $(53,000 - 3,900 - 11,950) = \$37,150$ . The net result is that B has \$3,000 less in taxable income. The top marginal tax rate for head of household filers with \$37,000 to \$40,000 in taxable income was 15% in

---

<sup>16</sup> A and B are not engaging in the bingo activity seeking a profit, merely as an enjoyable recreational activity.

<sup>17</sup> 26 U.S.C.A. § 165(b)

<sup>18</sup> Publication 501 Exemptions, Stand. Deduction, and Filing Info., 2013 WL 6688097 (I.R.S. 2013)

<sup>19</sup> *Id.*

<sup>20</sup> Itemized deductions include state, local, and property taxes under 26 U.S.C.A. § 67(b)2 and an allowance for the home mortgage interest deduction is provided under 26 U.S.C.A. § 67(b)1.

2013.<sup>21</sup> The difference in tax liability between A and B is  $(\$3,000 \times .15) = \$450$ . A accrues a tax liability of \$450 as a result of winning bingo prizes even though the prizes did not exceed her capital outlay in registering for the bingo events. B is in a more favorable position regarding her bingo activities on account of her higher level of expenses that qualified as itemized deductions and therefore does not accrue tax liability when she plays bingo and wins prizes that do not exceed the money she spent to play bingo in a given tax year.

---

<sup>21</sup> 26 U.S.C.A. § 1(b)



## Section II

### How Gambling Tax Reporting Works

Gambling activity that results in a gain is taxable as ordinary income.<sup>22</sup> This is fairly straightforward in the instance of a taxpayer going into a casino on one occasion, placing one \$50 wager, and winning \$50 in addition to receiving her \$50 wager back. This taxpayer has had an “undeniable accession to wealth, clearly realized, and over which the taxpayer(s) have complete dominion”<sup>23</sup> and as a result must include \$50 in gambling income on her tax return for the year in which the wager was resolved and the earnings were reduced to her “undisputed possession.”<sup>24</sup>

However, many recreational gamblers do not include any gambling income on their tax returns.<sup>25</sup> These individuals may gamble occasionally and may wrongly believe that small wagering in an office pool or fantasy sports league is not significant enough to warrant including it in their annual income tax return. They may also argue that there is no need to report income

---

<sup>22</sup> 26 U.S.C.A. § 61(a).

<sup>23</sup> C.I.R. v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955)

<sup>24</sup> Cesarini v. U.S., 296 F. Supp. 3, 5 (N.D. Ohio 1969) aff'd, 428 F.2d 812 (6th Cir. 1970). For an application of the imposition of taxpayer consequences resulting from small isolated wagers from bookmaking see Winkler v. U.S., 230 F.2d 766 (1st Cir. 1956)

<sup>25</sup> Grant, Tim. "Game of chance: Many don't report gambling winnings to the IRS." *Pittsburgh Post-Gazette*. PG Publishing Co., Web. 11 Mar 2008. <http://www.post-gazette.com/business/businessnews/2008/03/11/Game-of-chance-Many-don-t-report-gambling-winnings-to-the-IRS/stories/200803110170>

because their losses exceed any gains received.<sup>26</sup> This argument has routinely been rejected in cases such as McClanahan v. US, where the Fifth Circuit held that defendant must declare \$50,000 in gambling winnings coming from blackjack even though petitioner argued that his total gambling losses for the year exceeded that figure.<sup>27</sup>

McClanahan had a significant enough gambling loss deduction that would have compelled him to elect to itemize his deductions when the 5<sup>th</sup> Circuit required him to include his gambling winnings in his gross income. However, most occasional gamblers would realize no tax benefit from itemizing their deductions and claiming gambling losses to the extent of their gambling income because they do not have enough gambling losses to provide a net tax benefit given the standard deduction. According to Intuit, maker of TurboTax, only one out of four taxpayers receive a lower tax bill from itemizing, meaning that many individuals would receive no immediate tax benefit from gambling losses until their net itemized deduction total exceeded their standard deduction.<sup>28</sup> Consistent with Intuit's statement approximately 66.5% of all taxpayers claim the standard deduction in lieu of electing to itemize their deductions.<sup>29</sup>

There are further inequities that become apparent in the taxation of gambling income. For example, a gambler that wins a large wager one year and then goes on to lose money in a similar

---

<sup>26</sup> According to the Statistics of Income Bulletin published by the IRS only 1.9 million returns included any gambling income at all (including those with no net income from gambling activities) out of 145 million individual returns filed for tax year 2011. See the Fall 2013 SOI Bulletin at <http://www.irs.gov/uac/SOI-Tax-Stats-SOI-Bulletin:-Fall-2013>

<sup>27</sup> McClanahan v. U.S., 292 F.2d 630, 631 (5th Cir. 1961)

<sup>28</sup> "Tax Deduction Wisdom - Should You Itemize?" *Intuit TurboTax*. Intuit, Inc., Web. 21 Mar 2014. <https://turbotax.intuit.com/tax-tools/tax-tips/Tax-Deductions-and-Credits/Tax-Deduction-Wisdom---Should-You-Itemize-/INF12061.html>

<sup>29</sup> 26 U.S.C.A. § 63. Statistics on the use of the standard deduction can be found on page 8 of the Fall 2013 IRS SOI Bulletin at <http://www.irs.gov/uac/SOI-Tax-Stats-SOI-Bulletin:-Fall-2013>

wager in following years. Deductions on wagering losses are only allowed to the extent of gains from such transactions during that tax year and losses can only be claimed in the tax year they are sustained.<sup>30</sup> Like many other areas of the Code, timing is important and currently no provisions are made for the carry forward or back of gambling losses. Difficulties resulting from the timing of income and losses are not unusual for many taxpayers. As a result Congress has provided carry-forward (and back) provisions across tax years for certain items including business operating losses,<sup>31</sup> investment losses<sup>32</sup> and charitable contributions.<sup>33</sup> A similar provision for gambling losses would make the current tax regime less harsh.<sup>34</sup>

The US Supreme Court has acknowledged in Commissioner v Groetzinger that federal and state legislation and court decisions “have been reluctant to treat gambling on a parity with more ‘legitimate’ means of making a living.”<sup>35</sup> Gambling and those that partake in related activities have long had a reputation for unwholesomeness in our culture and some might even characterize the activity of gambling as sinful.<sup>36</sup> We have a long history in the United States of

---

<sup>30</sup> 26 U.S.C.A. § 165

<sup>31</sup> *Id.* at 172(b)

<sup>32</sup> *Id.* at 1212(a)

<sup>33</sup> *Id.* at 170(b)1D(ii)

<sup>34</sup> Las Vegas is a popular tourist destination for New Year’s Eve. Imagine a tourist flies in for the holiday intending to stay only one night. He begins gambling on December 31<sup>st</sup> and wins big in the evening, but continues to gamble losing it all back and then some at another casino in the early hours of Jan 1<sup>st</sup>. That unfortunate gambler escapes Vegas the next morning with a net of zero in his pocket, but potentially has reportable income for one tax year and no deduction for losses that occurred in another.

