FEDERAL TAXATION OF GAMBLING INCOME: TIME FOR A CHANGE

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I. INTRODUCTION

The Federal Government has evinced a thoroughly negative attitude toward gambling through a host of federal anti-gambling statutes.[1] In the area of taxation of gambling income, however, the Internal Revenue Code (Code) must provide rules to deal with this disfavored activity. As one might imagine, the result is some rather harsh as well as unique procedures[2] sometimes aimed at attempting to tax gambling out of existence, while at other times trying to collect politically favored "sin-tax" revenues. Due to these conflicting goals, in many ways the tax laws are

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1 See, e.g., 15 U.S.C.A. §§ 1171-1178 (makes it illegal to transport an illegal gambling device across a state line, legal manufacturers must register with the Attorney General and keep complete records of sales); 15 U.S.C.A. §§ 3001-3007 (very strict conditions imposed on interstate off-track betting (OTB)); 18 U.S.C.A. §§ 1081-1083 (illegal for U.S. citizen, or any U.S. flagged ship or anyone within the territorial waters of the U.S. to run a gambling game aboard ship); 18 U.S.C.A. § 1084 (illegal to use wire communications to assist in wagering); 18 U.S.C.A. §§ 1301-1307 (federal anti-lottery laws); 26 U.S.C.A. §§ 4401-24, 4901-02, 4904-06, 6419, 7262 (1988) (imposes heavy burdens on "bookies:" 1/4 percent tax on legal wagers and 2% tax on illegal bets, those running game must register with IRS and pay a flat occupation tax of $500 for illegal operators or $50 for legal operators). But cf., 26 U.S.C.A. §§ 48(a), 168(h)(1), 183, 1231 (1988) (favorable tax treatment to horse breeders and racing industry); 26 U.S.C.A. 513 (1988) (charity can run for-profit bingo games without losing tax-exempt status).

2 One court has stated a taxpayer with gambling losses and an otherwise legitimate claim to a deduction "was one of the unlucky few trapped in the interstices of the federal tax scheme created, in this instance, by a bias against gaming." Boyd v. United States, 588 F. Supp. 569, 570 (D.Nev. 1985) (Foley, J.), aff'd, 762 F.2d 1469 (9th Cir. 1985).

still groping to find a formula to detect and to tax income from this once largely illegal activity.

At the same time, the states have embraced gambling, if not wholeheartedly, as an easy and ready source of revenue.[3] This has caused an explosion in legal gambling income with which the tax code is, at best, ill at ease, and, at worst, needlessly hostile.

This note will explore the various federal taxation provisions which address gambling income. After addressing the purpose of such provisions, improvements will be recommended that eliminate needlessly hostile purposes while improving legitimate goals such as enhanced reporting and equitable treatment of gambling income.

II. HISTORY OF THE AREA

Gambling has always been a pervasive element in American Culture.[4] As early as the beginnings of the republic, gambling

[3] Betting on horse racing is legal in 36 states. Fifteen states have dog racing. Twenty-two states allow off-track betting (OTB). State Lotteries of various sizes and frequencies exist in 19 states. Card parlors are legal in 9 states. Jai alai is legal in four states while casinos are legal in only 2 states. See I.N. Rose, **Gambling and the Law** 3 (1986).

[4] See Note, Federal Regulation of Gambling: Betting on a Long Shot, 57 **Geo. L.J.** 573, 573 n.1 (1969) (stating that lotteries in America had been used to raise money for all kinds of worthy causes but that by 1910 most states had anti-gambling laws). For example, from 1744 to 1774 there were approximately 164 lotteries in the colonies. H.B. Weiss & G.M. Weiss, **The Early Lotteries of New Jersey** (1966) (citing J.S. Ezell,

has helped to shape the division of power between the federal and state governments. The first gambling case to reach the Supreme Court indicated the federal government's early hostility towards gambling activities[5] and, perhaps, set the stage for a nearly 150 year period when the federal government left the regulation of gambling largely to the states.[6] In that interim period, there was the famous Lottery Case[7] which is arguably the

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Fortune's Merry Wheel: The Lottery in America (1960)).

[5] See Cohens v. Virginia, 19 U.S. (6 Wheat.) 264 (1821) (Marshall, C.J.) (unanimous opinion). In Cohens, two brothers were convicted of selling **federal** lottery tickets, the revenues from which were being used to pay off Revolutionary War debts, in the State of Virginia. Id. at 265-91. The Supremacy Clause of the Constitution notwithstanding, the Supreme Court upheld the Cohens' convictions on the ground that the tickets were only meant for sale in the District of Columbia. Id. at 447. The court held the brothers' reliance on the Supremacy Clause was unreasonable in light of the general policy against lotteries in both the federal government and the states. Id. at 444.

Many scholars have simply labeled this case as wrongly decided on this issue, perhaps intentionally so to avoid friction with Virginia's powerful Chief Justice, Spencer Rhone. See E.L. Barrett & W. Cohen, **Constitutional Law: Cases and Materials** 52 (6th ed. 1981).

[6] The states at that time had a very negative policy stance against gaming inherited from English Law. See, e.g., Statute of Anne, 9 Anne, c. 14 § 1 (1710) (pronounced all gambling debts null and void); An Act for the Suppressing of Lotteries, 10 & 11 Will. III, c. 17 (1699) (§ 2 made lotteries totally illegal in England for hundreds of years); 12 Rich. II, c. 6 (1388) (illegal for working class persons to play "tennis, football, coits, dice, ... and other such importune games" so that archery skills could instead be honed). See generally, Blakey, Gaming, Lotteries, and Wagering: The Pre-Revolutionary Roots of the Law of Gambling, 16 **Rutgers L.J.** 211 (1985).

[7] Champion v. Ames, 188 U.S. 321 (1903) (Harlan, J.) (5-4

first decision in the line of cases that expanded federal jurisdiction to any transaction which could possibly have any effect in interstate commerce.[8]

At the end of this 150 year period, approximately after the end of World War II, theories of federal jurisdiction had been greatly expanded to the point where no transaction could escape federal control[9] if Congress chose to use its power under the Commerce Clause.[10] The income tax had also been in place for more than 30 years. In the years that followed, Congress would include more and more Americans in the tax base to the point where income taxes would become the major source of revenue for the federal government.[11]

At the same time, gambling had been undergoing major changes of its own. Most of this change happened after the Civil War as Americans opened the western frontier. Four

decision). In this case the Court held that the federal government had to have the power to control the "widespread pestilence of lotteries." Id. at 356 (quoting Phalen v. Virginia, 49 U.S. (8 How.) 163, 168 (1850)).

[8] See Rose, supra note 3, at 43-44.

[9] Perhaps the most famous of these cases was Wickard v. Filburn, 317 U.S. 111 (1942) (Jackson, J.) (unanimous opinion). A farmer sought to enjoin a fine imposed on him for violating the quota limits set for his farm. Id. at 113. Even though the extra grain was used for feed on his farm, such a use was held to have an "effect" in interstate commerce. Id. at 127-29.

[10] **U.S. Const.** art. II, § 8, cl. 2.

[11] W. Andrews, **Basic Federal Income Taxation** 1 (2d ed. 1979).

factors came together to make gambling a permanent American pastime. Chief among these factors was the economic surplus which was created. Many people, some for the first time in their lives, had extra money to spend on leisure activities. This substantial economic surplus, coupled with a still relatively unsophisticated economy, prompted the next two factors which helped spur the growth of gambling on the frontier. In this simple economy, there were few goods on which to spend the new-found wealth. The third factor was that peoples' incomes tended to be very cyclical: prospectors would hit a new vein after months of futile exploration, cattle owners and their hired hands would only get paid after the cattle were taken to market, and farmers, likewise, had large sums of money only after their crops were sold. These three foregoing factors combined with the de facto legality of many games of chance and skill,[12] to develop an environment ripe for gambling activity.

[12] The reasons for this are numerous. First, the games of skill were usually legal at least where they honed skills that were useful to society. This made horse racing, marksmanship contests and other "skills of war" legal. Rose, supra note 3, at 70. Many gambling games such as poker and karo, however, lie in a gray area where both skill and chance combine to determine a given hand or round. This left these two games perennially up in the air as a legal matter. Where legislatures acted to make these gambling games illegal, the English common law often handcuffed them. Id. at 70-71.

Under English law, each game and its variations had to outlawed with great specificity. Id. at 71-72. This accounts for the many variations in gambling games, especially poker. No sooner could a game be outlawed than the slippery scoundrels who ran the parlors would invent a new, slightly different game. This, along with a significant amount of official bribery, lead

After the West was won, there was a moral swing in the country that put gambling activity on some hard times.[13] This moral swing, of course, eventually lead to Prohibition[14] which proved to be a boon to gambling activity. It brought many Americans, for the first time, into contact with major gambling operations.[15]

After Prohibition, organized crime syndicates were cash rich from catering to the vice of the 1920's, but badly needed to diversify because their major source of income was legal again.[16] As these masters of vice looked around for new investments, they changed a little noticed event into the most

to virtually non-existent enforcement of all gambling laws in many locals. Id. See also E. Bushnell, **The Nevada Constitution: Origin and Growth** 107 (5th ed. 1980).

[13] Note, supra note 4, at 573 n.1 (noting that by 1910, most states had passed anti-gambling laws).

[14] See **U.S. Const.** amend. XVIII (declared ratified January 29, 1919, effective January 29, 1920), repealed by **U.S. Const.** amend. XXI (effective December 5, 1933).

