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Professional Gamblers Hit It Big in the Tax Court…Sort Of

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A brand new, full decision of the U.S. Tax Court recognizes that losses incurred by gamblers can lead to a net operating loss.[1] In so finding, the Court rejected a portion of its 1951 opinion concerning a gambler's ability to deduct associated business expenses where the court held that such expenses were to be treated the same as gambling losses – deductible only to the extent of gambling winnings. The decision was to be anticipated – the IRS had already revealed it's litigating position on the issue in late 2008.

Overview

The Internal Revenue Code does not define what a "gain" or "loss" is, and the courts haven't provided a great detail of clarity on the matter either. According to I.R.C. §165, "losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." So, if what a gambler receives from a wager is less than what was wagered, the "wagering loss" is the difference. Further complicating the matter is that wagering losses are not the same as "business expenses" under I.R.C. §162(a) or a net operating loss (NOL) from a business under I.R.C. §172. In addition, NOLs have another benefit to a taxpayer – they can be carried forward or back to offset gains in those years.

The historic rule has been that gambling losses only offset gains from gambling[2] and only in the same tax year. That has been the rule at least since the Tax Court decided a case in 1951.[3] But that rule only applies to gambling losses. It doesn't necessarily limit the deduction for business expenses of professional gamblers that is available under I.R.C. §162(a).[4]

Mayo v. Comr.[5]

Facts of the case. The taxpayers were engaged in the trade or business of gambling on horse races during 2001 – the tax year at issue. Their Schedule C reported gross receipts of $120,463 and expenses of $142,728. The expenses consisted of $131,760 for wagers placed and $10,968 in business expenses. They deducted the excess of their Schedule C expenses over their gross receipts - $22,265. IRS disagreed, disallowing the entire $22,265. According to the IRS, the deduction was limited to the taxpayers' gambling winnings in accordance with I.R.C. §165(d). IRS also claimed that the statutory phrase "losses from wagering transactions" included both the cost of wagers the taxpayers placed and the expenses incurred in their business of gambling.

Tax Court's rationale. In its 1951 decision in *Offutt*,[6] the court held that business

expenses were to be treated the same as gambling losses – deductible to the extent of the taxpayer's gambling winnings. But, there are really two tax aspects to gambling losses incurred by a professional gambler – losses from wagering transactions and business expenses incurred in the conduct of the taxpayer's trade or business. The Court held that its *Offutt* decision was still good law with respect to wagering losses. Deductible losses remain limited to gambling gains. That's the case for amateur as well as professional gamblers. However, the Tax Court rejected its 1951 opinion as applied to professional gamblers deducting trade or business expenses. The real question was whether such expenses were deductible under I.R.C. §165(d) (where they would be limited to gambling gains) or I.R.C. §162(a)(where they are not limited to gambling gains).

On the trade or business expenses deduction issue, the Tax Court examined the statutory phrase "gains from wagering transactions." On that point, the Tax Court noted that courts have generally held that "gains" from "wagering transactions" means what it says - actual wagers entered into by the taxpayer. So, *not included* in the definition are gains that arise in the conduct of wagering activities that aren't a direct result of a wager.[7] Indeed, IRS conceded this point in late 2008 in a Chief Counsel Memo.[8] so don't expect IRS to appeal.[9] Remember, they still won on the point that deductible gambling losses are limited to gambling winnings.

Conclusion

Mayo is an important case, particularly because it's a full decision of the Tax Court. It also is important because it allows professional gamblers to utilize NOLs arising from their gambling business. The rules governing NOLs have been made even more favorable in recent years. This is exactly what we've been pointing out to practitioners at seminars since late 2008.

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[1] Mayo v. Comr., 136 T.C. No. 4 (2011).
[2] See Tschetschot v. Comr., T.C. Memo. 2007-38. This is the rule regardless of whether the taxpayer is a professional gambler or not.
[3] Offutt v. Comr., 16 T.C. 1214 (1951).
[4] *See, e.g.*, IRS Chief Counsel Memo. AM2008-013 (Dec. 10, 2008).
[5] 136 T.C. No. 4 (2011).
[6] 16 T.C. 1214 (1951).
[7] For example, on this point, the court noted that it had held in Williams V. Comr., T. C. Memo. 1980-494, that a blackjack player's toke bets were not "gambling winnings."
[8] AM2008-013 (Dec. 10, 2008). The memorandum is of no precedential value, but has at least provided insight into the IRS's position on the issue for the past two years.
[9] Which raises the question why IRS took this position in the litigation.