<sup>35</sup> C.I.R. v. Groetzinger, 480 U.S. 23, 32 (1987)

<sup>36</sup> According to LDS.org the Church of Jesus Christ of Latter-day Saints stands opposed to gambling. See Oaks, Dallin. “Gambling-Morally Wrong and Politically Unwise.” *Intellectual Taxing Gambling* by Michael Roeseler, UNLV Boyd School of Law

trying to promote moral or “healthy” decision making through social policy.<sup>37</sup> One of the most popular means of achieving this end through the tax code are sin taxes placed on controlled substances like tobacco and alcohol.<sup>38</sup>

It is possible that Congress intended to impose harsher treatment on individuals with gambling income as a means of discouraging gambling activities in general. If that was the initial intent, I would argue that given the growing acceptance of gambling in our society, Congress should consider eliminating this harsh treatment.<sup>39</sup> States have allowed an increasing number of casinos to be built as a source of tax revenue (this is in addition to the numerous casinos already located on Native American Reservations) and there is widespread participation in gambling

---

*Reserve, Inc.* Accessed 27 May 2014. <https://www.lds.org/ensign/1987/06/gambling-morally-wrong-and-politically-unwise?lang=eng>

To read arguments for and against the morality of gambling visit a debate at: <http://www.debate.org/opinions/is-gambling-morally-wrong>

<sup>37</sup> One such policy includes the recent Family Smoking Prevention and Tobacco Control Act (FSPTCA), the FDA states on their website that “By regulating tobacco products in the United States, the Food and Drug Administration has taken several important steps in a larger public health effort aimed toward preventing our children from becoming the next generation of Americans to die prematurely from tobacco use and ultimately reducing death and disease associated with tobacco use.” Taken from <http://www.fda.gov/TobaccoProducts/NewsEvents/ucm173174.htm> October, 2010

<sup>38</sup> For background and analysis on sin taxes please see “Sin Taxes: Size, Growth, and Creation of the Industry” *Mercatus Center*. George Mason University. 5 Feb 2013. <http://mercatus.org/publication/sin-taxes-size-growth-and-creation-of-the-industry> and Sadowsky, James. “The Economics of Sin Taxes.” *The Action Institute*. Accessed 27 May 2014. <http://www.acton.org/pub/religion-liberty/volume-4-number-2/economics-sin-taxes>

<sup>39</sup> In a slightly different vein, look to the lessening of moral condemnation surrounding cannabis and consider the relaxed restrictions on marijuana that have made headway in several states as a result of political pressure stemming largely from a social movement. See Altman, Alex. “Why Legal Weed is Working in Colorado.” *Time*. 6 Jan 2014. <http://swampland.time.com/2014/01/06/why-legal-weed-is-working-in-colorado/>

activities by millions of Americans.<sup>40</sup> People earn their income both by working in the casinos and as professional gamblers, therefore it is appropriate to construct a tax policy that operates fairly without placing a moral judgment on legitimate wagering activity.

## **(a) Types of Gamblers**

There are certain characteristics we can use to define the subsets of professional gamblers. “Cash game players” include individuals who sit down at their game of choice and wager increments of coins or chips that are readily transferable to cash according to the prescribed rules for whatever game they are playing. These players are generally allowed to come and go as they please and may make additional wagers if they experience losses or desire to “up the stakes” during their course of play.

In contrast, a tournament usually has unique features that differentiate it from a cash game. There is typically one standard “buy-in” amount that the entrant will pay upfront with only limited opportunities to add a fixed amount of money or buy back in later if they experience misfortune.<sup>41</sup> These events usually run for a fixed period of time usually not taking longer than a few days to complete. Because of the discrete nature of when the tournament begins and the

---

<sup>40</sup> “Of the 50 states, only Hawaii and Utah can claim to be wager free. All other states offer at least a lottery, card room, racetrack or riverboat, if not a fully functioning land-based casino.” Rodriguez, Julio. “A Look at Casino Growth in the United States – Ten States Join Casino Race in the Last Five Years Alone,” *Poker News*. Card Player Media. 24 Apr 2012. <http://www.cardplayer.com/poker-news/13189-a-look-at-casino-growth-in-the-united-states>

<sup>41</sup> Tournaments are generally played until there is a single winner and prize money is distributed based on how many people a player has outlasted. There is a new trend in poker in particular that allows participants who lose early to “buy back in” and compete again as if they had just entered the tournament for the first time.

usually significant amount of time between events it is much easier to isolate and track individual gambling winnings and losses for tax reporting purposes.

It is very straightforward for tournament players to track their wins and losses without having to rely on netting considerations. A tournament player earns his or her income when he finishes “in the money” or cashes out in a tournament. The full amount of his cash won is added to gross income. Some taxpayers make the argument that the buy-in paid to enter into the tournament should be deducted from the amount cashed as a return of capital, but it is not clear that an allowance is made for this in the Code.

Because of the unclear return of capital adjustment and the multiple tournament entries that are potentially paid prior to cashing, the tournament player’s adjusted gross income becomes inflated above what can be considered their actual income realized. Consider the tax implications for a hypothetical professional tournament player who competes in a series of poker tournaments throughout the tax year that each have a buy-in of \$1000. The nature of poker is that there is a lot of variance in that a player may win a large sum of money at one event and then have a long stretch where no money is won. These seemingly random events of when a player finishes in the money tend to level off at what can be considered a long run win-rate or edge over time that can be ascribed to a particular player’s skill level.<sup>42</sup>

We have rough approximations of what an individual’s skill advantage might be because there are private markets where players can engage and “sell action” essentially allowing others to

---

<sup>42</sup> Poker players are rated, or ranked, based on the total value of their tournament cashes as well as their percentage of finishing in the money. The largest publicly available online poker player ranking database can be found at <http://pokerdb.thehendons.com/rankings>

bid on an appropriate mark up to pay to cover a particular player's tournament entry costs.<sup>43</sup> The very best players in the game of poker can generally sell a portion of their tournament buy-in for a markup of 1.3 meaning that the backer expects the tournament professional to return a profit of 30% over the long run in each tournament event he participates in.<sup>44</sup> If the player is expected to return a significantly higher rate the backer would bid more, and a player that fails to perform at that level for a period of time loses the ability to command that size premium.<sup>45</sup>

## **(b) Netting Calculations**

One particularly troublesome area of gambling tax reporting arises in the area of netting particular gambling transactions.<sup>46</sup> The Code is not specific as to what constitutes a wagering transaction. The government has provided technical advice stating that a wagering transaction is not complete until "gambling tokens" are redeemed.<sup>47</sup> The rationale behind this position is that at

---

<sup>43</sup> Perhaps the most popular staking forum can be found on the web in the 2+2 Marketplace at <http://forumserver.twoplustwo.com/102/marketplace/>

<sup>44</sup> An example might be a player that sells his entire future potential winnings from a \$1,000 poker tournament for the sum of \$1,300 (\$1,000 x 1.3 markup). However, generally deals are not structured to purchase all of a player's action, as that might be seen to reduce the incentive to perform, therefore a more typical example might be to sell 50% of a player's action for \$650 (\$500 x 1.3), and then the player retains the right to receive 50% of his tournament proceeds.