[15] The term "major gambling operation" is used for two reasons. First, to distinguish it from the "friendly game." Second, "organized crime" was still in its infancy so that term would be inappropriate. See R. King, **Gambling and Organized Crime** 23-25 (1969).
These gambling operations of the 1920's prospered in back rooms to speak-easys as well as actual casino rooms that existed in the resort locations of the day such as the Catskills and Atlantic City. See J. Hughes & G. Sternlieb, **The Atlantic City Gamble** 25 (1983) [hereinafter AC Gamble].

[16] AC Gamble, supra note 15, at 26 (commenting on "vast sums of money 'looking for action'" after the 1933 repeal of Prohibition). See also King, supra note 15, at 25.

significant moment in the history of gambling in America. This event was, of course, the nearly unnoticed legalization[17] of most gambling[18] in the State of Nevada in 1931.

After World War II, organized crime had a strangle hold on Las Vegas and on gambling in general in the U.S.[19] This caused a vast anti-gambling reaction in Congress.[20] Numerous laws were passed that took an unnecessarily harsh view of gambling activity and the income which was generated therefrom.[21]

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[17] What really happened was the legislature threw in the towel on trying to outlaw the rampant gambling in the state. Gambling was illegal in the Nevada Territory. This policy was affirmed in the first legislative session after statehood was granted when an anti-gambling law was passed in 1865. By 1869, however, gambling was legalized in the state. It was outlawed again in 1909 under pressure from religious and womens' groups.
The gambling just went underground, paying graft money for officials to look the other way. The legislature then put an end to this hypocrisy in 1931: Gambling establishments were made legal in return for licensing fees and minor controls by local officials. Taxes on gambling revenues, thought unenforceable at this early stage, were enacted later when the Nevada Tax Commission took over licensing in 1945. Background checks of licensees were instituted in 1949. The Gaming Control Board took over the regulation of gambling in 1955. Bushnell, supra note 12, at 106-108.

[18] Any table or machine game can be made legal upon approval of the Gaming Control Board by filing papers describing the rules and procedures of the game. **Nev. Rev. Stat.** § 463.152 (1985). Betting on any nearly any future event anywhere in the world is also possible via legal "bookies." **Nev. Rev. Stat.** §§ 464.005-.100 (1985).

[19] King, supra note 15, at 25.

[20] For a recount of the escapades of the Senate Crime (Kefauver) Committee, see id. at 88-97.

[21] See, e.g., 18 U.S.C.A. §§ 1951-55 (West 1984)

Human nature being what it is, however, gambling continued to grow despite Congress' disapproval. The states embraced gambling as a new revenue source.[22] Also, the "autonomous" bureaucracies of the federal government have done nothing to hinder gambling in the last three decades.[23]

(Racketeering Statutes).

[22] Some social engineering is also implicated here. Many states passed lotteries on the assumption that since people would gamble anyway, it was better that the profits go to the state rather than organized crime. See Hudson Institute, **Increased Legal Gambling in New York** 24-25 (1973). See also supra note 3.

[23] These "autonomous" entities are those agencies that are allowed to set their own rules (mainly because nobody in Congress understands what goes on in these agencies), and are in large part controlled by the special interests which the agency is supposed to be regulating. Some of these agencies have promoted what amounts to a major portion of the gambling activity in the U.S. For example, the Federal Reserve Board (FED) and Securities and Exchange Commission (SEC) did virtually nothing to halt the rampant gambling on the stocks in the 1960's and then again nothing was done in the 1980's to halt "equity arbitrage" despite the clear power they have to control margin requirements. See Securities and Exchange Act of 1934, ch. 404, § 7, 48 Stat. 886 (current version at 15 U.S.C.A. § 78g (West 1981 & Supp. 1990)). Additionally, Commodities Futures Trading Commission (CFTC) did absolutely nothing to put reasonable curbs on futures and options trading despite the volatility this brought to the stock market via equity arbitrage. See Commodity Exchange Act, c. 369 § 4a, 49 Stat. 1492 (current version at 7 U.S.C.A. § 6a (West Supp. 1990) (CFTC to control "[e]xcessive speculation ... or unreasonable fluctuations" in commodities)). Furthermore, the FDIC & FSLIC did nothing to limit gambling on real estate in the 1980's despite their power to control risks banks could take. See Federal Reserve Act of 1933, c. 89, § 264(h), 48 Stat. 424 (current version at 12 U.S.C.A. § 1817 (West 1989)).

Congress itself promoted the gambling in real estate in the

Since the early 1970's, about 19 states have established lotteries[24] to compete not only with illegal games but also with each other for gamblers' dollars. Jai alai was also legalized in both Connecticut and Florida during the 1970's.[25] Casino gambling became legal in Atlantic City in 1977.[26] While no other

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early 1980's with extremely lucrative depreciation schedules (Accelerated Cost Recovery System (ACRS), see former I.R.C. § 168(c)(1), (2) (West 1985) (amended 1986)) and other favorable tax breaks such as the investment tax credit. I.R.C. § 48 (West 1985) (repealed 1986) (could not be taken on real estate but was available for elevators, appliances and some other accouterments). Eventually, Congress acted to curb these practices, which in turn contributed substantially to the financial problems the FSLIC and FDIC have been experiencing. See Zelinsky, Efficiency and Income Taxes: The Rehabilitation of Tax Incentives, 64 Tex. L. Rev. 973, 1022 (1986) (predicts that stripping developers of the ACRS "may move the real estate market closer to the point of optimal allocation" but fails to predict externalities created by the reallocation).

Ironically, gambling treatment is denied to all of these transactions, mainly on policy grounds. See Jasinski v. Commissioner, 37 T.C.M. 1 (1978) (taxpayer argued he was gambling on high risk bonds and therefore should be allowed to deduct capital losses form the income derived from the bonds on the theory it was all one wager under § 165(d) to avoid capital loss restriction rules).

[24] Rose, supra note 3, at 3.

[25] Id. It is now also legal in Delaware, Rhode Island and Nevada. Id.

[26] See 1977 N.J. Laws c. 110, § 1 (effective date of Casino Control Act was June 2, 1977). The first casino (Resorts), however, did not open until May 28, 1978. AC Gamble, supra note 15, at 66, 176.

jurisdiction has followed the Las Vegas[27] or Atlantic City[28] models, riverboat[29] and cruise ship[30] gambling will likely be major growth industries in the 1990's.

Furthermore, although horse and dog tracks fell on hard times in the 1970's and 1980's as they competed first with

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[27] The Nevada Gaming Control Act is codified at **Nev. Rev. Stat. §§ 463.010-.720 (1985)**.

[28] The New Jersey Casino Control Act is codified at **N.J. Stat. Ann.** §§ 5:12-1 to -190 (West 1988 & Supp. 1990). Under authority of the Act, the Casino Control Commission has promulgated exhaustive regulations dealing with virtually every aspect of casino gaming in New Jersey. See **N.J. Admin. Code** tit. 19, §§ 40-54, 65 (1990). For an analysis of the Act and the Commission's regulations as originally promulgated, see Note, The Casino Act: Gambling's Past and The Casino Act's Future, 10 **Rut.-Cam. L.J.** 279 (1979) (authored by Jay M. Gutierrez).

[29] Riverboat gambling is legal to some extent in Illinois, Iowa and Mississippi. See Dinnen, Taking a Chance on Casino Riverboats, Wash. Post, Apr. 2, 1991, at D1, col. 2. Dinnen notes that, to date, seven boats have been licensed in Iowa -- beating Illinois and Mississippi to the draw. The gambling, however, will be limited to $5 per hand with a $200 daily loss limit. Id. Dinnen also mentions that Illinois riverboats, when legalized in 1992, will have no such limits and comments on the absence of Nevada and New Jersey casino interests. Id. at D5, col. 1.

Since riverboats travel on navigable waterways such as the Mississippi and Missouri Rivers, they fall within the maritime jurisdiction of the United States. 28 U.S.C.A. § 1333 (West 1966). The Constitution assigns Congress plenary authority in this area through the Commerce Clause. **U.S. Const.** art. II, § 8, cl. 2. In many cases, Congress has ceded its authority to the states but if it so chooses it could ban this activity.

For an Act of Congress which is clearly implicated by the gambling in Iowa, see 33 U.S.C.A. § 11 (1986) (giving states of North Dakota, South Dakota, Minnesota, Wisconsin, Iowa and Nebraska authority to decide among themselves which state will

lotteries, then casinos and perhaps even the generalized vice of the 1980's,[31] they now appear poised for a momentous comeback in the 1990's and beyond.[32]

III. THE TAX PROVISIONS

The Code provisions on gambling primarily amount to some modifications of the usual rules. However, the procedures in the Regulations and the vast number of forms that are supposed

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have jurisdiction over offenses on the waters forming boundaries between these states so long as such jurisdiction is "not in conflict with the Constitution of the United States or any law thereof ....").

[30] These trips often last only for the evening. Cruise ships travel outside the 12 mile jurisdictional limit of the United States and then the casino opens. See Pres. Proclamation No. 5928, 54 Fed. Reg. 777 (1988), reprinted in 43 U.S.C.A. § 1331 (West Supp. 1990) (claiming 12 nautical mile limit set by 1982 United Nations Convention on the Law of the Sea).

[31] A good case can be made that much of the gambling growth of the 1980's was in gambling on futures, options and real estate. See supra note 23.

[32] Modern technology has largely solved the tracks' two biggest problems: the distance of most tracks from population centers and the slow pace of the game. OTB neatly cures the former problem while simulcasting (both at the track and OTB locations) increases the pace of betting by allowing the bettor to wager on many different races at once. Between simulcasting and OTB, nearly half of most tracks' receipts come from people not physically present at their track.

Currently, Pennsylvania is "experimenting" with OTB locations, one of which is in downtown Philadelphia. See Florio, Off-Track Betting Promoters Aim Upscale for Pa. Suburbs, Phila. Inquirer, Mar. 14, 1991, at B3, col. 1 (N.J. ed.). Atlantic City casinos will soon have OTB parlors pursuant to the November constitutional amendment. Id.

to be filled out amount to needless harassment of gambling activity.

