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Memorandum

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subject: Professional Gambler's Wagering Losses and Business Expenses

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ISSUE

Whether expenses incurred by a professional gambler to engage in the business of gambling are subject to the limitation on deducting "losses from wagering transactions" in § 165(d) of the Internal Revenue Code.

CONCLUSION

The limitation in § 165(d) applies only to wagering losses, not to expenses incurred to engage in the business of gambling. Those business expenses are subject to the ordinary rules governing deductibility under § 162(a).

ANALYSIS

Statutory Provisions

Section 61 provides that gross income means all income from whatever source derived. Rev. Rul. 54-339, 1954-2 C.B. 89, holds that wagering gains are included in gross income.

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(c) limits an individual's deduction to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) certain casualty losses.

Section 165(d) provides that losses from wagering transactions are allowed as deductions only to the extent of the gains from such transactions.

Section 1.165-10 of the Income Tax Regulations provides that losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions.

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(a)(2) specifies that deductible business expenses include "traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or

extravagant under the circumstances) while away from home in the pursuit of a trade or business…"

Statutory Language

In applying § 165(d), it is necessary to interpret the words "gains" and "losses" from wagering transactions. These terms are not defined in the Code, regulations, legislative history, or published guidance. As discussed below, courts have differed in interpreting the terms.

The term "loss" is used in two different ways in the Internal Revenue Code. In § 165, as in other deduction provisions, a "loss" is the result of an event or transaction which caused the taxpayer to lose cash out-of-pocket or the taxpayer's investment or basis in property. However, the Code also uses the term "loss" more broadly to mean a "net loss," an excess of expenditures over receipts in a certain category, for example, a net operating loss as defined in § 172. The question for interpretation is essentially which usage is intended in § 165(d).

Section 165(d) provides that "losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." The statute refers to losses from "wagering *transactions*," not "wagering activity" or the business of wagering or gambling. That is, the statute uses the term loss in the narrow, transactional sense. That meaning comports with the ordinary understanding of the phrase "losses from wagering transactions" to mean the amount of the wager (basis) lost. If a wager returns less than the amount of the wager (basis), the wagering loss equals the wager (basis) minus the amount returned. The Code, regulations, and legislative history do not provide another,

technical definition. In the absence of a stated technical definition, statutory language is accorded its common meaning. *See* Capital Blue Cross and Subsidiaries v. Commissioner, 122 T.C. 224 (2004), *rev'd on other grounds*, 431 F.3d 117 (3d Cir. 2005).

It is important to distinguish § 165(d) wagering losses from (1) business expenses specifically deductible under § 162(a) and (2) business net operating losses that under § 172 may be carried over or back to offset gain in other years. In both the tax and accounting sense, a (wagering) loss is not an (business) expense.

Under § 165(d), a professional gambler may use wagering losses in a year to offset only wagering gains in that year and only up to the amount of the wagering gains in that year, and may not carry over wagering losses in excess of wagering gains to offset income (wagering or not) in another year. *See* Skeeles v. United States, 118 Ct. Cl. 362 (1951), *cert. denied*, 341 U.S. 948 (1951). *See also* Offutt v. Commissioner, 16 T.C. 1214 (1951). Therefore, we conclude that § 165(d) applies to only wagering losses and does not limit the deductions allowed by § 162(a) for a professional gambler's business expenses. [1]

Supporting Cases

[1] Of course, a casual gambler not engaged in the trade or business of gambling would not have deductible business expenses. The casual gambler's expenses to engage in gambling are nondeductible personal expenses under § 262. Like any other taxpayer, a gambler has the burden of proving that his activities rise to the level of a trade or business. *See* Merkin v. Commissioner, T.C. Memo. 2008-146.