<sup>45</sup> Obviously it can be difficult to assess the premium deserved by a poker player and compare his skill to that of another player. Helpful information includes records of previous tournament results, and online histories of poker games played on the internet. Risks in backing include counterparty trust that the player will not run off with the money and reliability risks that the historical results provided by the player are accurate. As a result of the risks involved there is a tendency for backers to form reoccurring relationships with the players they back and well know players in the community tend to have an easier ability to receive backing at a strong markup.

<sup>46</sup> IRS Publication 529 gives guidelines for how a taxpayer should declare their gambling activities. "You must report the full amount of your gambling winning for the year ... You cannot reduce your gambling winnings by your gambling losses and report the difference. You must keep an accurate diary or similar record of your losses and winning."

<sup>47</sup> IRS Chief Counsel Memorandum AM2008-011 (Dec. 5, 2008) at 2

the point of redemption there are no longer fluctuations in wins and losses but the result of the activities becomes an accession to wealth clearly realized over which the taxpayer has control.<sup>48</sup> Courts considering the issue of whether a transaction refers to every single play in a game or every wager made have found this standard unduly burdensome and unreasonable.<sup>49</sup>

Because of the difficulty of trying to isolate every individual wager, courts are forced to look to the timing of transfers of gaming chips to cash and this can lead to different tax results for similar wagering decisions. This distinction could be remedied by the maintenance of a daily transaction log or diary.<sup>50</sup> The ease of maintaining a gambling diary depends on the particular gambling activity involved. Compare for example, the differences between an individual who chooses to bet \$100 every weekend in a sixteen week season of his favorite football team and an individual who goes into a casino with the intention of placing sixteen \$100 bets at a blackjack table. Under the transaction theory laid out above the football gambler will have exactly \$1600 in gambling losses to deduct against his gambling winnings (A winning ticket for an even money bet in this example is stated as paying \$200 for a win where \$100 is a return of the initial wager amount similar to a return of capital invested). If he were to perform above expectation (above expectation because the house is going to maintain an edge in all wagers offered) and win half his bets he would be required to declare \$1,600 in gross income and have a \$1,600 itemized deduction. Despite the fact that the gambler would have no net income from his gambling activities, under the Code he would be required to increase his gross income potentially increasing his tax liability. An increase in tax liability could only be avoided if the taxpayer had

---

<sup>48</sup> 26 U.S.C.A. § 165, and IRS Chief Counsel Memorandum AM2008–011 (Dec. 5, 2008)

<sup>49</sup> See Green v. Commissioner, 66 T.C. 538, 1976 WL 3597 (1976)

<sup>50</sup> As suggested in IRS Publication 529



adequate expenses to itemize his deductions and was not subject to any AGI phase-outs or the AMT.<sup>51</sup> Any gambler who does not have other itemized deductions that are equal to or exceed the standard deduction would have to include \$1600 in income, increase their tax liability at their top marginal rate, even when their annual gambling activity resulted in no net income

The blackjack player who goes to the casino to place his \$100 wagers while keeping his money in casino chips will likely have a different tax outcome under the guidance described above. This individual is making discrete gambles that represent an almost identical betting behavior to the sports bettor when viewed in the abstract. The Code uses the plural term “transactions” implying that gain or loss may be calculated over a series of separate wagers where it would be impractical for an individual to record the win and loss of each particular wager occurring at a gaming table or slot machine over a relatively short period of time.<sup>52</sup> Individuals generally go to a casino for entertainment and do not keep meticulous notes or

---

<sup>51</sup> For an analysis on how phase outs and AGI limitations particularly effect those with gambling income see Chapter 6 of “All In Against the IRS: Every Gambler’s Tax Guide Second Edition,” written by Stephen Fishman and published by Pipsqueak Press in 2014.

The effects of an increased AGI the book discusses include:

Unreimbursed medical expenses under 26 U.S.C.A. § 213(a) can only be deducted by the amount they exceed 10% of your AGI.

Most miscellaneous itemized deductions under 26 U.S.C.A. §67(a) can only be deducted to the extent they exceed 2% of your AGI.

The Pease Provision codified as 26 U.S.C.A. §68(a) reduces a taxpayer’s itemized deductions allowed by 3% of the amount their AGI exceeds a threshold amount, up to 80%.

Up to 85% of Social Security benefits may become taxable under 26 U.S.C.A. §86 if taxpayer’s AGI exceeds certain tiers.

Tax credits like the earned income tax credit (26 U.S.C.A. §32), health insurance subsidies (under the Affordable Care Act), as well as the Medicare surtax (26 U.S.C.A. §1411) are all effected by a taxpayer’s AGI which includes gambling income without an allowance for gambling losses.

<sup>52</sup> Shollenberger v. C.I.R., 98 T.C.M. (CCH) 667 (Tax 2009)

records of each wager they place. Moreover, casino employed dealers are instructed to keep the games moving quickly, one hand dealt immediately after another.<sup>53</sup>

Anecdotal evidence strongly suggests that individual gamblers do not keep track of every single bet and the resulting gains or losses. Arguably the only entity capable of enforcing this type of process would be the casino. Casinos currently issue a W-2G for gambling earnings only on a per session basis when a certain amount is won and only at the end of the gambling session. A gambling session at a casino is not clearly defined, it can be as soon as someone stands up from a gaming table, or the W-2G can be issued at the conclusion of a several day poker tournament when the prize funds are distributed.<sup>54</sup>

The difficulty for individual gamblers concerned about accurately reporting their gambling activities is that there is no clear guidance as to what is a transaction. Gamblers may keep casino chips for longer periods of time and return regularly to make use of them.<sup>55</sup> Transactions could be considered individual sessions at a table, but sometimes play can go on for

---

<sup>53</sup> For background information and instructions given to casino employees at dealer schools, see “Working as a Casino Dealer” at <http://www.learnntodeal.com/245/working-as-a-casino-dealer>

<sup>54</sup> The IRS has issued guidance for when W-2G’s must be issued, which can be found at <http://www.irs.gov/instructions/iw2g/ar02.html>. My experience has been that if a situation arises where an amount is won at a gambling activity that approaches the limits stated in the IRS’s guidance, the casino will issue a W-2G before any funds are released to the taxpayer.

The casino may additionally be required to withhold a portion of the gambling proceeds to satisfy the gambler’s potential tax liability. According to “All In Against the IRS” casinos are responsible for paying the withholding amount if they fail to collect it on behalf of the tax payer. Withholding of 25% of gambling proceeds is required if the tax payer refuses to furnish his tax payer ID number or if he is a non-US resident who presumably would not otherwise be subjected to US Federal Income Tax. See <http://www.irs.gov/instructions/iw2g/ar02.html> for complete information.