A. The Alternative Minimum Tax

The Internal Revenue Service (IRS or Service) has assessed the Alternative Minimum Tax (AMT) against gamblers on the theory that their itemized gambling loss deductions are "items of tax preference."[33]

The AMT could be avoided, however, by proving that the taxpayer was in the trade or business of gambling. The IRS' position on this issue was gamblers, except for "bookies," could almost never meet this test. On the other hand, there were benefits to this treatment by the IRS. First, the taxpayer is not totally out of luck on her expenses. Though not in business, she can still deduct, albeit as itemized deductions, most expenses associated with her gambling income.[34] The main advantage, however, stems from not having to pay the self-

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[33] See P.L.R. 8018017 (advising taxpayer to pay AMT). Payment of the AMT was also the only issue in a recent major Supreme Court case involving gambling income. See infra notes 41-50 and accompanying text.

[34] I.R.C. § 212(1) (West 1989). This section allows "as a deduction all the ordinary and necessary expenses paid or incurred during the year for the production or collection of income." Id. Under this section, gamblers have been allowed to deduct transportation costs to the gaming establishment, meals and lodging and information costs associated with wagering.

employment tax.[35] In the past, the IRS probably got back what it lost in self-employment tax from the built-in floor for itemized deductions and assessments of the AMT.

The greatest revenue enhancement, though, probably came from denying Individual Retirement Account (IRA)[36] and other retirement deductions[37] to gamblers who win large sums of money who were actively seeking tax deductions to avoid the 50% marginal tax rate then in place.[38] Most gamblers who faced lower marginal rates[39], however, most likely considered not paying the

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[35] P.L.R. 8235006; P.L.R. 8206016; P.L.R. 8018017; c.f. Wells v. Commissioner, T.C. Memo 1984-507, 48 T.C.M. (CCH) 1200 (Losses were not items of tax preference but did have to pay the self-employment tax). Not paying the self-employment tax is quite an advantage. The tax has ranged from 11.3% in 1984 to 15.3 in 1991. I.R.C. § 1401 (West 1988). This increase resulted from increases in the underlying taxes (both a social security and hospital insurance tax) and the phaseout of a credit for self-employed individuals that allowed them to pay a lower tax than if they paid both the employee and the employer contribution. Id.

[36] I.R.C. § 408 (West 1988 & Supp. 1990).

[37] See, e.g., I.R.C. § 401 (West 1988 & Supp. 1990)

[38] See former I.R.C. § 1 (West 1985) (50% marginal tax rate). A major factor in this analysis is that while high stakes professional gamblers are few and far between, they are the only people who pay tax on gambling winnings with a legitimate claim that the winnings are "earned income," a necessary condition for deducting money placed in a retirement account. See, e.g., I.R.C. §§ 401(c)(2), 404(a)(8)(B) (West Supp. 1990). Smaller stakes professionals would have an equally legitimate claim but the fact of the matter is they almost never pay their taxes. Rose, supra note 3, at 109-110. For an in-depth discussion of these "retirement issues," see infra Part III. C.

[39] Assume an income level of $25,000 - $35,000.

self-employment tax in return for having to itemize their deductions and forgo retirement accounts an equitable trade-off.

For example, as far as these lower income gamblers were concerned, saving $3000 - $4000 per year in self-employment tax compared favorably to not saving $600 - $800 on an IRA and paying an extra $1000 - $2000 in income tax if the gambler had no itemized deductions other than his losses. The risk of being assessed the AMT was not significant for these individuals.[40]

The Supreme Court ruled on these issues in Commissioner v. Groetzinger.[41] Following the tax court analysis below, the Court held Groetzinger was in a trade or business.[42] He was, therefore, not liable for the AMT, which was the only issue in the case.[43]

However, the dicta in Groetzinger is very far reaching. It is absolutely clear the Supreme Court intended to answer in the affirmative the question of whether gamblers, under the proper

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40 If they were assessed tax under the AMT, they would likely owe very little additional tax. See infra note 53. After 1982, there was no risk of being assessed the AMT because of gambling activity. See infra notes 48 & 103.

41 489 U.S. 23 (1987).

42 This test was left to a case by case determination. Id. at 36. Groetzinger clearly met the tests of frequency and profit motive set out in the opinion because he attend the race track over 60 hours per week and keep careful financial and handicapping records. Id. at 24-25. The fact that he lost in the particular year was not deemed significant. Id. at 36.

43 Id. at 25-26, 35-36.

facts and circumstances, should be treated the same as other professionals.[44] The majority opinion was cognizant of the fact that this analysis could make gamblers liable for the self-employment tax.[45] However, trade or business treatment can have many tax advantages, particularly for high income gamblers.[46]

The issues addressed in the Groetzinger dicta may not be settled because there was a vigorous dissent by Justice White.[47] White made a highly plausible argument that the Court's analysis was illegitimate because Congress had already made the decision that gambling could never be a trade or business.[48] There is a considerable possibility that a majority of the court would now adhere to this view because two strict statutory constructionists in the White/Rehnquist mold[49] have replaced court members in the Groetzinger majority.

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44 Id. at 33-34.

45 Id. at 36 n.16.

46 See infra note 69.

47 He was joined by Chief Justice Rehnquist and Justice Scalia. See Groetzinger, 489 U.S. at 37.

48 Id. White asserted that Congress had "accepted the teaching of Gentile v. Commissioner" that gambling was not a trade or business. Id. at 37-38. In the 1982 amendments to the Code, Congress did declare that gambling losses were not items of tax preference to eliminate the inequity in Groetzinger but had made no other changes. White found this significant. Id. at 38.

49 They are Justices Kennedy and Souter.

In any case, any coherence the decision in Groetzinger might have brought to this field has not materialized. Gamblers are now free to argue, based on their particular circumstances, that they either are or are not in a trade or business depending on which position is more favorable to them.[50]

B. Section 165(d)

Obviously, gambling winnings are income in the year in which they are won under § 61 of the Code.[51] Gambling income, however, need only be reported in any year in which there is a net gain.[52]

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[50] Obviously, this may require a little tax planning.

[51] I.R.C. § 61 (West 1988). This is definitely in line with American theories of equal application of laws and everyone pulling his fair share. Many European countries, most notably England, do not tax individual gambling winnings. The policy reason for this is that the gambling winnings of individuals represent too small a source of revenue to be obtained at too great cost in either administrative process or disrespect of the tax laws or both. As long as the game operator is taxed on his profits, the government will get the lion's share of the gambling revenue at the least cost. See generally J.P. Eddy and L.L. Loewe, **The New Law of Gaming** (1969) (complete annotated text of the (United Kingdom's) Gaming Act of 1968 (121 H. of L. 1200)).

[52] Failure to report gambling income will not support even a civil fraud allegation where the taxpayer can show a net loss for the period in question. See Powell v. Commissioner, 18 T.C.M. 170 (1959). But cf. McClanahan v. United States, 292 F. 2d 630 (5th Cir. 1961) cert. denied 368 U.S. 913 (1962) (case of tax fraud is complete where government proves existence of winnings, taxpayer must then prove net loss to be acquitted).

The ephemeral nature of gambling winnings, however, tends to raise more questions than simply whether those earnings are taxed and at what rate.[53] Almost equally important are the questions of how long a period of time gains and losses may be netted out, and whether any resultant loss can be netted against other income. The Code takes a clear stand on these issues: winnings and losses can only be netted in the year in which they occur[54] and gambling losses cannot be netted against other income.[55]

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[53] See Justice White's dissent in Groetzinger where he proposed that the AMT really just amounted to a permanent disallowance of some (2.5%) gambling losses to offset gambling winnings. Groetzinger, 480 U.S. at 37 & n. 2. In a year where the gambler won more than he lost, this would only amount to his being in a higher tax bracket for his income than other taxpayers. Id.

[54] I.R.C. § 165(a) reads, "**General Rule. --** There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Id. [emphasis added]. This rule as such is not aimed at gamblers since anyone can only deduct losses in the year they occur. The problem was, before Groetzinger, gamblers were not allowed to use the trade or business provisions to have loss carrybacks and carryforwards. See infra notes 115-124 and accompanying text.

[55] I.R.C. § 165 (d) states, "**Wagering losses. --** Losses from wagering transactions shall be allowed only to the extent of gains from such transactions." Id.

Unlike § 165(a), this section is clearly aimed at gamblers and exemplifies the disfavored nature of gambling income. The legislative history clearly exemplifies this purpose:

> Existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under the interpretation of the courts, the illegal gambling losses can only be taken to the extent of gains on such transactions. A similar

Expense items also play a vital role in making taxable income reflect actual economic gain. Any income producing activity should be able to write off at least some of its expenses.[56] The preferred course of action is to write these items off under § 162 as business expenses.[57] The Service and the courts have been extremely hostile to treating gambling as a

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limitation on losses from legalized gambling is provided for in the bill. Under present law, many taxpayers take deductions for gambling losses but fail to report their gambling gains if they desire to deduct their gambling losses.

H.R. Rep. No. 704, 73 Cong. 2d Sess. 22 (1934).

[56] Before the enactment of 165(d), the Service had unsuccessfully argued that those involved in illegal gambling businesses should not be allowed to reduce their gross income by the amount of their losses and expenses. See McKenna v. Commissioner, 1 B.T.A. 326 (1925), acq., IV-1 C.B. 3. The IRS has acquiesced in this procedure for those in the trade or business of gambling. See Audit Technique Handbook for Internal Revenue Agent, **I.R. Manual MT 4231**, para. 73(10)(4). The problem is the IRS has traditionally taken the position that gambling is rarely a trade or business under the "holding one's self out" test so many legitimate expenses are disallowed.

