DEPARTMENT OF STATE REVENUE

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Letter of Findings: 08-0223
Individual Adjusted Gross Income Tax
For the Years 2003, 2004, 2005

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ISSUES

I. Adjusted Gross Income Tax – Professional Gambler Status (2003 and 2004).

Authority: IC § 6-8.1-5-1, IC § 6-2.5-3-2; IC § 6-3-1-3.5; 45 IAC 3.1-1-1; I.R.C. § 62; I.R.C. § 165; I.R.C. § 280A; I.R.C. § 3402; Rev. Proc. 77-29, 1997- 2 C.B. 538; Treas. Reg. 1.183-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Commissioner v. Groetzinger, 480 U.S. 23 (1987); Busch v. Commissioner of Revenue, 713 N.W.2d 337 (Minn. 2006); Golanty v. Commissioner, 72 T.C. 411 (1979); 2008 U.S. Master Tax Guide (CCH 2008); Curphey v. Commissioner, 73 T.C. 766 (1980).

Taxpayer protests an assessment of additional adjusted gross income tax on the ground that the additional taxes are based upon gambling earnings and that Taxpayer, as a professional gambler, should be permitted to offset the gambling losses against these earnings contrary to the Department's treatment.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an individual resident of Indiana filing Indiana individual income tax returns.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer for the years 2002, 2003, and 2004. The Department's audit found that Taxpayer had underpaid Indiana income tax for the years in question. The Department's audit disallowed all the gambling losses Taxpayer claimed on his Indiana return. Consequently, the Department assessed Taxpayer additional income tax, penalty, and interest. Taxpayer protested the assessment of additional income tax and the penalty arguing that, as a professional gambler, he is entitled to offset his gambling losses against his gambling earnings. A hearing was held on Taxpayer's protest and this Letter of Findings ensues. Additional facts will be presented as required.

I. Adjusted Gross Income Tax – Professional Gambler Status (2003 and 2004).

DISCUSSION

The Department's audit came to the conclusion that Taxpayer was not in the trade or business of gambling during 2003 and 2004. As a result, the Department's audit disallowed Taxpayer's gambling losses for 2003 and 2004, as well as a net operating loss which was carried forward to 2005. Also, for the year ending 12/31/2005, Taxpayer received a management fee of $400,000 from a company with which Taxpayer had an ongoing executive affiliation and which in 2005 appeared to have hired Taxpayer as an independent contractor. The Department's audit added the management fee to Taxpayer's 2005 income. Taxpayer protested the disallowance of the gambling expenses arguing that as a professional gambler he was entitled to take the losses as reported.

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

As a preliminary matter and subsequent to the hearing, Taxpayer raised the issue as to whether the 2003 proposed assessment was within the three-year statute of limitations. Taxpayer signed his 2003 IT-40 on January 10, 2005, and claims that he filed the return on the same day. However, the transmittal envelope relating to the original return shows that the return was mailed on February 1, 2005; therefore, the Department's January 28, 2008 proposed assessment was not barred by the three-year statute of limitations.

IC § 6-3-1-3.5 states as follows, "When used in IC 6-3, the term 'adjusted gross income' shall mean the following: (a) In the case of all individuals 'adjusted gross income' (as defined in Section 62 of the Internal Revenue Code)...." Thereafter, the statute specifies addbacks and deductions, peculiar to Indiana, which modify the Federal adjusted gross income amount. The Department's regulation concisely restates the formulary principal. 45 IAC 3.1-1-1 defines individual adjusted gross income as follows:

> For individuals, "Adjusted Gross Income" is "Adjusted Gross Income as defined in Internal Revenue Code § 62 modified as follows:
>
> (1) Begin with gross income as defined in section 61 of the Internal Revenue Code.
> (2) Subtract any deductions allowed by section 62 of the Internal Revenue Code.
> (3) Make all modifications required by IC 6-3-1-3.5(a).

Both the statute, IC § 6-3-1-3.5, and the accompanying regulation, 45 IAC 3.1-1-1, require that an Indiana taxpayer employ the Federal adjusted gross income calculation, as determined under I.R.C. § 62, as the starting

point for determining the taxpayer's Indiana adjusted gross income.

I.R.C. § 62 states that, "For purposes of this subtitle, the term 'adjusted gross income' means, in the case of an individual, gross income minus the following deductions...." The deductions specified under I.R.C. § 62 contain no provision permitting an individual to deduct gambling losses from his gross income. However, the federal law does permit the deduction of gambling losses to the extent of the taxpayer's gains from similar transactions. I.R.C. § 165(d). "Nonbusiness gambling losses are deductible only as deductions itemized on Schedule A of Form 1040." 2008 U.S. Master Tax Guide para. 788, p. 273 (CCH 2008). Thereafter, the total amount of itemized deductions from Schedule A is then subtracted from the amount of federal adjusted gross income yielding federal "taxable income." "If gambling is conducted as a business, the losses are deductible as business losses, but only to the extent of gains." Id.