<sup>55</sup> For instance, it is notably more convenient to carry around a \$5,000 casino chip than the equivalent amount or more of cash. Those that gamble regularly may occasionally keep and make use of casino chips without converting them to cash. Chips can also be brought to different casinos and converted for use there.

a 24 hour period or longer. It is unclear if a bathroom break, getting up to have a meal, or going home for a short nap should be considered the start of a new transaction when the chips are left in play (e.g., not cashed in).

Netting is more natural in some types of gambling activities relative to others. For example, slot machine play generally involves inserting currency into a machine and repeatedly pressing a button to begin a new cycle or “spin.” It might be a common occurrence to insert \$100, to have \$1,000 in winning spins, and \$700 in losing spins during the course of play. The gambler can then withdraw \$400 from the machine, subtract the \$100 that she began the gambling session with, and report \$300 in gambling income.

In Shollenberger, petitioners withdrew \$500 from their joint checking account to gamble at a local casino. Through the course of that day the husband hit a \$2,000 jackpot on a dollar slot machine. After receiving the jackpot winnings, petitioners each took \$200 from the prize awarded and began additional slot machine play. When they ended their slot machine play and left the casino they had \$1,600, which they deposited back into their joint checking account. The court in Shollenberger held that the petitioner’s gross income was \$1,100 (the \$1,600 they deposited minus their \$500 initial capital).<sup>56</sup> The court netted the entire day’s gambling activities and allowed a net gambling win to be declared when there were admittedly multiple transactions occurring (the most significant of which included the awarding of a \$2,000 prize which was later split for continued gambling).

Unfortunately asymmetrical tax outcomes occur based on the nature of the wagering activity that place a burden specific to particular taxpayers. Slot machine players as shown above are generally allowed netting for their playing sessions even if they get up and switch machines,

---

<sup>56</sup> Shollenberger v. C.I.R., 98 T.C.M. (CCH) 667 (Tax 2009)

leaving the machines to have a meal, use the restroom, see a show, or even escaping for a nap in their hotel room during the course of play. We can contrast this with the example of a tournament poker player who withdraws \$600 on his way to the casino for a day of playing in tournament gambling events. He might enter or “buy-in” to a particular \$167 poker event and then re-enter 2 additional times after losing his initial starting chips. He may then purchase a \$100 “add-on” for additional chips in the tournament. He has now exhausted his \$600 in outlays, much like a slot machine player might deposit all of his gambling money into a slot machine. Assume the poker player goes on to win \$2,000 in the poker tournament and returns in the evening to deposit the funds into his bank account. Unlike the slot machine player who was allowed to declare a net gambling gain figure based on the day’s wager activity, the case law suggests the tournament gambler must declare the full \$2,000 as gambling income and then only deduct his cash outlay of \$600 as an itemized deduction that may or may not provide a tax benefit.<sup>57</sup> The distinctions among wagering activities seems arbitrary to many players and this has different ramifications for certain subgroups in the gambling community. Lack of clear guidance for the appropriate netting procedure for wagering activities leaves many taxpayers stranded, without all relevant information required for accurate reporting, and unsure of how best to comply with the law. Unfortunately some taxpayers use this as an excuse to employ overly aggressive netting procedures or they fail to report the gambling income altogether.

---

<sup>57</sup> Hom v. C.I.R., 106 T.C.M. (CCH) 15 (Tax 2013)

## Section III

### Gambling Within a Trade or Business Context

There are opportunities in casinos and elsewhere where it is possible to place wagers with a long run expectation of profit. There are individuals who have developed skills in counting cards in blackjack, for instance, where they are able to identify situations where the odds of the game have turned in their favor and are able to capture an advantage through finely orchestrated betting patterns. There are also gambling opportunities offered such as in poker where individuals are playing against one another and individuals have been able to show an ability to profit over long periods of time. For everyone that decides to engage in gambling activities as a career there are significant tax implications that need to be considered including filing as a trade or business.

A professional gambler is someone who regularly engages in wagering transactions with a realistic positive expected return.<sup>58</sup> This is not a well-defined category of gamblers, because most individuals gamble because they believe they can win. However, many never do win over time. It is possible for a professional gambler to lose over any particular period of time, therefore objective determinations of a gambler's professional status can be difficult to identify. There is, however, a clear incentive for the dedicated individual who believes they are a professional gambler to attempt to engage in gambling as a trade or business.

---

<sup>58</sup> I will use the definition of professional gambler as synonymous with someone who engages in Advantage Gambling. For a brief definition and examples of games where this occurs please see [http://en.wikipedia.org/wiki/Professional\\_gambler](http://en.wikipedia.org/wiki/Professional_gambler)

Taxing Gambling by Michael Roeseler, UNLV Boyd School of Law

Characterizing gambling activities as a trade or business allows the taxpayer the benefit of deducting gambling losses above the line as ordinary and necessary business expenses.<sup>59</sup> Further, professional trade or business gamblers are able to deduct other “ordinary and necessary” business expenses against net gambling winnings.<sup>60</sup> This is analogous to how other trade or businesses are treated, but it is important to note that there is still a significant difference. Even if an individual is engaged in gambling as her trade or business, gambling losses are limited to the amount of one’s gambling winnings.<sup>61</sup> If gambling losses totaled with business expenses exceed net gains, the taxpayer may experience difficulty arguing they engaged in the business for profit, and they may lose the ability to qualify as a trade or business.<sup>62</sup>

### **(a) Difficulties Obtaining Trade or Business Status**

While there are clear benefits for gamblers to file as a trade or business, qualifying for such status is challenging for several reasons. Many professional gamblers are not aware of the

---

<sup>59</sup> 26 U.S.C.A. § 162 (providing a deduction for ordinary and necessary expenses for taxpayers engaged in a trade or business).

<sup>60</sup> Mayo v. C.I.R., 136 T.C. 81, 95 (Tax 2011) recommendation regarding acq., 2011 WL 6379402 (IRS AOD 2011) and acq., 2012-3 I.R.B. 285 (IRS ACQ 2012). Similarly, the US Supreme court has held that in the case of an illegal bookmaking operation gambling earnings may be offset by wages and rent expense that were ordinary and necessary business expenses deductible under Code section 162(a). C.I.R. v. Sullivan, 356 U.S. 27 (1958)

<sup>61</sup>This was the result found in Mayo, where the tax court held that wagering loss deductions were limited to the amount of winnings, but the nonwagering ordinary expenses related to the gambling business were deductible even though they generated a net loss. Mayo v. C.I.R., 136 T.C. 81, 95 (Tax 2011)

<sup>62</sup> See Commissioner v. Groetzinger, 480 U.S. 23 (1987) and Boyd v. United States, 762 F.2d 1369 (9th Cir.1985)

potential benefits of filing as a trade or business and not all that elect to do so qualify.<sup>63</sup> There has been much litigation regarding whether a particular taxpayer was engaged in a trade or business of gambling. In Groetzinger, the Supreme Court held that respondent was engaged in a trade or business because he went to the track six days a week for forty-eight weeks of the tax year, devoted sixty to eighty hours per week to the particular wagering activity, had no other employment, and spent a substantial amount of time studying racing forms, programs, and other materials.<sup>64</sup> Mr. Groetzinger never placed bets on behalf of any other person or engaged in bookmaking and he kept a detailed accounting of his wagers every day recording winnings and losses in a record book. The Supreme Court held that not everyone could qualify as a trade or business, but that the taxpayer must be involved in an activity with “continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.”<sup>65</sup>

Many professional gamblers do not meet these requirements. Professional gamblers ongoing efforts to further their business activity predominately involves continued gambling. Even the best poker players in the world can go through long periods of time where they are losing at the tables and there is no demonstrable means by which they can prove they are making a good faith effort to earn a profit unless they already have had a long track record of success.