[57] The enactment of § 165(d) did not change this approach, although it disallows such deductions when a net loss occurs.

For casual gambling, however, the winnings must be included in gross income and losses must be claimed as itemized deductions. Carter v. Commissioner, 35 T.C.M. 83 (1976). See also Heidelberg v. Commissioner, 36 T.C.M. 566 (1977); Stien v. Commissioner, 48 T.C.M. 724 (1984). Under this approach, if the gamblers' deductions do not exceed the old zero bracket amount (1978-1986) or the standard deduction (1987-present), they have no tax benefit. This has questionable policy implications because many casual gamblers have below average incomes and will be pushed into higher tax brackets yet have no benefit from loss deductions because they have no mortgage interest and other deductions that make itemization worthwhile.

business.[58]

Typical of this hostility was the now overruled case of Gentile v. Commissioner.[59] The Gentile court held that being in a trade or business "involves holding one's self out to others as engaged in the selling of goods and services."[60] Furthermore, continuity and regularity of activity together with a profit motive are not sufficient grounds for concluding that a taxpayer

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[58] One can guess the main reason for this was to try to discourage the underlying activity, which was usually illegal, by imposing a de facto higher marginal tax rate by disallowing otherwise legitimate deductions. See, e.g., Nitzberg v. Commissioner, 580 F.2d 357 (9th Cir. 1978) r'ving 34 T.C.M. 707 and 34 T.C.M. 996 (1975) (net losses of card room shills were not deductible as governed by more specific § 165(d) despite business motive in incurring losses which convinced tax court such losses were deductible under general § 162(a)); Boyd v. United States, 588 F. Supp. 569 (D.Nev. 1984), aff'd, 762 F.2d 1369 (9th Cir. 1985).

Boyd was paid to gamble in poker games (with his own money) and run the poker room at the Las Vegas Golden Nugget. Id. at 570. He filed a refund suit for the years 1973-75 when he sustained gambling losses that he wanted to offset against his ordinary income from the Golden Nugget. Id. at 571. He claimed the net losses were business expenses under § 162(a). Id. The court, admitting the result was unfair (Id. at 571 (see quote supra note 2)), reasoned it had no choice but to follow the unanimous authority that the more specific § 165(d), rather than § 162(a), controlled the case. As a result Boyd, was prohibited from deducting gambling losses from ordinary income. Id. at 573. One would assume the same result would obtain if Boyd had relied on § 212(1) instead of § 162(a). The main point of this note is that this reasoning is outdated and Boyd clearly should have been decided for the taxpayer.

[59] 65 T.C. 1 (1975), acq., 1981-1 C.B. 1, overruled by Groetzinger, 480 U.S. at 36.

[60] Id. at 5 (quoting Deputy v. DuPont, 308 U.S. 488, 499 (1940) (Frankfurter, J., concurring)).

is engaged in a trade or business.[61] Under this rationale for example, the Service has denied gamblers deductions for contributions to retirement plans because the income is not earned income within the meaning of § 401(c)(2).[62]

1. Substantiation Rules under § 165(d)

The regulations are more coherent than the court decisions in this area but they do impose some ridiculous burdens on gambling income. Perhaps the most amusing of these is the regulations suggestion of what substantiation is required to claim losses.[63]

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[61] Id. at 4 (citing Higgins v. Commissioner, 312 U.S. 212, 217 (1941)). But see Groetzinger, 480 U.S. at 36 (endorsing the Higgins formula).

[62] See, e.g., P.L.R. 8235006 (where professional sports handicapper and card player was denied H.R. 10 retirement deductions).

[63] The regulations require the gambler to record the amount of win or loss, where and with whom the wager was made, the number of the table, window or machine where the wager was made and any witnesses who were present at the transaction. Rev. Proc. 77-29 (contained in 1977-2 C.B. 538). It is virtually impossible in any gambling environment to obtain all of this information. Luckily, the courts have rarely required gamblers to comply with all these requirements. See Wolkomir v. Commissioner, 40 T.C.M. 1078 (1980) (horse bettor able to substantiate losses in excess of winnings of $423,900 reported on Forms 1099 and W-2G with losing tickets as well as records and schedules of losses where testimony was credible); Dunnock v. Commissioner, 41 T.C.M. 146 (1980) (wagering records substantiate losses on horse racing); Green v. Commissioner, 66 T.C. 538 (1976), acq. 1980-2 C.B. 1 (partnership operating illegal casino obviously could not keep accurate records of each bet; therefore, daily tabulation of amount of chips purchased

Other provisions, however, are more legitimate given the extremely low taxpayer compliance in the area of gambling income. The Service has been on a decade-long campaign to increase reporting of gambling income. The principle weapon in this arsenal is form W-2G and its attendant 20% withholding requirement.[64]

Additionally, Congress has put casinos under the cash reporting requirements formerly applicable only to banks and other financial institutions.[65] This is obviously aimed at high

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minus both money paid to redeem chips and operating expenses would constitute adequate record of gross income); Doyle v. Commissioner, 13 T.C.M. 1171 (1954), <u>aff'd on other grounds</u>, 231 F.2d 635 (7th Cir. 1956) (taxpayer's engaging in illegal business did not increase taxpayer's burden to rebut IRS' determination of deficiency where taxpayer had adequate bookkeeping system and credible demeanor). <u>But cf.</u> Rowles v. Commissioner, 51 T.C.M. 330 (1986) (taxpayers unable to prove loss); Glazer v. Commissioner, 40 T.C.M. 1065 (1980) (gambler not entitled to deduction where he kept no records and could "only" show the loss of his business and large, contemporaneous increase in personal debt to offset winnings on 1099 Forms); Scoccimarro v. Commissioner, 39 T.C.M. 486 (1979) (taxpayer must prove he purchased parimutuel tickets before losses would be allowed).

[64] Gamblers who exceed certain set formulas have to produce identification so a W-2G can be filled out. I.R.C. § 3402(q) (West 1989) (generally withholding occurs where proceeds of wagering transaction are more than $1000 and such proceeds are at least 300 times the amount wagered). As an incentive to give correct information, 20% of the win is withheld. <u>Id.</u> at § 3402(q)(1). The 20% figure is lower than most peoples' marginal tax rate so many people give false information. <u>But see id.</u> at 3402(q)(6) (penalties of perjury apply to statement of name, address and taxpayer identification number).

[65] <u>See</u> Pub. L. 99-570, § 1362, Oct. 27, 1986, 100 Stat. 3207-33 (amending 31 U.S.C.A. § 5312(a)(2) (West Supp. 1990) to

stakes players. However, one must question whether these requirements, formerly aimed only at drug dealers and other money launderers, should apply to gamblers who usually lose and who are generally not engaged in any illegal activity.[66]

C. Retirement Issues

While Groetzinger may solve many of the problems of the high-income professional gambler,[67] virtually all other gamblers can be subjected to wanton caprice either by strict application of the Code or by deft interpretations put forward by the IRS. An example of this is the IRS flip-flop on its long standing practice of holding that gambling for one's account was not a trade or business. When the IRS realized it was losing revenue on the self-employment tax to a discernible but limited number of professional gamblers, it switched its position and held these individuals were in a trade or business.

Many of these individuals, in later tax years, responded to the IRS position by behaving exactly like other professionals. They opened lucrative retirement accounts and sheltered large

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include "any business ... similar to ... any business described in this paragraph...." Id. at § 5213(a)(2)(X)).

[66] See infra notes 137-139 and accompanying text.

[67] Albeit that this result is attained at the cost of being liable for the self-employment tax. See supra note 45 and accompanying text.

portions of their income from taxation.[68] Realizing that this counter move resulted in even lower tax receipts,[69] the Service re-flip-flopped to its original position -- that gambling on one's own account was not income from self-employment -- to try to recapture the lost revenues. This attempt failed but serves to show that the IRS feels it is free to argue opposite

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[68] See supra note 38 and accompanying text.

[69] This occurred because the self-employment tax caps off at a certain sum each year. For the years in question the amount was about $5000. See Schedule SE. Even assuming that this $5000 is considered money down the drain, gamblers who funded their retirement funds with as little as $15,000 would break even on the deal with a 33% tax rate. Usually, up to 25% of one's income can be deposited in most retirement funds. See, e.g, I.R.C. § 412(m)(4)(C) (West Supp. 1990). Based on these assumptions, this "break even" result could be attained at $60,000 net income level. Many of the gamblers in question had incomes into the many hundreds of thousands of dollars, and saved a great deal of money on their taxes.

Of course, it is not fair to characterize the $5000 in self-employment tax as "money down the drain," this payment will also add to the gambler's retirement income assuming she has the requisite 40 quarters to qualify for social security retirement benefits. See 42 U.S.C.A. 402(a) (West Supp. 1990) (entitled to benefits if "fully insured," aged 62 and have filed for benefits); Id. at § 414(a)(2) (West 1983) (person with 40 quarters of coverage is "fully insured individual"). Only some portion of the self-employment tax is wasted due the government's sub-optimal investment strategies. See id. at § 401(d) (must invest in "obligations of the United States"). This occurs because social security money is treated as though it were invested in 30 year government bonds -- this obviously is historically a far worse investment than investing in stocks for 30 years. To make the waste even worse the money is not really invested. At present it is applied to reduce the budget deficit, while a theoretical investment is made in government bonds, backed by the promise of the U.S. Government to repay the debt to the Social Security Trust Fund at its full future value in 30 years. See generally id. at § 401.

positions with different taxpayers, in similar situations, with the hope of extorting maximum revenue from each.

