

Taxation of the Gambler

By Reece B. Morrel, Jr., Esq.

With the growth of gambling in the United States, many industries have rushed in to provide the needed support and expertise. The area of taxation is no different. Many lawyers, accountants, and other tax professionals have quickly developed the necessary proficiency to help their clients properly record and report their gambling income. I would like to share with you some of the basic issues so that you may help and at the very least protect the interests of your clients.

Gambling is Big Business in the United States

With the recent proliferation of state lotteries, Indian casinos, and the expansive growth of commercial casinos in Las Vegas, most Americans would agree that gambling is big business. But few people truly understand the magnitude of the gambling industry in the United States economy. Here are some quick facts as of 2010:

- Gross gaming revenue from commercial and racetrack casinos totaled \$34.6 billion.
- Gross gaming revenue from Indian casinos totaled \$26.6 billion.
- There are over 450 tribal casinos in the United States.
- State lottery ticket sales exceeded \$53 billion in 2006 (last available data).
- United States commercial casinos employed over 340,000 people and paid wages of over \$13.3 billion.

For comparison purposes, in 2010, the gambling industry was larger than several other well known industries:

- \$94.0 billion—cable television;
- \$29.3 billion—candy;
- \$10.9 billion—outdoor equipment; and
- \$10.6 billion—United States box office receipts

Another way of measuring the proliferation of gambling is by counting the number of electronic gaming machines in operation. Throughout the United States, there are almost 855,000 electronic gaming machines scattered among 39 states. The top four states are:

- Nevada—87,000 machines (21.9%);
- California—67,000 machines (7.8%);
- Oklahoma—62,000 machines (7.3%); and
- Louisiana—42,000 machines (4.9%)



All Means All

Section 61 of the Internal Revenue Code is the starting point for all questions regarding income. This section defines “gross income” very broadly as meaning “all income from whatever source derived.” The United States Supreme Court has interpreted this to mean that Congress intended to express its full power to tax income to the extent that such taxation is permitted under Article I, Section 8, Clause 1 (the Taxing and Spending Clause) of the Constitution of the United States and under the Constitution’s Sixteenth Amendment. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

In other words, “gross income” includes everything unless you can find an exception (IRC Sections 101 through 140). Since “gambling winnings” are not listed as one of the exceptions, “gambling winnings” are includible as income. Furthermore, many people mistakenly believe that “gambling winnings” only include the amounts reported by the casinos to the IRS on Form W-2G. Unfortunately, this is not the case. “Gambling winnings” also include the amounts won from the casinos of less than \$1,200 while playing slot machines, as well as the amounts won from Internet websites, casinos in foreign countries, or casinos on cruise ships in international waters. Technically, one should not forget to include those “friendly” wagers made on behalf of college alma maters, March Madness office pools, or the Super Bowl. In other words, when it comes to “gambling winnings,” all means all!

Legislative Grace

It is well established that deductions from gross income are a matter of legislative grace, to be bestowed or withheld by Congress. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *Winkler v. United States*, 230 F.2d 766 (1956); *Hochman v. Commissioner*, T.C. Memo. 1986-24 (1986); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992); *LaPlante v. Commissioner*, T.C. Memo. 2009-226 (2009). Fortunately, Congress graciously bestowed such a deduction with IRC Section 165(d): “Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.”

Basically, it means that a taxpayer can only deduct losses up to the amount of wagering gains. For example, if the taxpayer has wagering gains of \$10,000 and wagering losses of \$8,000, the taxpayer’s taxable income has increased by \$2,000. But on the other hand, if the taxpayer has wagering gains of \$8,000 and wagering losses of \$10,000, the taxpayer’s wagering losses are limited to \$8,000. Thus, the taxpayer does not get to deduct the entire \$10,000.

How the wagering losses are deducted and where on the income tax return they are reported depends on whether the gambler is considered a professional or recreational gambler.

Many people (gamblers and tax professionals alike) are under the mistaken impression that casino win/loss statements and summary reports from a casino player’s card will suffice.

The Professional Gambler

The professional gambler first reports his “wagering gains” as gross receipts on Schedule C. Then, the professional gambler is able to deduct his wagering loss expense (limited by the amount of his wagering gains) on Schedule C. The professional gambler is finally allowed to deduct without limitation his ordinary and necessary trade or business expenses

as permitted by IRC Section 162(a). IRS Chief Counsel Advice Memorandum 2008-013; *Mayo v. Commissioner of Internal Revenue*, 136 T.C. 4 (2011) with 12 judges joining together for the majority opinion and 3 judges joining together for the concurring opinion. This net amount is finally reported on page 1 of the gambler’s Form 1040 individual income tax return as business income or loss.

