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Gambler Finds Better Odds against the Internal Revenue Service

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GAMBLER FINDS BETTER ODDS AGAINST THE INTERNAL REVENUE SERVICE

	GROETZINGER	IRS
UNITED STATES TAX COURT	*Won*	*Lost*
UNITED STATES COURT OF APPEALS	*Won*	*Lost*
UNITED STATES SUPREME COURT	*Won*	*Lost*

In *Commissioner of Internal Revenue Service v. Groetzinger*[1] (*"Groetzinger"*), the United States Supreme Court held that a taxpayer pursuing his livelihood by gambling on a full-time basis is engaged in a trade or business and therefore is not subject to minimum tax.[2] After twenty years of service, Robert Groetzinger's employer, Gerstenslager Company, an Illinois manufacturer, terminated him from his sales and market research position in February 1978. For the remainder of the year, Groetzinger went to the track in Florida or Colorado on an average of six days each week, wagering mostly on greyhound races. He spent sixty to eighty hours each week studying racing forms, programs and other related materials for gambling. Based on Groetzinger's detailed daily records, his gross winnings were $70,000 and his losses were $72,032, for a net gambling loss of $2,032 in 1978.[3] Groetzinger gambled only for his own account. He never placed bets on behalf of another, sold betting tips or received commissions. He gambled to earn a living and had no other employment during this period.[4]

On his 1978 federal tax return, Groetzinger did not report any gambling winnings or deduct his net gambling losses.[5] He reported only his income from non-gambling sources in the amount of $6,498, which he received as interest, dividends, capital gains and wages prior to his termi-

1. __U.S.__, 107 S. Ct. 980 (1987). Justice Blackmun delivered the opinion in which Justices Brennan, Marshall, Powell, Stevens and O'Connor joined. Justice White, joined by Chief Justice Rehnquist and Justice Scalia, filed the dissenting opinion.

2. Section 56 of the Internal Revenue Code of 1954 explains the various circumstances under which additional tax may be due based on the applicability of minimum tax. The minimum tax was enacted to increase the tax burden of individuals receiving extensive tax benefits through the use of certain tax deductions. These deductions are identified as preference items. These preference items are generally added back to the taxpayer's income to determine the minimum tax. Gambling losses were considered a preference item for tax years prior to 1983, before the Tax Equity and Responsibility Act took effect. I.R.C. § 56 (1954).

3. *Groetzinger*, 107 S. Ct. at 982.

4. *Id.*

5. *Id.* Groetzinger reported gambling losses of $2,032 as his supplemental income, but did not use any of these losses to reduce his total income. *Id.*

nation. Based on the audit conducted by the Internal Revenue Service ("IRS"), the Commissioner of the Internal Revenue Service ("Commissioner") determined that Groetzinger's gambling losses did not completely offset his tax liability created by the winnings. Although section 165(d) of the Internal Revenue Code ("the Code")[6] allowed a deduction for gambling losses to the extent of gambling winnings, the gambling losses not connected to a trade or business gave rise to a minimum tax.[7] The Code provision in effect between 1976 and 1983 treated gambling winnings as a preference item,[8] since gambling losses were allowed to

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6. I.R.C. § 165(d) (1986). Section 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of gains from such transactions." Any gambling losses in excess of winnings are not deductible. *Id.* Generally, gambling losses are treated as miscellaneous itemized deductions. *Id.* § 63(h) (1986). Therefore, gambling losses may not completely offset an equal amount of gambling winnings unless the taxpayer is entitled to other itemized deductions in excess of the standard deduction. A taxpayer will generally use the standard deduction to offset the adjusted gross income unless an election is made to use the itemized deductions to reduce the adjusted gross income. There is no benefit to itemizing deductions unless they exceed the standard deduction.

If gambling losses were the only itemized deductions, the actual benefit from gambling losses to reduce the adjusted gross income would be the excess of gambling losses over the standard deduction provided that gambling losses do not exceed gambling winnings. For example, if a single taxpayer in 1987, with a standard deduction of $2,540, wins $70,000 and loses $70,000 from gambling activities, only $67,460 ($70,000 minus $2,540) of benefit is derived from the gambling losses to offset his gambling income provided that the taxpayer is not entitled to other itemized deductions. This result occurs because the standard deduction is lost when a taxpayer elects to itemize.