The tax reporting of a professional gambler is different from that of a recreational gambler. A recreational gambler can report losses only to the extent of gains from gambling activity. The recreational gambler reports gains as part of adjusted gross income and may report losses only if deductions are itemized. The professional gambler is not required to report losses as an itemized deduction. Instead, losses and gains are reported on Schedule C. The net gain or loss is then reported on Form 1040 prior to arriving at adjusted gross income. This should cause the professional gambler's adjusted gross income to be lower than that of the recreational gambler. The professional gambler is able to deduct necessary and ordinary business expenses from gambling gains. It should be noted that the net income calculated on Schedule C is subject to self-employment tax.

Taxpayer argues that the United States Supreme Court in Commissioner v. Groetzinger, 480 U.S. 23 (1987) ruled that:

> [G]ambling activity will be treated as a trade or business for purposes of I.R.C. § 62 if the taxpayer is involved with such activity with (1) continuity and regularity, and ([2]) that the taxpayer's primary purpose for engaging in the activity mus[t] be for income or profit. Thus, the Supreme Court held that the test was whether the taxpayer intended to earn a profit from the activity rather than, as the auditor contends, whether the taxpayer actually earned a profit.

The determination as to whether a taxpayer is pursuing an activity as a business or as a hobby is fact intensive, documentation driven, and determined on a case-by-case basis. Revenue Procedure 77-29, 1997-2 C.B. 538 sets out the type of documentation required in order to distinguish between a professional or recreational gambler. First and foremost is the requirement that the taxpayer maintain a personal gambling diary that is supported by appropriate evidence of both winnings and losses. Records should include: the type of gambling activity, the date the activity took place, where the activity took place, who the taxpayer was with, and a statement of the amount won and/or lost. Additional documentation could include airline or other travel documentation to the gambling locations, hotel charges, cash credit card advances, bank withdrawals, casino statements, programs.

The only documentation Taxpayer has presented in support of his protest are casino statements from Indiana casinos and which do not reflect records of casinos in Las Vegas where Taxpayer also stated he gambled. These statements do not substitute for Taxpayer's own gambling records, especially a personal diary or log of his activities not just at the casinos, but any activities relating to his gambling pursuits. Had Taxpayer maintained his own records, the casino statements may then have served as corroboration of Taxpayer's own records.

Taxpayer argues that he must only have the intent to make a profit. The intent must be genuine if not reasonable. Busch v. Commissioner of Revenue, 713 N.W.2d 337 (Minn. 2006). Whether a taxpayer has an honest and objective intent is "redetermined on a year-to-year basis." Golanty v. Commissioner, 72 T.C. 411 (1979). Therefore, Taxpayer argues, the auditor's reliance on a 2002 article describing Taxpayer's activities is not relevant to 2003 and 2004. Taxpayer states that he gambled frequently and on a large scale on amounts he would borrow from his lines of credit with the casinos. Also, Taxpayer states he made a profit one of the years he gambled, and also made short term gains in each of the years he gambled. Actually, based on the casino statements provided by Taxpayer, in the two years Taxpayer is claiming he was a professional gambler, he gambled at most 10 days a month, and most months more like 4-6 days. When he gambled, Taxpayer rarely spent more than 3-4 hours doing so. Only one month stands out, April 2004, when Taxpayer gambled 16 days that month for an average of about 4-5 hours per day (on only one day that month did Taxpayer spend 12 hours at the blackjack tables).

Irrespective of whether the audit report's reference to Taxpayer's 2002 activities is relevant, Treas. Reg. § 1.183-2(b) offers guidance as to the sorts of questions one must ask in these fact-sensitive determinations in order to gauge a taxpayer's intent to gamble professionally. The tax regulations list nine factors to be taken into account in determining whether a taxpayer acted with the requisite profit objective. Treas. Reg. § 1.183-2(b). In most cases, the following will be relevant: (1) the manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his or her advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Id. These factors are not

exclusive, and no one factor or mathematical preponderance of factors is determinative. Id. The regulation factors should not merely be counted to determine the number of items "for" and "against" the taxpayer. All the facts and circumstances must be considered and more weight may be given to some of the factors. Not all the factors may be applicable in every case and no one factor is considered controlling.