---

<sup>63</sup> According to IRS.gov:

A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. The regularity of activities and transactions and the production of income are important elements. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.

<http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Business-Activities>

<sup>64</sup> C.I.R. v. Groetzinger, 480 U.S. 23, 24 (1987)

<sup>65</sup> *Id.* at 35

Courts often give greater weight to objective facts regarding profit motive than a taxpayer's statements of intent.<sup>66</sup>

In Calvao v. Commissioner, the taxpayer unsuccessfully argued that his gambling activities rose to the level of a trade or business.<sup>67</sup> The Tax Court held that there was no showing of a good faith effort to make a profit after petitioner testified that he spent approximately 2,206.5 hours gambling at various casinos, studied how slot machine cycles worked, read approximately 20 books on slot machines, and subscribed to a gambling magazine. Petitioner testified that he maintained daily records of his gambling activity but these were not introduced into evidence. The taxpayer received substantially all of his income working 20-25 hours a week at his wholly-owned business, which was unrelated to gambling.<sup>68</sup>

The requirement of having regular and continuous activities and transactions can be a bar to trade or business filings as there are many gambling professionals who perform other lines of work and may only occasionally gamble or go through spurts of high activity and then long periods without engaging in gambling activities for income.<sup>69</sup> These individuals may nonetheless show considerable income from gambling winnings while not be allowed the benefit of filing as a trade or business.

---

<sup>66</sup> Hastings v. C.I.R., 97 T.C.M. (CCH) 1355 (Tax 2009)

<sup>67</sup> Calvao v. C.I.R., 93 T.C.M. (CCH) 988 (Tax 2007)

<sup>68</sup> *Id.*

<sup>69</sup> Part of the rationale of why tournament poker players in particular go through periods of inactivity has to do with the seasonal nature of when tournaments are offered. Certain areas will only have large tournaments a few times a year and often travel is needed to play consistently. Many of these players would contend they are pursuing gambling as a profitable trade or business.



In Moore v. Commissioner, the taxpayer unsuccessfully argued that he should be granted trade or business status for his gambling activities.<sup>70</sup> Moore worked full-time as a traveling x-ray technician and gambled primarily at slots around his assigned shifts. He declared gross gambling winnings of \$25,534 for 2006 but did not keep a schedule of his casino visits or a record of his gambling transactions. Interestingly, the court's analysis applied the nine hobby loss factors to determine profit motive, concluding that Moore did not engage in gambling for profit.<sup>71</sup>

One difficulty with reviewing the case law on trade or business gambling is that the jurisprudence on this topic is replete with gamblers who are engaging in casino games where there is objectively almost no possibility for long run profit.<sup>72</sup> These taxpayers are simply

---

<sup>70</sup> Moore v. C.I.R., 102 T.C.M. (CCH) 74 (Tax 2011)

<sup>71</sup> *Id.* Those factors as applied to the case were:

1. Lack of maintaining records showed he did not maintain his gambling activity in a businesslike manner.
2. Moore did not study gambling, consult gaming experts in preparation for his casino visits, or attempt to improve his profitability.
3. Moore's primary activity was working as an x-ray technician, while he gambled frequently, the time he devoted to it depended on his job schedule.
4. Moore's gambling did not involve assets so expectation of appreciation in value was irrelevant.
5. Moore had no history of success with this business activity or in any other that would suggest success in gambling.
6. Moore conceded gambling has never been profitable for him.
7. There were no earned occasional profits.
8. Moore derived the bulk of his income from work as an x-ray tech
9. Moore's gambling involved elements of personal pleasure and recreation and he started gambling because he needed an activity to occupy his leisure time.

<sup>72</sup> Perhaps it is possible to draw a distinction among those seeking trade or business status where the taxpayer can demonstrate she is engaged in a gambling activity that has a positive mathematical expected rate of return. Because of the nature of probabilities it is possible to engage in a wagering activity with a negative expected return and result in a gain (even though it's unlikely a coin can be flipped resulting in heads nine times in a row), just like it is possible to engage in a positive expectation activity and result in a loss (most people refer to this as a run of bad luck). It follows that the determination of profit motive should not then be based entirely on whether there was a high net income resulting from an activity, but rather if a logical case could

attempting to deduct their gambling losses and related personal expenses against ordinary income. Clearly this is contrary to the intent of the trade or business case law and Code Section 162 because these taxpayers are attempting to get a tax deduction for what amounts to participation in a recreational activity. The case law for gambling trade or businesses largely focus on whether certain deductions should be allowed as Section 162(a) trade or business deductions or Section 165(d) gambling loss deductions.

In our effort to understand tax policy in this area it is crucial to note that most casual and even professional gamblers fall outside of the trade or business construct. This taxpayer must follow prescribed gambling tax reporting procedures which can have a distortive effect on an individual's AGI as discussed above. The remainder of this article will attempt to address the problems that arise for the gambler that is unable to file as a trade or business.

---

be made that the taxpayer engaged in an activity that was likely to result in a positive expected rate of return.

## Section IV

### Problems in the Sphere of Gambling Taxation

The Article has already discussed the limiting nature of gambling loss deductions that results from the characterization as a miscellaneous itemized deduction.<sup>73</sup> There are additional tax burdens that successful high volume professional gamblers (not engaged in a trade or business) must overcome.

#### (a) AMT Considerations

The Alternative Minimum Tax (AMT) has potentially adverse consequences on the tournament professional who accurately reports his gambling activities. The AMT is imposed at essentially a flat rate (26%-28%) on alternative minimum taxable income above a certain threshold.<sup>74</sup> In 2013 there is an exemption on the first \$51,900 of alternative minimum taxable income but this is phased out between \$115,400 and \$323,000 of alternative minimum taxable income.<sup>75</sup> Taxpayers must add back many deductions allowed for regular income tax purposes to determine taxable income for the AMT including any miscellaneous itemized deductions.<sup>76</sup> This

---

<sup>73</sup> See discussion above in Section II(b)

<sup>74</sup> 26 U.S.C.A. § 63(c)

<sup>75</sup> *Id.* at 55(d)3

<sup>76</sup> *Id.* at 56(b)1A(i)

means that the professional gambler is subject to the AMT for their winnings in a given year and allowed none of the benefit of deducting related losses (or costs of generating the income).<sup>77</sup>

There are many successful professional tournament players who net far in excess of \$50,000 per year and who likely do not qualify as a trade or business under the strict facts and circumstances analysis presented in Section III(a) above.<sup>78</sup> These individuals may maintain other fulltime employment, take extended leaves from the game, or travel abroad and only occasional partake in tournament poker when work schedules afford the opportunity.