The Recreational Gambler

At first glance, the reporting requirements for the recreational gambler seem quite easy. The recreational gambler must report his wagering gains as “other income” on the first page of his Form 1040. But then, the recreational gambler must decide whether to take the standard deduction or itemize his deductions. If the recreational gambler decides to take the standard deduction, he is done. He forfeits whatever wagering losses he has accumulated. However, if the recreational gambler decides to itemize deductions, he then reports his wagering losses (not to exceed the amount won) on Schedule A as a miscellaneous deduction not subject to the 2% limitation.

For the recreational gambler, this separation of gains and losses has a serious side effect—the “Gambler’s AGI Penalty.” If a gambler has wagering gains equal to the amount of his wagering losses, it will not affect his “Taxable Income.” However, it will inflate the gambler’s “Adjusted Gross Income” (“AGI”) which is frequently used as a multiplier and/or phase-out index for certain deductions, credits, and exclusions. Some of the more common items include:

- Social Security
- IRA contributions
- Medical expense
- Mortgage interest
- Charitable contributions
- Casualty losses
- Miscellaneous deductions subject to the 2% limitation
- Child tax credit
- Earned income credit
- Adoption credit

As an extreme example, if a taxpayer has \$500,000 of gambling winnings and \$500,000 of gambling losses, his taxable income would stay the same.

However, the threshold for deductible medical expenses has now increased by \$50,000 (10% of AGI), the threshold for miscellaneous deductions subject to the 2% limitation has increased by \$10,000 (2% of AGI), he is now disqualified from making any IRA contributions, and more of his Social Security is now taxable.

Naïve, lazy, or dishonest taxpayers will frequently try to cut corners and “net” together their wins and losses to avoid the Gambler’s AGI Penalty. Unfortunately, such action can easily trigger an audit when the IRS computers cannot match winnings reported on Form W-2Gs by the casinos with a corresponding amount on the taxpayer’s return. Do not think it will not happen. The United States Tax Court has numerous reported cases where the only change made, at the insistence of the IRS, was the “un-netting” of a gambler’s wins and losses. *Spencer v. Commissioner of Internal Revenue*, T.C. Summ. Op. 2006-95 (2006)—a \$2,525 deficiency; *LaPlante v. Commissioner of Internal Revenue*, T.C. Memo. 2009-226 (2009)—a \$1,808 deficiency; and *Shollenberger v. Commissioner of Internal Revenue*, T.C. Memo. 2009-306 (2009)—a \$555 deficiency. What is probably the most remarkable attribute of this sampling of cases is the relatively small amount being litigated—as little as \$555!

As an alternative, many recreational gamblers try to recharacterize their activity as a

business with their wins and losses reported on Schedule C. This does allow the taxpayer to avoid the Gambler’s AGI Penalty by deducting the wagering losses “above-the-line” instead of “below-the-line.” But this strategy presents problems of its own. For example, the taxpayer may now be liable for self-employment tax which is currently at 15.30% on the net income of Schedule C business, and the taxpayer will be held to a higher standard of recordkeeping by the IRS and the courts. Moreover, if this strategy fails, the taxpayer may have exposed himself to various penalties in addition to the original tax deficiency. Take for instance the case of Dr. Merkin, a noted New York City psychiatrist with his private practice located on Park Avenue. He was unable to convince the IRS or the court that he was a professional gambler specializing in video poker (*Merkin v. Commissioner of Internal Revenue*, T.C. Memo 2008-146 (2008)) and an accuracy-related penalty of 20% was imposed.

A further complication arises from the nature of the gambling activity itself. The games are frequently divided into two types. Games such as slot machines, roulette, and bingo are considered games of “chance” while poker, blackjack, and horse and dog racing are considered games of “skill.” It may be more difficult for a taxpayer to convince the IRS or a judge that the playing of slot machines is akin to the conduct of a trade or business when no skill or exercise of judgment of the taxpayer affects the outcome of the wager. (But see *Kochevar v. Commissioner of Internal Revenue*, T.C. Memo. 1995-607 (1995), whereby the court did not

overrule an IRS Appeals Officer’s finding that the husband and wife were professional gamblers playing progressive slot machines.)

But games of “skill” are different and are easier to prove. Taxpayers that have regularly participated in gambling activities while using a systematic judgmental methodology—whether financially successful or not—have convinced the courts that they are indeed professional gamblers. *Barrish v. Commissioner of Internal Revenue*, T.C. Memo. 1984-602 (1984).