D. The New Issue: Income from the Discharge of Indebtedness

Another case where the IRS exemplified a good amount of hostility to gambling activity is Zarin v. Commissioner.[70] In Zarin, a gambler was charged with income from the discharge of indebtedness[71] when he settled his "markers" with a casino for less than face value.

Mr. Zarin was one of the first "high rollers" in the Atlantic City casinos. After moving to Atlantic City shortly after the casinos opened, Zarin quickly began losing money in the only casino then operating, Resorts International (Resorts). Zarin eventually began betting the house maximum on every roll of the dice at craps.[72] He quickly became a "valued gaming

[70] 92 T.C. 1084 (1989), rev'd 916 F.2d 110 (3d Cir 1990).

[71] Income from the discharge of indebtedness in specifically defined as income by I.R.C. § 61(a)(12) (West 1989). But see id. at § 108 (under certain conditions discharge will not be counted in income).

[72] Without cheating, it is impossible to win at craps as a matter of pure statistics. The best bets on the table (the "don't pass" or "don't come" bets) have a negative expectation of about 1.37%. The "pass" and "come" bets follow closely behind at -1.41%. See **N.J. Admin Code** tit. 19, § 47-1.2(a)(1) to (4). While these are bets on which about 80% of the money in craps is bet, there are significant "side bets" on various outcomes that have disadvantages that range to -13.89%. See id. at §§ 47-1.2(a)(16), 47-1.4(b) (the "boxcars" bet, that the next roll will be 12, pays 30 to 1 whereas the true odds are 35 to 1 -- on average the gambler will lose five bets for each 36 made).

patron" at Resorts.[73] Zarin was given free suites at the hotel, free meals and 24-hour limousine service. By December 1979, Zarin had gambling debts[74] to Resorts of approximately $2.5 million, which he paid in full.[75]

Unfortunately for Resorts, most of this credit had been illegally extended to Zarin.[76] Zarin continued to gamble into

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The approximate average of these side bets is -5%. Therefore, the weighed average expectation at craps is probably around 2.12% (1.4%*80% + 5%*20%) for most players.

[73] Zarin, 92 T.C. at 1085-86.

[74] Casino gambling debts are collectible in New Jersey. **N.J. Stat. Ann.** § 5:12-101(f) (West 1988). In Nevada, the state courts consistently refused to hold that the Statute of Anne was overruled by implication with the passage of the Gaming Control Act. West Indies, Inc. v. First Nat. Bank of Nevada, 67 Nev. 13, 29, 214 P.2d 144, 152 (1950) ("[T]hose portions of the Statute of Anne are in force which are applicable to our conditions and not in conflict with our statutory law ...."). One can assume, therefore, that if Zarin had gambled in Nevada, the nullity of the underlying debt would have foreclosed application of I.R.C. § 61(a)(12). But see infra note 79 (IRS has successfully argued that nonrecourse debt gives rise to discharge of indebtedness income).

In 1983 the Nevada legislature, following the favorable experience in New Jersey (at least so far as the casinos were concerned), legalized the collection of valid gambling debts. See **Nev. Rev. Stat.** § 463.368(1) (1985). Since then, I.R.C. § 61(a)(12) would be equally applicable in Nevada.

[75] Zarin, 92 T.C. at 1086-87.

[76] Id. at 1087. Resorts was being investigated for 809 violations of state gambling laws, including at least 100 that related to Zarin. A cease and desist order was issued not to extend anyone credit above his or her limit. Id. Resorts attempted to get around this order in at least two different ways. First, credit limits, which are subject to rather strict legal guidelines, were ignored in Zarin's case as he received

April of 1980 when his personal checks to be applied to his outstanding debt of $3,435,000 began to bounce. His credit was immediately cut off.[77]

Resorts sued for the entire amount owed. Zarin asserted several affirmative defenses and the case was settled for $500,000. Upon audit by the IRS, Zarin was charged with income from the discharge of indebtedness in the amount of $2,935,000.[78]

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instant increases in his credit upon request. Id. Second, his checks to pay off his debts (making more of his credit available again) were treated as "considered cleared" when he wrote them rather than when the checks actually cleared as required by law. Id.

This style of extending as much credit as casino thinks the patron is worth as quickly as possible is known as the "stretch and break" in the casino business. It invariably ends in the casino forgiving some of the debt.

At first, the casino will generally allow the player more credit as long as he makes some payment on his old debts. Eventually, however, the checks start to bounce and the gambler gets no more credit. If the casino has in fact "broken" the gambler, he is a candidate for a bankruptcy filing with the casino debt likely to be his primary unsecured debt. Rather than possibly incur bad publicity (and possible state fines relating to this illegal procedure) and legal fees relating to the liquidation of the gambler's assets, a very favorable offer of settlement is usually made for, say, all the debtor's liquid assets. See generally **Report and Recommendations of the State of New Jersey Commission of Investigation on the Abuse and Misuse of Credit Controls at Atlantic City Casinos** (1983) [hereinafter Credit Controls].

In this particular case, Resorts executives may have been trying to "stretch and break" Zarin so that they could personally benefit from being partners in one of Zarin's real estate tax shelters in return for the debt forgiveness. Id. at 180-82.

[77] Zarin, 92 T.C. at 1087-88.

[78] Id. at 1088.

Zarin's first argument before the tax court was that there was no discharge of indebtedness because his assets were never subject to Resort's unenforceable debt. Unfortunately for Zarin, the tax court has moved away from an "assets being subject to" analysis in recent years in favor of a "benefit conferred" analysis.[79] He lost on this issue because, assuming he were rational, he must have derived some benefit from his gambling activities.[80]

His second argument was statutory and in many ways much more sophisticated. He claimed he had a "purchase price" adjustment with regard to the chips that Resorts gave him. Under § 108(e)(5) of the Internal Revenue Code, such an adjustment was not considered taxable income.[81] The tax court

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[79] Most of these cases concern nonrecourse financing which is largely analogous to Zarin's situation. The debt is not enforceable against the debtor yet the debtor may have received a benefit from its discharge. This benefit may be as ephemeral as merely having the chance in the past (before the investment or gamble, as the case may be, was lost) to make money. Id. at 1092 (citing Tufts v. Commissioner, 461 U.S. 300, 309-310 (1983)).

[80] The tax court also noted that, regardless of his rationality as to gambling, it was perfectly rational to derive benefit from the free rooms, meals and limousine rides he received. Zarin, 92 T.C. at 1099. See also Credit Controls, supra note 76, at 183-184 (Zarin's testimony about Resorts' complimentary services).

[81] I.R.C. § 108(e)(5) reads:

(5) Purchase-money debt reduction for solvent debtor treated as price reduction. --If--

held the section was only applicable to "tangible property."[82] Not having succeeded on the arguments he could muster, Zarin lost the case and appealed to the Third Circuit.

The Third Circuit reversed[83] by a divided court[84] holding that the transaction did not give rise to cancellation of indebtedness income as defined in § 108(d)(1)[85] because the issue

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(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur --

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

Id.

[82] Zarin, 92 T.C. at 1100.

[83] Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990) (Cowen and Weis, JJ. for reversal).

[84] Id. at 117 (Stapleton, J. dissenting).

[85] I.R.C. § 108(d)(1) (West 1989) reads as follows:

(d) Meaning of terms; special rules relating to subsections (a) and (b). --

(1) Indebtedness of taxpayer. -- For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness --

between Zarin and Resorts went to the amount of the debt as well as its enforceability.

Professor Daniel Shaviro of the University of Chicago Law School has written an excellent article[86] criticizing both the tax court[87] and the Third Circuit[88] for their respective rationales in this case.

Generally, his argument against the tax court is based on a "gut" reaction that Zarin should not have been charged with so great a windfall -- a windfall ordinary observers see he never received. Zarin was merely hopelessly addicted to the game of craps, he received no "benefit" from playing. Shaviro plainly admits he is uncomfortable with his sympathetic reasoning in the case.[89] He admits as a matter of statutory construction the

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(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

Id.

[86] Shaviro, The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption, 45 **Tax L. Rev.** 215 (1990).

[87] Id. at 241-51.

[88] Id. at 252-58.

[89] Id. at 250. He points out that the result in this case has symmetry with the case where the gambler can pay her debts (with money on which she has paid tax) but gets no write-off under I.R.C. § 165(d). Id. at 239-40. For example, A earns $12 million, pays $6 million tax at the 50% maximum rate then applicable and then loses the other $6 million in the casino to

court may even have been right. Shaviro correctly points out the real problem with this case is the failure of the market mechanism to determine the "value," if any,[90] of what Zarin received. Zarin could have lost more than would be expected, but this probably did not happen.[91] The real issue then is that

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be flat broke. Zarin, on the other hand, earns, say, $6 million, pays $3 million tax and then loses $6 million on credit. The casino settles the debt (for whatever reason) for the $3 million and considers the matter closed. The IRS, however, does not consider the matter closed. Both gamblers are flat broke and have "enjoyed" the same level of consumption but A paid $3 million more in tax.

To be absolutely fair, Zarin should have to pay tax of $3 million to put him on equal footing with A. Notice that this is not what happens, there is no "gross-up" as with the estate tax to put Zarin on equal footing. He is merely charged with $3 million of debt cancellation income and will owe only $1.5 million in extra tax. He will still be treated more favorably than A who paid $6 million tax to Zarin's $4.5 million. This result treats him as though he were in business while gambling, a contention that is clearly erroneous in this case. This differential treatment, however, does serve to prove that cancellation of indebtedness theories (and both §§ 61(a)(12), 108) are inapplicable in this situation.

[90] Id. at 226-29. Shaviro points out the value may well have been negative because of the displeasure one would ordinarily encounter at losing so much money without knowing in advance that you would not have to pay 100% back. Id. at 235.