Some courts distinguish between § 162 business expenses and § 165 wagering losses. *See* Whitten v. Commissioner, T.C. Memo. 1995-508, holding that transportation, meals, and lodging expenses incurred to engage in gambling are not amounts lost on bets or wagers, and thus are not wagering losses subject to § 165(d). *See also* Humphrey et al. v. Commissioner, 162 F.2d 853 (1947), *cert. denied*, 332 U.S. 817 (1948). The court explained that § 23(h), the predecessor of § 165(d), was a special allowance provision enacted to conform the treatment of legal and illegal gambling. The court held that: "Each lettered paragraph [§ 23(h)] authorizes a class of deductions. Wagering losses are made [by § 23(h)] a class to themselves and 'shall be allowed as deductions,' but 'only to the extent of gains from such transactions'…." 162 F.2d at 855. The court correctly described the statutory scheme before and after the enactment of § 23(h), now § 165(d). Wagering losses are not deductible business expenses: wagering losses are a separate class of expenditures deductible under a special allowance provision, § 165(d).

Admittedly, other courts have viewed business expenses as "losses from wagering transactions" subject to the § 165(d) limitation on deductibility. *See* the Offutt/Todisco line discussed below. We think that line of cases fundamentally misconstrued the relationship between § 165 losses and § 162 expenses. More importantly, the cases are inconsistent with the Supreme Court's view of the scope of those statutes.

In Commissioner v. Groetzinger, 480 U.S. 23 (1987), the Court held that a full-time gambler who makes wagers for his own account may be engaged in a "trade or business" under § 162(a). The Court considered the trade or business of gambling to

be like any other trade or business for which a taxpayer may deduct qualified business expenses under § 162. Groetzinger at 33. The Court did not define business expenses as wagering losses subject to the § 165(d) limitation on deductibility. The Court necessarily rejected the reading of § 165(d) as covering business expenses, because such a reading would presume all of a professional gambler's business expenses are limited by § 165(d) and would preclude the possibility of the § 162 business expense contemplated by the Court.

Prior to Groetzinger, the Service distinguished wagering losses subject to § 165(d) from § 162 expenses, and Groetzinger neither addressed nor disturbed the existing administrative position. Rev. Rul. 54-219, 1954-1 C.B. 51, holds that payments for the federal excise tax on wagers and the special tax paid by persons engaged in receiving wagers are deductible as ordinary and necessary business expenses. The wagering tax is imposed on the wagering activity or business of gambling without regard to the outcome of specific wagering transactions. In Commissioner v. Sullivan, 356 U.S. 27 (1958), citing the conclusion in Rev. Rul. 54-219 that a gambling enterprise is a business for federal tax purposes, the Court held that amounts incurred for rent and salaries in the conduct of a gambling enterprise were deductible as ordinary and necessary business expenses. The Court noted that "[t]he policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions [for business expenses] of the rent and wages necessary to operate it." Sullivan at 29. Neither Rev. Rul. 54-219 nor Sullivan applied § 165(d) [or its predecessors] to restrict the deductibility of ordinary and necessary expenses incurred

to engage in the business of gambling. Rather, each treated the business expenses as independently deductible under § 162(a).

Contrary Cases

In Offutt v. Commissioner, 16 T.C. 1214 (1951), the Tax Court upheld the Service's position that a bookmaker could not deduct wagering losses against non-gambling income. Unfortunately, without explanation, the court also characterized certain business expenses (mailing, printing and stenographic expenses) as wagering losses. Citing Offutt, several courts subsequently adopted that characterization and applied the § 165(d) limitation to the sum of a gambler's wagering losses and business expenses. *See* Estate of Todisco v. Commissioner, 757 F. 2d 1 (1st Cir. 1985), *affg*. T.C. Memo. 1983-247; Kozma v. Commissioner, T.C. Memo. 1986-177; Valenti v. Commissioner, T.C. Memo. 1994-483; Kochevar v. Commissioner, T.C. Memo. 1995-607; and Praytor v. Commissioner, T.C. Memo. 2000-282.