As to the manner in which Taxpayer conducted business, Taxpayer asserts that he established lines of credit with various casinos and that he maintained a separate bank account entitled "[Taxpayer] Gaming Account" in order to keep those gambling transactions separate from his personal account. Taxpayer was asked to present that documentation at the hearing, but the documentation was not forthcoming.

As to Taxpayer's expertise, Taxpayer claims that he consulted with various study aids and experts in an attempt to improve his skill at blackjack, which he states was his single gambling activity for the years at issue. Other than Taxpayer's self-serving statement, however, Taxpayer offered no specific references, log, or other documentation of this claim.

As to the time and effort expended by Taxpayer in this pursuit, Taxpayer argues that he consistently and regularly gambled up to 15-16 hours per day. Based on the casino statements provided by Taxpayer, in the two years Taxpayer claimed he was a professional gambler, he gambled at most 10 days a month, and most months he gambled only 4-6 days. When he gambled, Taxpayer rarely spent more than 3-4 hours doing so. Only one month stands out, April 2004, when Taxpayer gambled 16 days that month for an average of about 4-5 hours per day (on only one day that month did Taxpayer spend 12 hours at the blackjack tables). If Taxpayer spent more time gambling, Taxpayer has not fully documented his activities. Taxpayer argues that "regularly" does not mean "all the time or exclusively" citing to Curphey v. Commissioner, 73 T.C. 766 (1980). Taxpayer's reference to this case is misguided. Murphey interprets I.R.C. § 280A that deals with the disallowance of certain expenses in connection with business use of a home, and determines when property is deemed to be used exclusively and regularly for business purposes. Furthermore, in Groetzinger, the taxpayer spent all day, six days a week gambling.

As to Taxpayer's history of income or losses with respect to the activity and the related question of the amount of occasional profits that were earned, Taxpayer states that he only incurred losses in one of the two years at issue. Taxpayer states he earned $44,200 in 2004 which is similar to what might be considered a normal salary for an average person. Taxpayer also points to the very large short-term gains at other times and suggests that those short-term winnings enabled Taxpayer to earn a livelihood. However, it is difficult to gauge Taxpayer's history with only a two year window into his gambling activities and without additional documentation requested by the audit, but which was not forthcoming (see below).

As to Taxpayer's financial status, Taxpayer claims his only income was from gambling as per his 2003 and 2004 returns. Given that Taxpayer had been reporting substantial Net Operating Losses previously and in 2005, and given that Taxpayer did not document the source of these Net Operating Losses per request of the audit, it is difficult to gauge Taxpayer's source of income overall as compared to previous years.

Therefore, given all the available facts, Taxpayer has not substantiated his claim that his gambling activities constituted a business pursuit.

Lastly, Taxpayer protests, in the event Taxpayer does not qualify for the status of a professional gambler during 2003 and 2004, that the audit's adjustments are nonetheless incorrect. Taxpayer argues that the amount to be included in his income are "gambling winnings" as defined in the Internal Revenue Code. I.R.C. § 3402(q) defines "gambling winnings" as "proceeds from a wager." I.R.C. § 3402(q)(4)(A) defines "proceeds from a wager" as "the amount received reduced by the amount of the wager." Therefore, Taxpayer argues, the $1.9 million increase in income proposed by the Department's audit to be included for 2003 are not "gambling winnings" but "gross proceeds" without deducting the amount of the wagers. The same goes for the $6.5 million increase for 2004. Taxpayer has presented a summary of his calculations of Gross Wagering Proceeds per I.R.C. § 3402(q)(4)(A) for 2003 and 2004.

I.R.C. § 3402(q) that Taxpayer references defines "gambling winnings" for withholding tax purposes. Irrespective of whether or not the Department agrees with Taxpayer's argument in this regard, Taxpayer has not presented any of his W-2G forms, "Certain Gambling Winnings Form," as requested both during the Department's audit and at the hearing on Taxpayer's protest. It is difficult to corroborate Taxpayer's numbers without more documentation – this is especially a concern with table games such as Blackjack, because it is generally not known to the house what the initial wager placed at the table was.

Absent additional documentation, Taxpayer did not meet his burden in support of his protest.

FINDING

Taxpayer's protest of the denial of his status as a professional gambler is respectfully denied, as is his protest of the amounts upon which Taxpayer's tax obligations were calculated.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or

diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has not affirmatively established, as required by 45 IAC 15-11-2(c), that his underpayment of Indiana income tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest of the negligence penalty is denied.

CONCLUSION

Taxpayer's protest of the denial of his status as a professional gambler is respectfully denied, as is his protest of the amounts upon which Taxpayer's tax obligations were calculated.

Taxpayer's protest of the negligence penalty is also denied.

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