[91] Shaviro points out that Zarin must have been near expected value due to the time he played. Id. at 233. This assumption can be tested. Zarin lost at least $6 million at a game with a 2% disadvantage. See infra note 72 and text accompanying notes 75-77. Therefore, he must have bet about $300 million dollars. Is it temporally possible to do this in a two year period from June, 1978 to April, 1980? See Zarin, 92 T.C. at 1085, 1088.

While Zarin's bets increased as he got deeper in debt, there is ample evidence he often bet at least $5,000 per outcome at the dice game. Credit Controls, supra note 76, at 176, 186. See also Zarin, 92 T.C. at 1087-88 (betting up to $15,000 per

Zarin's addiction negated any attempt to value his "benefit" from the experience by referencing the amount debt that was discharged.

Shaviro freely admits he offers no alternate method to value the experience that Zarin received at Resort's gaming tables. He merely assumes the experience was negative and advocates letting Zarin pay no tax.[92] This note agrees with Shaviro's analysis of the two opinions in Zarin, but does not rely on his largely sympathetic analysis based on Zarin's addiction to gambling to resolve the case. The Third Circuit was "on the right track" in holding that §§ 61(a)(12) and 108 were inapplicable but then badly distorted the analysis.

The correct analysis of Zarin comes from realizing that he had already paid $2.5 million in debts and that he arguably had an actionable tort committed on him by being "stretched and broken."[93] Under this analysis, he could have sued Resorts for

roll as of January, 1980). Since the dealers were slow back in those days, no more than 30 outcomes took place per hour. See K. Uston, **Million Dollar Blackjack** 57 (1984). Therefore, he was betting perhaps $150,000 per hour so it would take 2000 hours to bet $300 million. The 2000 hours seems to be a reasonable approximation of what he actually played so Shaviro's assumption would seem valid. See id. at 1087 (Zarin playing 12-16 hours per day, 7 days per week as of January, 1980).

[92] Like some of the dissenters in the tax court, Shaviro would have no problem taxing Zarin on the value of the free services he received. Shaviro, supra note 86, at 235-36. This is good policy and probably legally correct but the government made no such contention in this case so the point was moot.

[93] See supra note 76 and accompanying text.

all of his past casino losses as well as to have any outstanding debts declared null and void.[94] If Shaviro is right that this was an overall negative experience, he could also recover for psychic damages as well.[95] Faced with this prospect, it is clear why Resorts settled Zarin's **total** debt of $6 million[96] for 50 cents on the dollar. This also points a way to the resolution of this case.

While Zarin had only raised "affirmative defenses" to the payment of the debts at the time he settled, it must have been clear to all involved he could have sued Resorts to disgorge any money he had paid them on the same theories.[97] Therefore, the "benefit" he got from being let off the hook on the $3 million in debt represented, either a "return" of money he should never

[94] Given the gross number of violations in his case this result seems feasible. In other cases, only some portion of the losses would be attributable to illegal practices in the casino.

[95] See Shaviro, supra note 86, at 237-38 & n. 76. These damages would be tax free under I.R.C. § 61 since they would be compensation for loss and not income. This says nothing of punitive damages which might have been available given Resorts illegal and outrageous conduct. Punitive damages, however, are taxable but this is only fair given their windfall nature. Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955).

[96] That is the $ 2.5 million Zarin had paid but was at risk of being disgorged from Resorts as well as the $ 3.5 million he may have owed Resorts. See Zarin, 92 T.C. at 1087-88.

[97] Additionally, even if as a mere precaution, Resorts' lawyers must have had Zarin sign away any actions he may have had against Resorts when he settled his markers.

have lost[98] or compensation for injuries he received from Resort's illegal activity.[99] Actually the truth probably involves both of these analyses.[100]

The problem with this analysis is that it only gets Zarin off the hook. Other gamblers who were not illegally coerced[101]

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[98] Such money would be not be taxable under I.R.C. § 111(a) (West 1989) because that section excludes from taxation of money recovered only "to the extent such amount did not reduce the amount of tax [in a prior year]." Id. It would be taxable if he had been, say, scammed in a securities fraud case, taken a deduction for the capital loss and then recovered in a lawsuit. Dobson v. Commissioner, 320 U.S. 489 (1943).

[99] Under this analysis, the $3.5 million is owed as a matter of pure contract law: the debt is not forgiven. However, Resorts may be liable for an injury judgment in the amount of $3 million, or perhaps more, so it settles the tort case for $3 million and applies the payment to the outstanding debt of $3.5 million. Zarin pays the remaining $500,000. The transaction is tax-free because Zarin has applied money from a tax-free tort suit settlement to his gambling debts paying them in full.

[100] This entire analysis could be applied to the paying of $3.5 million debt with $ 500,000 because Resorts' conduct with respect to Zarin was so outrageous it was a virtual certainty that the debt was totally unenforceable. See Resorts International Hotel, Inc. v. Salamone, 178 N.J. Super. 598, 429 A.2d 1078 (App. Div. 1981).

[101] As a practical matter, all gambling debtors can claim some kind of coercion when answering the casinos' complaints for payments of markers. Since most markers do not involve violations of the credit granting rules, the usual claim is the casino illegally plied the debtor with liquor while he was gambling. See **N.J. Stat. Ann.** § 5:12-103 (making it a violation of law to serve a "visibly intoxicated" person); GNOC Corp. v. Aboud, 715 F. Supp. 644, 654 (D.N.J. 1989) (Cohen, Senior Judge) (If plaintiff can prove he was served alcohol in violation of statute, debt is void). See generally Hallam, Rolling the Dice: Should Intoxicated Gamblers Recover Their Losses?, 85 **Nw. U.L.**

into losing money would have discharge of indebtedness income. Perhaps this is the right result so long as they could have paid the debt.

The point of the case is that, at a minimum, lawyers must be very careful when negotiating payments with casinos to be sure that some legal theory is properly raised that would support the client's paying no tax on the reduction of indebtedness. Usually a claim can easily be made in good faith that the client's actions were not totally voluntary and that the casino in some way illegally enticed his activity.

IV. ANALYSIS

These provisions[102] are needlessly hostile to gambling income. This note will now analyze the various provisions in the previous section with an eye towards reforming them. It will conclude that the distinction between business and non-business gamblers should be largely eliminated. Additionally, it will recommend an addition to the I.R.C. that will solve many of the problems caused by § 165(d) without eviscerating the policy behind that section.

Rev. 240 (1990) (criticizing Aboud and suggesting that, in most circumstances, even intoxicated gamblers should have to pay debts).

[102] See infra Part III.

A. The Alternative Minimum Tax

This issue was resolved by the 1982 amendments to the Code. Gambling income was specifically excluded from being considered an item of tax preference.[103] For those who might still be litigating cases which originated prior to 1982, the Supreme Court's opinion in Groetzinger resolves the issue of whether gambling income is an item of tax preference against the Service.

The fact that this issue ever came up, however, especially when Congress had spoken on the issue in 1982 before Groetzinger was even heard in the Tax Court, shows the IRS' extreme hostility towards gamblers. The "new issue" of charging gamblers with discharge of indebtedness income has a pedigree identical to the AMT issue. Both provisions are basically aimed at tax shelter investors who have excessive paper losses in relation to their income. Because gamblers have large losses in relation to their actual income,[104] they are perennially falling into the mechanisms Congress has set up to penalize tax shelters.

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103 I.R.C. §§ 55(b), 55(e)(1)(A), 165(d) (1982 ed. and Supp. III)

104 A typical example of this would be that the gambler has a 5% advantage at the game she plays. If she bets $1,000,000, she can expect to have income of about $50,000. Her income tax return, however, would have gross income (whether on Schedule C or line 22 of Form 1040) of, say, $525,000 and losses (whether on Schedule C or itemized on Schedule A) of $475,000. This looks like a tax shelter scheme but is really more closely related to a low margin business with a high inventory turnover.

B. Section 165(d)

The original purpose of § 165(d) was to bring gambling winnings that were going unreported out of the woodwork.[105] The message that § 165(d) actually sends to taxpayers is not to bother saving gambling records. If they show losses, they will

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[105] Section 165(d) was first enacted in 1934, as section 23(g) of the Revenue Act of 1934. Section 165(d) reads verbatim as section 23(g) did in 1934. The only recorded Congressional discussion of section 23(g) took place at a Senate Finance Committee hearing. The discussion, provided below, was led principally by Dr. Roswell Magill, who was Assistant to the Secretary of the Treasury:

DR. MAGILL: The next paragraph (g), is a new provision which is self explanatory, that losses from wagering transactions are to be allowed only to the extent of gains from such transactions.

SENATOR REED: Doctor, on its face, it looks entirely reasonable; but is there not a danger of a lot of litigation, growing out of a claim by the Government that various transactions in securities are wagering transactions, in fact?

SENATOR GORE: In securities you say?

SENATOR REED: Yes. A man buys stock on margin. He is really betting that that stock is going to go up.

DR. MAGILL: I would doubt it. I haven't thought of it in that light. I doubt it, because of the fact that, as you know, there has been a good deal of litigation in the past, in which gambling transactions and what are not such transactions are pretty well defined under various State laws.

SENATOR GEORGE: Your commodity exchanges have been held not to be gaming under the Federal laws?

SENATOR REED: I think you are probably right.

most likely be useless, or, in the event the losses can be utilized, they will be very heavily scrutinized. If the records show gains, they can only count against the taxpayer.[106]

Under this scenario, the only time the gambler is likely to report any gambling activity is when she has winnings she must

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. . .

DR. MAGILL: Well, that means, to take Senator Barkley's illustration, if a man bets on horse races during the year, and loses $10,000 and he has made no successful bets during the year, he can no longer deduct the $10,000 from his salary.

SENATOR HASTINGS: Can he do that under the old law? Could he deduct the $10,000?