For example, consider the following typical professional gambler. Using a benchmark 1.3 ratio for a strong successful poker player,<sup>79</sup> we can say that we expect this individual who pays \$300,000 in tournament buy-ins to accumulate \$390,000 in tournament cashes in a given year.<sup>80</sup> This taxpayer then has \$90,000 in net annual earnings. The AMT was designed to target medium

---

<sup>77</sup> *Id.*

<sup>78</sup> Cardplayer Magazine tracks top tournament finishes and lists hundreds of US and Canadian poker players that have earned six figures and greater in the last year. That list can be found at <http://www.cardplayer.com/poker-players/player-of-the-year/north-america/2014>

<sup>79</sup> Remember that the ratio of 1.3 is used to determine how much of a premium a backer would pay to put a player in a tournament. If the backer were to buy 100% of a player's tournament result, this would mean he would give the player \$130 to enter a \$100 tournament, and expect that on average the player would win more than this total from the prize pool. For more information on backing and markup, please visit <http://pokerstakes.com/articles/what-is-markup-staking>. This article states that the standard markup is a ratio between 1 and 1.25, and even in the case of a strong player it might not be worth it to stake someone over 1.3.

<sup>80</sup> This is a hypothetical return based on anticipated edge and individual results will likely vary widely.

to high-income earners who were capitalizing on too many deductions and paying very low effective tax rates.<sup>81</sup>

A professional tournament player with no other sources of income who cashes for \$390,000 with \$300,000 in buy-ins is subject to the AMT.<sup>82</sup> The AMT is applied to the full \$390,000 at a rate of 26% on the first \$179,500 and 28% on the income above that amount.<sup>83</sup> Because of the AMT, this taxpayer is subject to a minimum tax liability of \$105,610 (\$46,670+\$58,940).<sup>84</sup> This is obviously an absurd result as it is not possible for an individual with \$90,000 in net income to pay a \$105,610 tax liability. The taxpayer could articulate a strong defense for a reduction in tax liability based on an ability to pay theory,<sup>85</sup> however this could be a complicated process.<sup>86</sup>

---

<sup>81</sup> According to Intuit: “In 1969, Congress noticed that 155 people with high incomes were legally using so many deductions and other tax breaks that they were paying absolutely nothing in federal income taxes. Their nonexistent tax bills were an embarrassment.” “Alternative Minimum Tax: Common Questions,” *Intuit TurboTax*. Intuit, Inc., Web. 21 Mar 2014. <https://turbotax.intuit.com/tax-tools/tax-tips/IRS-Tax-Return/Alternative-Minimum-Tax--Common-Questions/INF12072.html>

<sup>82</sup> Normally an individual with a \$90,000 earned income would not be subject to the AMT because he would only be required to pay the AMT if the amount exceeded his regular tax liability according to 26 U.S.C.A. § 55(a). The exemption amount under *Id.* at 55(d) first allows for a deduction from \$90,000 of \$51,900 which would give us a targetable income of \$38,100 for the AMT calculation. Under *Id.* at 55(b)1(A)i(i) we multiply \$38,100 by a tax rate of 26% showing a minimum potential liability of \$9,906 which is likely not to exceed his regular tax liability and therefore leaves him unaffected by the AMT.

<sup>83</sup> 26 U.S.C.A. § 55(b)1(A)i(i) and (ii)

<sup>84</sup> 26 U.S.C.A. § 55(a) states that a taxpayer is subject to the greater of their normal tax liability or their liability calculated under the AMT.

<sup>85</sup> *In re Grothues*, 226 F.3d 334, 339 (5th Cir. 2000) the Fifth Circuit discusses that ability to pay a tax is a key factor in making a deficiency determination.

<sup>86</sup> Similar circumstances surrounding ability to pay arose during the 1990s dot com boom era, where employee's exercised stock options creating huge AMT obligations that were unable to be

A taxpayer in the untenable situation outlined above has limited options which include attempting make the appropriate modifications to qualify and elect to file as a trade or business. This can be quite onerous and include foregoing other gainful employment. Alternatively, the taxpayer is faced with having to refrain from his chosen profession or, the far more common scenario, the taxpayer is incentivized to inaccurately report his gambling activities on his tax return. Unless Congress intends to discourage tournament gambling, then changes should be made to better implement the purposes of the AMT given true levels of taxable income for professional tournament players.<sup>87</sup>

## **(b) Phase-Outs**

The consequences of a high AGI relative to actual take home income also impacts several tax deductions and credits that apply to similarly situated income earners. Personal exemptions and overall itemized deductions are reduced,<sup>88</sup> the taxpayer can no longer qualify for certain education credits,<sup>89</sup> the deduction of student loan interest is limited,<sup>90</sup> there are limitations on allowable contributions to Roth IRAs,<sup>91</sup> and the new Medicare surtax of up to 3.8% must be

---

paid because the stocks later crashed in value. See Lipman, Francine. "Incentive Stock Options and the Alternative Minimum Tax: The Worst of Times." *Harvard Journal on Legislation*. Vol. 39, No. 2, 2002.

<sup>87</sup> Since inception the AMT has been controversial and dedicated groups have actively sought its repeal. See <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/alternative-minimum-tax/>

<sup>88</sup> 26 U.S.C.A. § 68(a)

<sup>89</sup> The Hope and Lifetime learning credits are phased out based on AGI. 26 U.S.C.A. § 25A(d)

<sup>90</sup> *Id.* at 221(b)2

<sup>91</sup> 26 U.S.C.A. § 408A(c)3

applied on net investment income.<sup>92</sup> Additionally, AGI is used for other financial calculations such as income based repayments for student loans, alimony payments, and Medicare premiums for senior citizens.<sup>93</sup>

### **(c) Timing Concerns**

The third serious issue facing the non-trade or business gambler is timing of gains and losses. Gambling losses can occur at any time regardless of winnings and are only allowed to the extent of gambling income for the taxable year.<sup>94</sup> Given the inherent variability in gambling activities, all participants run the risk of accruing losses in one tax year that are not offset by subsequent gains regardless of taxes paid in prior and subsequent years on gambling winnings.