Regardless of whether you are a recreational or professional gambler, it is imperative that you have sufficient records in order to prove your wins and losses. But how?

The Gambling Session

It is helpful to remember that the focus of Section 165(d) is on gambling “transactions” and not the overall gambling “activity.” Even early on, courts recognized that it was impractical and onerous to even attempt to record every single roll of the dice, spin of the wheel, draw of a card, or pull of the handle. So over the years the courts, the IRS, and tax professionals have developed the concept of a “gambling session” to group together a series of gambling transactions when they can be identified by a specific action or wagering activity and discrete, isolated time periods and/or locations. (Please refer to IRS Chief Counsel Memorandum 2008-011 for additional examples and explanation.)

For instance, if a gambler plays at one casino in the morning and another casino in the afternoon, then he has at least two gambling sessions. If a gambler starts off playing slot machines and then switches to blackjack, then he has at least two gambling sessions. But if a gambler enters a three-day poker tournament, the tournament counts as just one session. Every horse or dog race at a track is a separate gambling session. So for each gambling session then, a gambler needs to determine and record his gambling income. But how is “gambling income” calculated?



The J + O – I of Gambling Income

“J+O-I” is the easiest way to remember the “gambling income” formula.

“J” = Hand-Paid Jackpots

The letter “J” represents hand-paid jackpots. Typically, if a slot machine player hits a jackpot of \$1,200 or more, the slot machine locks up to prevent further play and the casino immediately hand pays the gambler the amount of the jackpot just won and issues a W-2G. Then and only then is the slot machine unlocked and the gambler allowed to continue. In other words, this amount should be easy to determine. Since the casinos are required by law to issue a W-2G for every hand-paid jackpot, the taxpayer groups together the W-2Gs he received for each gambling session.

“O” = Cash-Out

The letter “O” represents the cash-out that a gambler receives. This amount is made up of two possible components. First, this amount can include amounts won for which a W-2G was not issued. As an example, a slot machine player could win ten jackpots of \$500. Although the slot machine player has won \$5,000 (an amount greater than \$1,200), the casino is not required to issue a W-2G because each of the individual jackpots was below the \$1,200 requirement.

Second, this amount could simply be a refund of the gambler’s own money. In “accountant-speak,” this amount represents a “return-of-basis.” For example, if a taxpayer buys a stock for \$20 and then sells it for \$21, he has \$1 of income and a “return-of-basis” of \$20. Thus, if a slot machine player inserts \$20 into a machine and makes \$5 worth of bets without winning anything and then decides to move to a different machine, the player would have a “cash-out” or “return-of-basis” of \$15.

“I” = Cash-In

The letter “I” represents the amount of the gambler’s bet. The source of these funds is typically from cash on hand, checks cashed, ATM withdrawals, credit card charges, or casino markers. Again, in “accountant-speak,” this amount is the gambler’s “basis” in the transaction or wager.

Regardless of whether you are a recreational or professional gambler, it is imperative that you have sufficient records in order to prove your wins and losses.

J + O – I = Gambling Income

Putting it all together now, the gambling income for each gambling session is equal to the hand-paid Jackpots PLUS Cash-Out MINUS Cash-In.

Recordkeeping

To help understand proper recordkeeping requirements, the mnemonic “CARVR” is helpful. The taxpayer needs Contemporaneous, Adequate, Regular, and Verifiable Records. Unfortunately, very few gamblers use a regular double-entry set of books that would easily meet the CARVR standard to track their gambling transactions. As an alternative, the IRS, in Revenue Procedure 77-29, describes in detail the information that should be recorded for each gambling session and

type of wager. To begin with, the IRS strongly recommends that a gambler use a “gambling diary or log” to record the required information. Think of it as a mileage log or expense sheet for gambling.

Sadly, even after more than 30 years, gamblers are still reluctant to implement such recordkeeping efforts in spite of the judges in multiple court decisions crying out for, or in some cases demanding, a gambling diary. Instead of relying upon Revenue Procedure 77-29, many gamblers choose to rely on bad advice, gut instinct, urban legends, and just wrong information. Many people (gamblers and tax professionals alike) are under the mistaken impression that casino win/loss statements and summary reports from a casino player’s card will suffice. Nothing could be farther from the truth! The IRS has consistently and regularly rejected the use and reliance upon such information. The IRS belligerence is primarily based on two factors. First, the casinos explicitly state in their reports that the information they track is merely an inaccurate estimate and should not be used for accounting or tax reporting purposes. With such disclaimers from the casinos, it should come as no surprise that the IRS refuses to consider them. Second, the reports from the casinos generally provide a net “activity” total and not a breakdown by “gambling session” or transaction. Thus, the reports are not able to meet the stringent requirements of a Section 165(d) analysis.