DR. MAGILL: No; I should say not, generally speaking. The line which the Treasury draws, is, I believe, whether or not the particular gambling transaction was legal in the State in which it occurred; and they have gone into a good deal of dissertation as to whether it is legal gambling.

MR. PARKER: He could deduct it, if it was conducted in Maryland under the State law, and that is what the provision is aiming at.

SENATOR REED: Also, haven't they discussed the question of whether that is the taxpayer's regular business?

DR. MAGILL: You wouldn't need to in this connection, because he could get the deduction as a loss, if the transaction was entered into for profit, in the event that the transaction was legal.

SENATOR LA FOLLETTE: Isn't this really aimed at the States where they have legalized betting or horse races and dog races, and things of that kind?

report because W-2Gs were filed on her behalf by the gaming establishment. Otherwise, the taxpayer is walking into the lion's den by reporting gambling income.

Since § 165(d) has most likely failed miserably at causing gambling income to be reported, it is comforting to know it has

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MR. PARKER: Yes. We don't need this rule at all in respect to illegal gambling, because that is the way the courts have already interpreted it. This was put in to cover the cases where you have legal gambling, like in Maryland. The claim is that persons go over there, and bring in a lot of tickets to prove the losses and forget about the gains. Thus they get the losses but don't report the gains.

THE CHAIRMAN: Without objection, that will be adopted.

An Act to Provide Revenue, Equal Taxation, and for Other Purposes, Part 1: Hearings on H.R. 7835 Before the Comm. on Finance, United States Senate, 73d Cong., 2d Sess. 32-33 (Mar. 6, 1934) [emphasis added].

[106] The government can accept the taxpayer's records as to winnings but ignore losses if the records are inadequate and she is unable to prove that the IRS' determination is in error. See, e.g., Plisco v. United States, 306 F.2d 784 (D.C. Cir. 1962), cert. denied, 371 U.S. 948 (1963) (court held this approach reasonable because taxpayer had no incentive to overstate wins but did have such a motive with respect to losses); but cf. Reyer v. Commissioner, 21 T.C.M. 1276 (1962) (opposite result where evidence points to credibility).

The same result can be reached under Federal Evidence Rule 801(d)(2) using the winning records as declarations against interest. Green v. Commissioner, 66 T.C. 538 (1976) acq. 1980-2 C.B. 1; Manzo v. Commissioner, 31 T.C.M. 714 (1972).

A taxpayer must present some evidence other than her own testimony to convince the court of the claimed losses. See, e.g. Schooler v. Commissioner, 68 T.C. 867 (1977). Such evidence can be in the form of canceled checks or losing tickets. Myers v. Commissioner, 35 T.C.M. 823 (1976); Rogers v. Commissioner, 33 T.C.M. 14 (1974); Gauthier v. Commissioner, 35 T.C.M. 746

fulfilled its main purpose -- to prevent the fraudulent deduction of losses against ordinary income.[107] While the original reason for this apparently was simply that Congress had a "gut" reaction against such deductions, there are well-founded policy reasons for not allowing deductions for net gambling losses.

The first reason, already discussed, is to eliminate fraud. The second and more subtle reason is that gambling losses, at least in part, represent consumption.[108] Under this view, all § 165(d) amounts to is an irrebuttable presumption that gambling losses are items of personal consumption.[109] This is exactly what the tax court was arguing in the Zarin case. Obviously, this analysis works well for garden variety losses that occur while on vacation or during a night at the track. The analysis

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(1976). A convincing and candid witness, however, can greatly influence the court. Drews v. Commissioner, 25 T.C. 1354 (1956), acq., 1956-2 C.B. 5; Gallagher v. Commissioner, 27 T.C.M. 124 (1968); Myers v. Commissioner, 35 T.C.M. 823 (1976).

[107] "Fraudulent" where a gambler has winnings to match losses but "forgets" about them. See supra note 105. Of course, it also prevents the deduction of legitimate losses but this apparently has become the main policy behind § 165(d).

[108] Congress did not articulate this reason when it created § 165(d). One can well imagine that the "gut" reaction against such a deduction is founded at least partially in the notion that gambling losses represent personal expenses.

[109] It is not really irrebuttable. Under the Groetzinger test, one must show sufficient facts and circumstances to prove the losses were not items of personal consumption. Groetzinger, 480 U.S. at 36.

seriously breaks down, however, where the gambler is engaged in a legitimate attempt to earn money or is addicted to gambling. In the former case, the professional gambler is ideally totally detached from his work although he may derive some pleasure from it.[110] Thus, in the event of a losing year, it cannot be said that the activity was a personal expenditure. In the latter case, the gambler has a perverse relationship to the game where he gets a negative utility from the loses which reinforce his lack of self-worth. Since this reinforcement of self-worth is unhealthy from the standpoint of the non-addicted, it can hardly be said to be a personal consumption expenditure any more than other non-voluntary expenditures such as those for medical bills or for replacing stolen property.[111]

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[110] This is a difficult analysis. Obviously, just because someone enjoys their job does not make them a candidate for extra taxation vis-a-vis someone who is more neutral toward their occupation (although a case could be made that this is a significant reason for progressive taxation on the theory that those who enjoy their jobs will earn more money than those who do not). As an example, the fictional character "Fast" Eddie Felson (played by Paul Newman) in the movie The Color of Money states, "money won is twice as sweet as money earned." Yet there is no sound reason to impose double taxation on those who agree with Felson's analysis.

[111] Both of these items involve "floors" which must be exceeded before the excess over the floor can be deducted, this is a possible solution to the gambling loss issue. This notion is rejected because gambling is, in the final analysis, a voluntary activity. See, e.g., Credit Controls, supra note 76, at 194 (Zarin conceded that a "major responsibility for regulating gambling behavior must rest with the gambler himself....").

1. Proposal for amending Section 165(d)

To partially ameliorate the problems with § 165(d), this note recommends abandoning the trade or business test with respect to that section in favor of an empirical test based on the individual's actual gambling income over time.

Under this approach, all gamblers would be treated as though they are in business.[112] Any gambler could fill out a Schedule C[113] to report gambling win or loss. Net winnings would be includable in gross income. Losses could be suspended in the same fashion that § 469 losses are suspended until there is corresponding gain.[114]

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[112] There is considerable support for this position. Everyone, even the compulsive gambler, would like to make a "big score" and that is a substantial reason for the gambling activity. The compulsive gambler, however, due to a defect in his personality will more than likely lose the money back over time.

[113] A new Schedule G could be created for this purpose that is more specifically aimed at reporting gambling wins and losses than Schedule C. Given the boom in gambling that is predicted to occur well into the next century (See generally Rose, supra note 3, at 1-21.), this new schedule could become one of the more frequently filed federal tax forms, perhaps exceeded only by Form 1040 and Schedules A & B.

[114] Two alternate versions of § 165(d) are suggested:

(d) Wagering Losses. -- Gambling activity shall constitute a separate activity, treated as a business, the losses from which shall not be used to offset any other income.

(d) Wagering Losses. -- Gambling activity shall constitute

2. The Proposed time period to match gains and losses

Since the gambler is presumed to be in business, there is no reason why § 172[115] should not apply to him, the same as any

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a separate passive activity, to be considered only by itself, under section 469.

The former proposal relies on I.R.C. § 172 (§ 172 proposal) to determine the scope of the period during which gains and losses can be netted. See infra note 115 for the text of § 172. The latter section relies on I.R.C. § 469 (§ 469 proposal) for its scope so it would allow indefinite accumulation of losses but would not allow loss carrybacks. I.R.C. § 469(b) (West 1989). See also infra note 121 for an additional rule that would likely be needed to implement either proposal.

[115] I.R.C. § 172 (West 1989). Section 172 provides in relevant part:

(a) Deduction allowed. -- There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year. plus (2) the net operating loss carrybacks to such year. . . .

(b) Net operating loss carrybacks and carryovers. --

(1) Years to which loss may be carried. --

(A) Except as provided in subparagraphs (D), (E), (F), (G), (H), (I), (J), and (K), a net operating loss for any taxable year shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C), (D), and (E), a net operating loss for any taxable year ending after December 31, 1955, shall be a

other business person.[116] Therefore, gamblers would be allowed a three-year carryback and a fifteen-year carryforward of losses. The carryback presents no administrative issue because the loss would be audited in due course just as the previous wins were subject to audit as they were reported. This procedure would, however, represent a revenue loss to the treasury.[117]

There is a potential administrative problem with loss carryforwards. At the current time the IRS is about 3 years behind in audits. Since the statute of limitations for notifying the taxpayer of a disputed item is 3 years,[118] as a

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> net operating loss carryover to each of the 5 taxable years following the taxable year of such loss. Except as provided in subparagraphs (C), (D), (E), (F), (G), (H), and (J), a net operating loss for any taxable year ending after December 31, 1975, shall be a net operating loss carryover to each of the 15 taxable years following the taxable year of such loss.

Id. [emphasis added].

[116] The § 469 proposal is an alternative to the § 172 proposal in case of vigorous objection to the trade or business treatment afforded under the § 172 proposal. The § 469 proposal, however, is thought to be less manageable than the § 172 proposal because § 469 losses are suspended indefinitely and can be used anytime the passive activity has a gain. I.R.C. § 469(b). This objection could be overcome with a hybrid proposal that imposes some time limitation on the use of suspended gambling losses.

[117] Anytime the "measuring period" is increased for gambling activity, the grater the likelihood that the gambler will present a net loss for the period and, thus, not be liable for any tax.