---

<sup>92</sup> For a good resource on how the 2013 tax changes impact high income individuals go to: <https://www.fidelity.com/viewpoints/personal-finance/taxpayers-guide>

<sup>93</sup> Your federal AGI calculation can additionally effect your state income tax liability. All 50 states include gambling winnings in gross income like the federal system, however the states of Connecticut, Illinois, Indiana, Kansas, Louisiana, Massachusetts, Michigan, Ohio, Rhode Island, West Virginia, and Wisconsin all do not allow a miscellaneous itemized deduction or any other deduction for gambling losses. Taken from:  
Fishman, Stephen. “All In Against the IRS: Every Gambler’s Tax Guide Second Edition.”  
Berkley: Pipsqueak Press, 2014.

<sup>94</sup> 26 U.S.C.A. § 165(d)

# Chapter V

## Potential Improvements

The Code was not developed in one setting with each provision considered as part of an integrated system and balanced against the effects of other parts of the Code. Instead, the Code has emerged over 100 years as a series of compromises and fixes that sought to address the leading issues of that time. Because of this emergent process there are areas of the Code that are less developed and do not function as smoothly as a result of the competing policies imbedded in various code amendments and revenue rulings. The argument could be made that the taxation of gambling income is one such area that can benefit from deeper analysis and some minor modifications, with the stated aim being to facilitate broader compliance among the millions of taxpayers who have gambling income and are potentially reporting it incorrectly under the current regime. The size of the US gambling market is staggering, according to the American Gaming Association the gross gaming revenue at commercial casinos exceed \$37.34 billion in 2012 with 32% of Americans stating to a public opinion poll that they had gambled at a casino within the last 12 months.<sup>95</sup>

---

<sup>95</sup> More statistics can be found in the State of the States: The AGA Survey of Casino Entertainment at <http://www.americangaming.org/industry-resources/research/state-states>

Taxing Gambling by Michael Roeseler, UNLV Boyd School of Law



## **(a) Fixing the AMT Problem**

As discussed earlier, the AMT affects certain professional gamblers adversely with an unreasonable tax liability given their actual net earnings. The AMT calculation could result in a tax liability that exceeds a tax payer's actual income for the year. Clearly a fix for this absurd result would be to allow the gambling losses deduction to the extent of gambling winnings for the purpose of calculating AMT liability. This simple amendment would result in tax calculations that more truly reflect Congressional intent when it enacted the AMT.<sup>96</sup>

While this amendment would fix AMT hardships for some professional gamblers, this Article will further present another amendment that might increase tax revenues, clean up confusion regarding the netting procedure, and address the issue of unintended tax benefit phase-outs. Improving the gambling taxation landscape will likely require several different adjustments to the Code, which will be discussed in the next several sections.

## **(b) Proactively Withholding**

A seemingly straightforward means of encouraging greater tax compliance is withholding gambling winnings that are won at the time the proceeds are distributed. For example, IRS guidelines state various levels of gambling winnings that must be reported by casino operators on Form W-2G when paid out.<sup>97</sup> In addition to merely reporting on a W-2G, Casinos are required to

---

<sup>96</sup> A predecessor to the AMT was the "minimum tax" enacted by the Tax Reform Act of 1969 which was an add-on tax for high income households. This tax was prompted by an announcement from then Treasury Secretary Joseph Barr that 155 high-income households had not paid a dime of federal income tax because they had taken advantage of so many tax benefits and deductions. See [http://en.wikipedia.org/wiki/Alternative\\_minimum\\_tax](http://en.wikipedia.org/wiki/Alternative_minimum_tax)

<sup>97</sup> Current levels of winnings are \$1,200 or more from a bingo game or slot machine, \$1,500 or more from a keno game, more than \$5,000 for a poker tournament, as well as all other gambling

Taxing Gambling by Michael Roeseler, UNLV Boyd School of Law

withhold 25% of gambling winnings if the winnings minus the wager are more than \$5,000 from sweepstakes, wagering pools, lotteries, or other transactions involving horse races, dog races, or jai alai.<sup>98</sup>

Currently poker and most other types of gambling taking place in a casino are not subject to the mandatory withholding requirement. This was not always the case, as on March 4, 2008 Revenue Procedure 2007-57 took effect concluding that poker tournaments were “wagering pools” subject to the required withholding rate. This move was wildly unpopular in the poker community and it targeted only poker tournament and not cash game players. The law was quickly amended to allow a safe harbor from the withholding requirement for casinos that served as poker tournament sponsors as long as they collected the name, address, and taxpayer IDs of all tournament winners who received payments in excess of \$5,000.<sup>99</sup>

There are important benefits that would come from broadening the scheme for mandatory withholding of gambling income. Based on my experience it is readily apparent that many poker participants and professional gamblers do not accurately report income. Withholding can provide a stronger incentive for compliance and it can serve as a defacto budgeting tool for many in an industry that have traditionally not set aside enough earnings throughout the year to cover their tax liability. The taxpayer must be allowed to state current and anticipated gambling losses to adjust the percentage withheld to truly reflect his anticipated liability. All types of gambling

---

winnings of \$600 or more where the amount won was at least 300 times the amount of the wager. See <http://www.irs.gov/instructions/iw2g/ar02.html>

<sup>98</sup> *Id.*

<sup>99</sup> Kulick, Peter. “Federal Tax Reporting and Withholding Requirements for Casino Operators,” *Casino Enterprise Management*. Casino Enterprise Management, Web. 1 Feb 2009. <http://www.casinoenterprisemanagement.com/articles/february-2009/federal-tax-reporting-and-withholding-requirements-casino-operators>

behavior must be targeted, not just tournament play. The end goal is to increase the transparency for all parties and inform the tax authority of actual levels gambling income.

There were serious problems with the withholding system as it was proposed under Revenue Procedure 2007-57. Only a portion of a taxpayer's gambling income was withheld at a rate that did not necessarily correspond with actual tax liability. This was because there were likely many other tournament or other gambling winnings that fell below the radar. The difficulty still remains that a taxpayer must only be honest to the extent of the income reported in W-2Gs and can use gambling losses or receipts for tournament buy-ins from events where the winnings went unreported to offset the reported income and receive a return of much of the withheld income. This illicit reporting behavior will likely continue and that is why it is vital to create a more effective system, which can detect gambling income at the source, and in a manner in which casino operators and individual taxpayers will accept.

### **(c) Reevaluating the Netting Process**

While proactive withholding done at the location of the gambling activity is a step toward broader tax compliance it is vitally important that it be implemented concomitant with a clear framework to base netting calculations on. There is still considerable confusion regarding which wagers may be lumped together to be consider a single "transaction" and therefore netted for reporting purposes.<sup>100</sup>

---

<sup>100</sup> Recently the D.C. Circuit Court reversed a Tax Court decision and held that gambling winnings should be calculated the same for U.S. citizens and nonresident aliens. The Tax Court stated that the South Korean individual's gains from slot machine winnings should be calculated based on a per-bet basis rather than on a per-session basis. See Arora, James. "IRS Must Calculate Gambling Winnings Consistently for Citizens and Foreigners, Court Holds," *Tax Notes Today*. Tax Analysts. 10 July 2013.

