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You Win Some, You Lose Some

Know how to correctly report the wagering gains and losses of recreational gamblers.



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By Reece B. Morrel, CPA, JD

The 17 words of Internal Revenue Code Section 165(d) provide little guidance on the reporting requirements of wagering gains and losses.^[FN1] The IRS instructions say little more than gambling income shall be reported as “other income” on IRS Form 1040^[FN2], and, if a taxpayer elects to itemize his deductions, then gambling losses are included on Schedule A as “other miscellaneous deductions not subject to the 2 percent limitation” but only up to the amount of winnings.^[FN3] Therefore, with such little information readily available, it comes as no surprise that the vast majority of tax returns which report gambling income, whether prepared by the taxpayer, a tax professional or tax software, are prepared incorrectly.

Over the years, the courts, taxpayers, tax professionals and the IRS developed an informal series of guidelines. Then in 2008, the IRS — relying upon these guidelines — formalized its position when it published Chief Counsel Advice Memorandum 2008-011 Reporting of Wagering Gains and Losses.

This article will explore the principles put forth by the Advice Memorandum so that the reader will have a more thorough understanding of IRC Section 165(d) and be better equipped to serve his or her clients in their tax preparation needs.

Gambling is big business in Oklahoma.

In its 2011 State of the States survey of casino entertainment, the American Gaming Association reports that Oklahoma has 109 casinos — more than 20 percent of the nation’s total. These casinos are filled with more than 62,000 gaming machines, ranking our state third for most gaming machines, following Nevada with 187,000 and California with 68,000 gaming

machines. Additionally, Oklahoma has several of the world’s largest casinos. As a matter of fact, the third largest casino in the world is located in Thackerville, Okla., just north of the Red River on Interstate 35. It has more than 380,000 square feet of space dedicated to gambling activities.

All of this adds up to the gambling industry being a \$3.2 billion business in Oklahoma — and a big reason to report gains and losses accurately.

Step 1: Include all wagering gains in gross income.

IRC Section 61 provides that gross income includes all income from whatever source derived. IRS Revenue Ruling 54-339 established that wagering gains shall be included in gross income (See *Umstead v. Commissioner*, T.C. Memo. 1982-573 (U.S. Tax Ct. 1982)). This not only includes winnings for which an IRS Form W-2G or Form 1099-MISC are issued, but amounts won below the reporting thresholds or from online gambling, cruise ship casinos and other international locations, from friendly wagers with friends or March Madness office pools. And don’t think the IRS or the judges won’t notice. In several reported cases, the courts were reluctant to show much mercy since the taxpayers only included gambling income that was already reported to the IRS on Form W-2G. After hearing the testimony regarding the facts and circumstances, the courts suspected that the taxpayers had more gambling income than what they originally reported (See *Norgaard v. Commissioner*, 939 F.2d 87 (9th Cir. 1991) and *LaPlante v. Commissioner*, T.C. Memo. 2009-226 (U.S. Tax Ct. 2009)). Simply put, all means all!

Step 2: Exclude the basis of your wagering gains.

Revenue Ruling 83-103, 1983-2 C.B. 148, provides that the basis of a wager is excluded from the amount of a wagering gain. So for example, if a taxpayer purchased a \$20 lottery ticket that ultimately won \$1,000,000, then his wagering gain is \$999,980 — not \$1 million. This step is frequently overlooked or mistakenly included as part of the calculation for wagering losses.

Step 3: Total your wagering transactions by “gambling session.”

It is important to recognize that the focus of IRC Section 165(d) is on “wagering transactions” — not on wagering as an activity. This is why taxpayers are not allowed to simply net together their gains and losses and report the difference or rely upon a win/loss statement from a casino (See *United States v. Scholl*, 166 F.3d 964 (9th Cir. 1999), and *Shollenberger v. Commissioner*, T.C. Memo. 2009-306 (U.S. Tax Ct. 2009)).