[118] I.R.C. § 6501(a) (West 1989). There is no limitation if

practical matter the IRS could probably only reach back one year if a string of losses were followed by a win which was diluted or eliminated by past years' carryforwards. As a result, the IRS might be put in the position of auditing losses in case the gambler ever declares a win in the future.[119] This would be too wasteful of valuable IRS resources and would undermine this proposal.[120] To cure this defect, the IRS could be given authority to audit any losses used to offset a win as long as the win was still subject to audit.[121]

Under this proposal, those who thought it was worth the trouble could file a Schedule C documenting their losses for possible future use. Those who filed no such notice of losses would simply have § 165(d) operate with respect to their gambling activity in the same manner as it does currently. In the unlikely event a significant win, the gambler could have the

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fraud can be proven. Id. at 6501(c)(1)-(3).

[119] This procedure is followed for § 469 losses and § 172 Net Operating Losses (NOLs). There is, however, a virtual 100% certainty that § 469 losses and NOLs will be used sooner or later.

[120] The object of this proposal is, within the reasonable limitations imposed by § 172 (or § 469), to tax a gambler on his actual results. The beauty of the plan is that most losses would either go unused or unreported.

[121] To implement this policy both of the proposals, supra note 114, would have this second sentence added to them: "When such activity has a gain for a given year, any loss from a previous year used to diminish such gain shall be treated as though it were incurred in the year of the gain for purposes of section 6501."

benefit of past losses, so long as they can be substantiated. At the same time, because there is no audit when the losses are filed, the proposal does not burden the IRS. Information returns are filed that will likely never be used.[122]

On the winning side of the ledger, those with net wins obviously have reporting obligations under § 61. The fact that they, perhaps, have past losses to lighten or eliminate the tax bite out of the win will encourage them to declare the win rather than risk prosecution. Administratively, the win could be audited in due course. Any past losses used to offset the win could be audited at that time as previously explained. Once again, since this procedure can only help the gambler who honestly reports his wins and losses, it could result in loss of revenue to the Treasury Department but this result is not certain.[123]

The only major policy problem with this proposal is a gambler with a large win would have up to three years to squander his win and get back the tax he paid to the government. Under current law, the gambler has this privilege for only a maximum of one year.

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[122] If the loss were being used to offset a win under the carryback provisions, the taxpayer should have to notify the IRS of this fact because it might not be obvious the return was being used to generate a deduction.

[123] This policy could easily result in a higher reporting of gambling winnings which will offset the losses from a static model of taxpayer compliance.

While the image of the government making tax refunds to a gambler who squanders his good fortune is painful to all, it does not represent a great departure from the present system. Assuming all large wins are withheld at the 20% rate, the gambler is totally entitled to a refund of his 20% if he can substantiate losses greater than or equal to his reported win for a given year. Furthermore, this policy of expanding the time period for evaluating gambler's total gambling income is intended to be beneficial both to the IRS (from less litigation and more reporting of income) and to the taxpayer. This purpose is thwarted if the gambler intentionally sets about to lose back his winnings to deny the government tax revenues.[124] A more likely scenario is that the gambler would have lost the money back anyway, probably because he was a compulsive gambler and the refund could possibly help to get him back on his feet if he seeks treatment.

C. Retirement Issues

[124] This scenario is extremely unlikely. Given a maximum tax rate of 31% and general casino policy of providing free services to the customer for about 20% of her expected loss (<u>See</u> Uston, <u>supra</u> note 91, at 279.), the gambler can only expect to get about 50 cents of value (31 cent refund and 20 cents of free services) out of every dollar she loses back. While this is a better "deal" than the person with no such previous win (who at most receives 20 cents of value from every dollar lost), the difference is probably not enough to alter a person's behavior.

The present regime where the gambler is at the mercy of the Service should be changed. The proposals above will largely help to alleviate some of the issue in this area.[125] The trade or business test, however, will have to remain in place with respect to the self-employment tax and retirement plans. Clearly, some test must exist to prevent the "weekend gambler" from paying self-employment tax on his occasional big win. On the other hand, professional gamblers should pay their fair share to support the social security system.[126] Some ad hoc test is needed to separate these two groups even though borderline cases will be very difficult.[127] There should be a rule, however, that if the gambler pays the self-employment tax, the IRS cannot question that he was employed as a gambler in that year.[128]

[125] By taking a longer term perspective on gambling winnings, it will become clear which players are the professional players.

[126] Some of the self-employment tax also goes to support the Medicare system. This portion is ignored here but the same arguments apply.

[127] Hopefully, many of the "borderline" cases will involve people who have income from an occupation other than gambling. Since there is a cap on the maximum amount each individual must pay in FICA tax, many in this category will be near the cap so the amount of tax they have to pay because of their gambling winnings will be small. In some cases, they will have exceeded the cap with non-gambling income so the question will be moot.

[128] This would allow the sheltering of some gambling income via retirement plans by people who have no legitimate claim to being in the business of gambling. However, if the goal of the retirement fund system is to encourage the individual to save some portion of her lifetime income for retirement, there is no real reason to exclude gambling income from this formula.

D. Discharge of Indebtedness Income

This is a legitimate issue in some circumstances. For example, if the gambler had a preconceived plan to defraud the casino by not paying his markers there is no reason not to use the § 108 theory against him. In any case where § 108 is applied the results should be grossed up so that the cash and credit losing[129] gambler are put on equal footing.[130]

E. Possible Future Issues

It is not impossible for new issues to arise under § 165(d). Most of the issues that arise involve the interaction of new Code sections or changes in what might be called "gambling procedure"[131] with § 165(d). For example, the AMT became effective in 1978 and Groetzinger immediately ran afoul of its provisions. Likewise, markers became collectible in New Jersey in 1978 and by 1981 Zarin ran afoul of the combined effect of § 61(a)(12) and § 165(d). Roughly, these issues

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[129] The gross-up only becomes an issue if the gambler lost. Otherwise, the current § 108 procedure puts winning or break even gamblers on equal footing. <u>See supra</u> note 89.

[130] Recall the losing credit gambler in the <u>Zarin</u> example was $1.5 million better off than his cash playing counterpart. <u>See supra</u> note 89 and accompanying text.

[131] "Gambling procedure" means the customs and practices in the gambling industry as well as the actual games that are available.

revolve around tax shelter provisions. In the future, mainly because tax shelters are a dead letter, gamblers will run afoul of the various provisions of the Code aimed at drug dealers.

1. Possible Future "Tax Shelter" Issues

It would seem that gamblers have a habit of running afoul of the provisions of the tax code aimed at tax shelters. This has happened in the AMT cases, and to a lesser extent in Zarin.[132] The only tax shelter section that has not been applied to gamblers would be section § 469, limiting the use of passive losses. While some gambling activities may resemble passive activities,[133] § 165(d) is far harsher than § 469 in prohibiting the use of losses against other income[134] so the Service would

[132] It is unclear whether Zarin was an isolated case (he may have been selected for special treatment because he was in the tax shelter business) or whether the IRS was seeking to establish precedence that settling gambling debts created income under § 61(a)(12). In the later case, the Third Circuit probably put an end to any hopes of applying the theory to anyone in the future.

[133] Buying a lottery ticket, for example, is probably passive in that it is similar to the effort involved in purchasing an interest in a real estate limited partnership. Gambling in the casino, on the other hand, probably would require "material participation." See I.R.C. § 469(c)(1)(B) & (h). Betting on the races might fall in a gray area which could perhaps be resolved by whether the taxpayer actively seeks out information about the races or just "takes his chances."

[134] Recall § 469 allows the losses to accumulate and be used in future years, § 165(d) has no such accumulation feature. See supra notes 55 & 114.

never use this theory against ordinary gamblers. There is a possibility that § 469 could be used against a professional gambler attempting to make a loss carryback after an unprofitable year. Since such carrybacks are not allowed under § 469,[135] the IRS might be successful in blocking the carryback if they could convince a court the gambler's activity was passive.[136]

2. Possible Future "Drug Dealer" Issues

Gamblers who deal in large sums of money risk violating the currency reporting requirements either when they travel both into and out of the United States[137] or when they collect a win in the United States.[138] These provisions, and the heavy penalties associated with them,[139] are aimed at catching and punishing

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135 Only accumulations for use in the future are allowed. See I.R.C. § 469(b) (West 1989).

136 If the gambler has paid social security tax on past winnings this argument should be unavailable to the IRS. See supra note 128 and accompanying text.

137 See 31 U.S.C.A. § 5316 (West 1983 & Supp. 1990) (entitled "Reports on exporting and importing monetary instruments").

138 See id at § 5313 (West 1983) (entitled "Reports on domestic coins and currency transactions").

139 See id. at §§ 5321-22 (West Supp 1990). The civil penalties require forfeiture of undisclosed monetary instruments in most cases. Id. at § 5321. In 1984, the maximum criminal penalty was raised from a $1000 fine and 1 year in prison to a $250,000 fine and 5 years in prison. Id. at § 5322.

participants in the drug trade, not an ignorant[140] gambler leaving for or returning from the Bahamas.

While not wholly a tax issue, these currency reporting requirements probably represent a growth area in the harassment of those with gambling income. Perhaps gamblers should be allowed to register to become exempt or only have to file monthly reports on their transactions.[141]

V. CONCLUSION

This note has examined various sections of the Internal Revenue Code that are hostile to gambling income. In many cases, this hostility is out of date. While the courts have been exceptionally prescient at treating gamblers in a more liberal fashion than a strict reading of the Code would allow, it is time for a change of some of the underlying Code sections themselves. It is hoped that the changes proposed in this note will avoid needless litigation while actually increasing the amount of gambling income reported.

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140 Most people are unaware of these provisions and the Customs Service does not post sufficient notices of the requirements, particularly when leaving the country.

141 It is assumed that drug dealers would not want to identify themselves as holders of large amounts of cash whereas legal gamblers, at least those who pay their taxes, have no such corresponding fear of exposing themselves to prosecution.