The IRS released a Chief Counsel Attorney Memorandum on December 12, 2008 that directly addresses the types of netting allowed in reporting gambling income.<sup>101</sup> Casual gamblers are allowed to deduct gambling losses to the extent of their gambling gains but the difficulty lies in Section 165(d) using the term wagering transactions to determine amount won or lost.<sup>102</sup> It has been argued that transaction means every single wager and basis should be computed through all transactions as separate taxable events.<sup>103</sup> Courts have found this standard unduly burdensome and unreasonable.<sup>104</sup> Furthermore, the statute uses the plural term “transactions” which implies that gain or loss may be calculated over a series of separate plays or wagers.<sup>105</sup>

The fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems the tokens at the conclusion of the activity.<sup>106</sup> This does not entirely clear up the difficulty in determining what constitutes a transaction. Courts have held an entire day’s wagering activities, from the time a couple makes a withdrawal from their bank account in the morning, to their deposit of their proceeds in the evening, may be netted as a single transaction.<sup>107</sup> I would argue this is a beneficial interpretation of the code because it does not force the court to dig into the random minutia of the situation to make arbitrary determinations of

---

<sup>101</sup> IRS Chief Counsel Memorandum AM2008–011 (Dec. 5, 2008)

<sup>102</sup> *Id.* at 2 and *Skeeles v. United States*, 118 Ct. Cl. 362 (1951),

<sup>103</sup> IRS Chief Counsel Memorandum AM2008–011 (Dec. 5, 2008) at 2

<sup>104</sup> . See *Green v. Commissioner*, 66 T.C. 538 (1976) and *Szkircsak v. Commissioner*, T.C. Memo. 1980-129

<sup>105</sup> IRS Chief Counsel Memorandum AM2008–011 (Dec. 5, 2008) at 2

<sup>106</sup> *Id.*

<sup>107</sup> *Shollenberger v. C.I.R.*, 98 T.C.M. (CCH) 667 (Tax 2009)

when bathroom breaks may have occurred, when tokens were transferred between games, or used to purchase food. I would go slightly further and say a series of wagering activities does not even have to occur within a single 24 hour period to constitute a single transaction. There are recorded accounts of poker players playing at a single table for days on end with only minor breaks.<sup>108</sup> Also, I would argue the casual tourist flying into Vegas for a Friday through Sunday stay should be allowed to net his vacation activities for that short of a period.

The casual netting I am suggesting above is likely how many taxpayers who report their gambling activities already instinctively net and would arguably not stray from current precedent. An area that I believe needs more illumination is for tournament gamblers who pay discrete entry fees and receive their portion of the prize pool upon completion of the event. Based on how winnings are reported on W-2G's no allowance is made for tournament buy-ins. For example, a tournament poker player might buy-in to the same \$100 tournament three times before winning a prize of \$1,000. I would argue his actual accession to wealth is the extra \$700 he is able to leave the event with that accounts for his return of capital (\$1,000 prize - \$300 entry fees). Events may run in series and stretch on for days or weeks, including preliminary or satellite events that allow you to enter various stages. I believe netting should be allowed across these types of events as well and I know several taxpayers that take this view. Unfortunately I am unable to find anything on point in the literature that states this is acceptable when every individual wager generally involves direct conversions of cash to tournament tokens and vice versa.

A more lenient netting process that allows taxpayers to determine and state what they believe to be reasonable netting for their gambling activities empowers taxpayers to appropriately characterize their gambling behavior and allows them the latitude to avoid the

---

<sup>108</sup> In 2010 Phil Laak set a record for longest poker session without sleep at just under 80 hours of play. See <https://www.youtube.com/watch?v=qw-g3fusEzE>

pitfall of having an excessively high AGI that does not accurately reflect true levels of taxable income.

### **(d) Hobby Loss Application**

Professional gamblers that qualify as a trade or business are not effected by most of the problems we have already discussed. They are allowed to net their losses against top line income thereby side stepping the AMT concern. They are also allowed to deduct their ordinary and necessary expenses to engage in their trade or business.<sup>109</sup> They are allowed to deduct losses to their extent at risk and carry forward losses to future years.<sup>110</sup> We have discussed above why many professional gamblers do not qualify as in the trade or business of gambling due to timing restrictions or inability to show a profit motive. I believe a potential solution to alleviate the strain placed on those dedicated professionals who are not qualified trade or businesses would be to place them in a special Hobby category subject to the Section 183 Hobby Loss Rules.<sup>111</sup>

We should continue to allow gambling loss deductions to the extent of gambling winnings under Section 165(d), but by default place those that do not qualify as trade or business gamblers into a hobby category that allows for the deduction of many of the same ordinary and necessary expenses they incur engaging in the activity to the extent of profits earned. This makes

---

<sup>109</sup> 26 U.S.C.A. § 162(a)

<sup>110</sup> *Id.* at 465

<sup>111</sup> The Hobby Loss rules kick in when a tax payer is unsuccessful in arguing he or she engaged in the activity for profit. See 26 C.F.R. § 1.183-2.

the cliff for those unable to qualify as a trade or business less harsh and still prevents abuse from those looking to write off gambling losses against ordinary income.<sup>112</sup>

Calvin H. Johnson, professor of law at the University of Texas, proposes amending the hobby loss rules to defer the deduction of losses until which time they can be deducted against future revenue or capital gain from the activity.<sup>113</sup> If the taxpayer abandoned the activity without recovering all of the losses, she would deduct the unabsorbed losses, but only through a refund claim and only for expenses paid when the activity had a positive reasonably expected present value.<sup>114</sup> Implementation of this reform would address the timing issue that affects gamblers unable to claim losses because of arbitrary tax year distinctions. Further, gamblers with questionable earning potential are incentivized to abandon the endeavor because they then may deduct accumulated losses.

The reforms suggested above work best in conjunction with one another to address the current struggle those reporting gambling income face. Many taxpayers engage in gambling activities without the full understanding of the tax consequences. Illumination can be found in other areas of the code where solutions have already been presented and similar issues have been resolved.

---

<sup>112</sup> Hobby losses are categorized as miscellaneous itemized deductions under Section 67, subject to a 2% floor of AGI. Currently gambling losses are miscellaneous itemized deductions exempt from the 2% floor, and I believe this exemption should be carried over if gambling activities are absorbed into the hobby loss regime.

<sup>113</sup> Johnson, Calvin H. "Horse Losses and Other Pleasures." *Shelf Project Tax Notes*. Tax Analysts. 31 March 2014.

<sup>114</sup> *Id.*

# Chapter VI

## Conclusion

There are millions of Americans that engage in some manner of gambling activities each year. It has been my experience that the majority of these individuals do not accurately report their gambling activities on their tax returns. For this reason alone we should be encouraged to take a closer look at the current system and implement appropriate correcting mechanisms. Structural changes are needed to broaden compliance by addressing the disproportionate impact the current gambling taxation regime has on millions of professional and casual gamblers.