We recognize that the Service has not always been consistent in litigating § 165(d) cases. *Compare* Whitten with Kochevar. [2] However, for the reasons stated above, we conclude that the Service should not follow the Offutt/Todisco line of cases. Rather, the Service should apply § 165(d) consistently with the Supreme Court's decisions in Sullivan and Groetzinger, as well as Rev. Rul. 54-219. That is, § 165(d) applies to only wagering losses, not to expenses incurred to engage in the business of

[2] More recently, the Commissioner conceded that a professional gambler's expenses were deductible under § 162(a) and not subject to the § 165(d) limitation on deducting wagering losses. Tschetschot v. Commissioner, T.C. Memo. 2007-38.

wagering or gambling. Expenses incurred to engage in the trade or business of gambling are deductible to the extent allowed under § 162(a).

Examples

The following formula applies in the examples below.

Schedule C

Wagering gains
- Wagering losses, as limited by § 165(d)
Wagering income
- Business expenses
Business income or loss → ***Form 1040***

Business income or loss (Form 1040, line 12)
+ Additional income (Form 1040, lines 7-21)
Total Income (Form 1040, line 22)

Situation 1. A is a professional gambler engaged in the trade or business of playing poker. Gambling is A's sole occupation; A is not employed and has no other income. Throughout the year, A traveled to various casinos and other venues where gambling is legal to participate in poker tournaments. At the end of the year, A had total wagering gains of $100,000, total wagering losses of $75,000, and incurred $15,000 in business expenses for transportation, meals and lodging.

A must report the $100,000 of wagering gains as gross receipts. Under § 165(d), A may subtract $75,000 of wagering losses from the $100,000 of gross receipts, resulting in $25,000 of wagering income. Under § 162(a)(2), A may then deduct $15,000 in business expenses from the $25,000 of wagering income, resulting in $10,000 of business income.

Situation 2. Assume the same facts as Situation 1, except that B also had $10,000 of (taxable) investment income. B must report the $100,000 of wagering gains as gross receipts. Under § 165(d), B may subtract $75,000 of wagering losses from the $100,000 of gross receipts, resulting in $25,000 of wagering income. Under § 162(a)(2), B may then deduct $15,000 in business expenses from the $25,000 of wagering income, resulting in $10,000 of business income. B also must report the $10,000 of investment income as gross income under § 61. B therefore has $20,000 of total income ($10,000 business income + $10,000 investment income).

Situation 3. C is a professional gambler engaged in the trade or business of playing poker. Gambling is C's sole occupation; C is not employed and has no other income. Throughout the year, C traveled to various casinos and other venues where gambling is legal to participate in poker tournaments. At the end of the year, C had total wagering gains of $75,000, total wagering losses of $100,000, and incurred $15,000 in business expenses for transportation, meals and lodging.

C must report the $75,000 of wagering gains as gross receipts. Under § 165(d), C may deduct wagering losses to the extent of wagering gains. Therefore, C may subtract only $75,000 of his $100,000 of wagering losses from gross receipts, completely offsetting his $75,000 of gross receipts. C may not carry over the excess $25,000 of (unused) wagering losses to offset wagering gains or other (non-wagering) income in another taxable year. Under § 162(a)(2), C may then deduct the $15,000 business expense without regard to § 165(d), resulting in a net operating loss of $15,000. C may carry that $15,000 net operating loss over or back to another year under § 172(b).

Situation 4. Assume the same facts as Situation 3, except that D also had $10,000 of (taxable) investment income. D must report the $75,000 of wagering gains as gross receipts. Under § 165(d), D may deduct wagering losses to the extent of wagering gains. Therefore, D may subtract only $75,000 of his $100,000 of wagering losses from gross receipts, completely offsetting his $75,000 of gross receipts. D may not carry over the excess $25,000 of (unused) wagering losses to offset wagering gains or other (non-wagering) income in another taxable year. Under § 162(a)(2), D may then deduct the $15,000 business expense without regard to § 165(d), resulting in a business loss of $15,000 from gambling. D must also report the $10,000 of investment income as gross income under § 61, resulting is a net operating loss of $5,000 ($10,000 investment income - $15,000 business loss). D may carry this $5,000 net operating loss over or back to another year under § 172(b).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Justin G. Meeks at (202) 622-5020 if you have any further questions.