Simply repeating that “nobody ever wins” may be stating the obvious, but is insufficient for evidence purposes. So when all else fails, the taxpayers, IRS, and courts are regularly called on to estimate a gambler’s losses. Courts have considered all manner of evidence including napkins, matches, cards, and other scraps of paper in an effort to recreate some type of a gambling diary in order to document a gambler’s losses. *Stein v. Commissioner*, 322 F.2d 78 (5th Cir. 1963). In doing so, many courts have relied on the wisdom of Judge Learned Hand as expressed in the case of *Cohan v. Commissioner of Internal Revenue*, 39 F.2d 540 (2nd Cir. 1930). Mr. Cohan was a Broadway producer and had very few records detailing the production costs of his plays. But it could easily be surmised that he incurred a substantial amount of expenses such as wages, rent,

utilities, etc. in carrying out his business from which an estimate could be made. Unfortunately for most gamblers, such a foundation is difficult to come by. But in *Doffin v. Commissioner*, T.C. Memo. 1991-114 (1991), such a foundation was found based on the type and number of pull-tabs the taxpayer played. In other words a *Cohan* analysis is not an automatic substitute for proper recordkeeping and can only be attempted once a proper foundation has been laid. If no such foundation exists, the courts have no choice but to disallow a gambler's losses.

Summary

Gambling is big business and will only get bigger. Naturally, Congress is interested in its "piece of the action." Through the 17 words of IRC Section 165(d), the IRS is given the task of enforcing the government's percentage. The IRS has demonstrated that it is ready, willing, and able to challenge any taxpayer from retired, widowed grandmothers to Park

Avenue psychiatrists over seemingly insignificant amounts.

After considering this article, you should have the distinct impression that most gambling cases turn on "substantiation" issues and not legal issues. Therefore, a taxpayer's best protection against an IRS assault is to have the appropriate records organized and ready for inspection. In a perfect world, the taxpayer would have recorded the gambling income (J+O-I) of each gambling session in a gambling diary. The diary, along with any of the underlying CARVR-type documents, would then be kept and ready for any IRS audit and inspection. In a not-so-perfect world, the tax professional may be called on to help the taxpayer recreate or reasonably estimate the wagering gains and losses using a *Cohan* or *Doffin*-type analysis. With such substantiation completed, a gambler/taxpayer can rest assured that his tax burden has been accurately determined.

You either prove it or lose it!

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IMPORTANT ELECTIONS UPDATE

This is an exciting time for NALS as we embark on the inaugural year for electronic ballots for the 2012-2013 Officer Elections. In order to receive a ballot, each member must have a valid email address registered with NALS. How do you know if NALS has your correct email address? Log on to the "Members Only" section of the NALS website to review and update your contact information following these easy steps:

1. Log on to www.nals.org;
2. Select "Log In" under the Welcome tab;
3. Click on "Click Here to Log In";
4. Follow the instructions for logging in;
5. Select "My Profile";
6. Review the information listed and correct as needed; and
7. Press "Submit."

Any member who does not have a personal computer can visit their local library or community center to use available free computers. It is easy to sign up for a free email account and there are several companies that offer this (Google, Yahoo, or Hotmail). You must register a valid email address with NALS prior to October 3, 2011. No paper ballots will be mailed.

Beginning October 3, 2011, each NALS member will receive (in their valid email account inbox) an email from NALS providing a hyperlink and voting instructions. The hyperlink will take you to your electronic ballot. Completing the ballot is very simple and should take less than a minute to complete. The Nominations and Elections Committee strongly suggests that you view the candidates' pages on the NALS website prior to the opening of electronic voting. Once you click on the hyperlink, you must complete the voting process. You cannot click on the hyperlink, close out of your incomplete ballot, and then try to click on the hyperlink again because the hyperlink will be disabled. This procedure is necessary to prevent double voting.

When you complete your electronic ballot and cast your vote, it will go to an outside source for the counting of ballots after elections close on October 28, 2011. The elected officers will be announced in a November e-News after all candidates have been notified of election results.

Any questions should be directed to Nominations and Elections Chair, Patricia E. Infanti, PP, PLS, at infanti@ballardspahr.com or 609-471-2153 or Staff Liaison Jennifer King at king@nals.org or 918-582-5188.

Thank you for being part of this historic NALS event!