But on the other hand, the courts recognized early on that it was impractical for a taxpayer to report every roll of the dice, pull of a slot machine handle, draw of a card or spin of a wheel. See *Green v. Commissioner*, 66 T.C. 538 (U.S. Tax Ct. 1976) and *Szkircsak v. Commissioner*, T.C. Memo. 1980-129 (U.S. Tax Ct. 1980). Furthermore, from a theoretical standpoint, it was recognized that it could not be determined if a taxpayer even had an “accession to wealth” until the taxpayer stopped gambling. See *Commissioner v. Glenshaw Glass Co.* 348 U.S. 426 (1955). So over time, the concept of a “gambling session” evolved.

In general, a gambling session is comprised of three unique components — time, place and activity. For example, a taxpayer who gambled at two different casinos on the same day would have at least two different gambling sessions. A taxpayer that played slot machines and black jack on the same day at the same casino would have at least two different gambling sessions. A taxpayer that played slot machines over three days at the same casino would have at least three gambling sessions. But by comparison,

a taxpayer involved in a three-day poker tournament, could have only one gambling session.

In the IRS Chief Counsel Advice Memorandum, the IRS gives the example of a taxpayer that enters a casino with \$100 and then at the end of the day redeems \$300 worth of tokens. During this gambling session, the IRS explains that the taxpayer has a wagering gain of \$200 (\$300 - \$100). It is also interesting to note the comment of the IRS that “[t]his is true even though the taxpayer may have had \$1,000 of winning spins and \$700 in losing spins during the course of play.”

As another example, the IRS describes a taxpayer that enters a casino with \$100 and loses the entire amount. The result is a wagering loss of \$100. The IRS again commented that this is true “even though the casual gambler may have had winning spins of \$1,000 and losing spins of \$1,100 during the course of play.”

Step 4: Report wagering gains as other income and wagering losses as other miscellaneous deductions.

Following the logic of the IRS examples contained in the IRS Chief Counsel Advice Memorandum 2008-011 (contrary to the instructions of IRS Publication 525, Taxable and Nontaxable Income), it is not proper to merely total a taxpayer’s Form W-2Gs or Form 1099-MISC and insert that amount as “other income.” Instead, the taxpayer or tax professional should analyze each gambling session to determine if it resulted in a wagering gain or loss.

All the gambling sessions with wagering gains should be totaled together and included on Form 1040 as other income. Next, if the taxpayer elects to itemize his deductions, all the gambling sessions with wagering losses should be totaled together and included on Schedule A as other miscellaneous deductions not subject to the 2 percent limitation. And don’t forget, the amount of the wagering losses may not exceed the amount of the wagering gains.

Step 5: Prepare a gambling session analysis and explanation for the IRS.

The IRS computers do a thorough job of matching amounts from documents submitted by third parties to the amounts reported on income tax returns. Unfortunately, they have not been properly programmed to implement the principles of IRS Chief Counsel Advice Memorandum 2008-011. Until such time as they are reprogrammed or the IRS provides a new and improved form or schedule for reporting the wagering gains and losses of gambling sessions, it behooves the taxpayer and/or the tax professional to prepare and submit with the income tax return a detailed analysis grouping the Forms W-2Gs by gambling sessions with an explanation describing how the taxpayer and/or tax professional relied upon IRS Chief Counsel Advice Memorandum 2008-011 for guidance. By doing so, a manual review, if necessary, will permit the IRS to find and match-up the Form W-2Gs reported under the taxpayer’s tax identification number.

It is very likely that gambling and casino entertainment will continue to be a growth industry for Oklahoma. Now more than ever, Oklahoma CPAs need to become better prepared and equipped to assist their clients in this evolving area of the tax law. Working together, taxpayers, Oklahoma tax professionals and the IRS can help improve the accuracy, compliance and understanding of the taxation of recreational gamblers. €

[FN1] IRC Section 165(d). Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

[FN2] IRS Publication 525, Taxable and Nontaxable Income, pages 33 – 34.

[FN3] IRS Publication 529, Miscellaneous Deductions, page 11.