If the taxpayer does not have enough gambling losses or other itemized deductions in excess of the standard deduction, no benefit is derived from using the gambling losses to offset gambling winnings. For example, if a single taxpayer in 1987, with a standard deduction of $2,540, wins $70,000 but only loses $2,000 in gambling, the taxpayer does not benefit from the gambling losses since taking the standard deduction of $2,540 will be more advantageous than deducting $2,000 in gambling losses.

7. I.R.C. § 56(a) (1976). Even though gambling losses may eliminate the gambling gains, gambling losses are added back to calculate the minimum tax to the extent the losses are not connected to a trade or business. *Id. See supra* note 2.

8. I.R.C. § 57 (1976). Preference items are added back to the taxpayer's income to calculate the minimun tax. *Id. See supra* note 2. The notion of preference items developed as taxpayers were greatly reducing their taxes through the use of allowable deductions. These deductions, or portions of them, required to be added back to income to calculate minimum tax are called preference items.

The policy rationale for designating gambling losses as a preference item most likely resulted from the legislature's belief that it was inequitable for gambling losses to reduce taxpayers' tax liabilities. For some, gambling has a negative moral stigma which creates strong disincentives against promoting it through favorable tax treatment. Also, the legislators were probably reluctant to allow a full deduction for gambling expenses because they are usually a form of personal consumption. While investment losses are deductible in certain instances, personal expenses for leisure are not deductible.

Because gambling may take the form of either leisure or investment, the legislature made a concession and allowed gambling losses to be deductible but only to the extent of gambling

offset gambling winnings only if they were "attributable to a trade or business"[9] for the calculation of the minimum tax. Groetzinger took the position that his gambling activities constituted a trade or business and were therefore not subject to the minimum tax.

The Commissioner determined that Groetzinger was subject to a minimum tax of $2,142 along with other adjustments for a total tax deficiency of $2,522 for 1978.[10] The United States Tax Court held that Groetzinger was in the trade or business of gambling and therefore the gambling winnings were not a preference item for the computation of minimum tax.[11] After the Seventh Circuit affirmed the Tax Court's ruling,[12] the United States Supreme Court granted certiorari to resolve the current state of conflict among the courts of appeal, and affirmed.

The facts of the present case were undisputed. The sole issue for the Supreme Court was to ascertain the meaning of "trade or business" under the Code sections applicable to the minimum tax. The Court began its analysis by noting that the phrase "trade or business" is used in more than 50 sections and 800 subsections of the Code, but the Code contains no definition of these words.[13] In addition, no regulation has been issued for its general application.[14]

The Court reviewed numerous cases dealing with this issue and concluded that no completely satisfactory definition had yet been developed. Justice Blackmun, writing for the majority, began by looking to the early case of *Flint v. Stone Tracy Co.*,[15] in which the Court had discussed a very broad definition of the word "business" as "that which occupies time, attention and labor of men for the purpose of livelihood or profit."[16] The majority also gave some weight to the idea that Congress uses words and phrases in their popular meanings because statutes are more practical if words stand for their commonly understood meaning.[17]

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gains. However, since gambling can also be a leisure activity, the legislature designated gambling losses as a preference item to prevent excessive tax deductions.

9. I.R.C. §§ 57(a)(1), 57(b)(1)(a), 62(1) (1976).

10. Commissioner v. Groetzinger, 107 S. Ct. 980, 982 (1987).

11. Commissioner v. Groetzinger, 82 T.C. 793 (1984). The Tax Court followed its earlier decision in Ditunno v. Commissioner, 80 T.C. 362 (1983), and held that full-time gambling may be a trade or business. *Ditunno* overruled an earlier Tax Court decision in Gentile v. Commissioner, 65 T.C. 1 (1975), which denied the Internal Revenue Service the ability to assess self-employment taxes against a full-time gambler, holding that the gambler was not engaged in a trade or business. *Id.*

12. Commissioner v. Groetzinger, 771 F.2d 269 (7th Cir. 1985).

13. *Groetzinger,* 107 S. Ct. at 983 (1987).

14. *Id.*

15. 220 U.S. 107 (1911).

16. *Id.* at 171.

17. *Groetzinger,* 107 S. Ct. at 984 (1987).

The Court then distinguished an active securities trader engaged in a recognized trade from an investor trading only for his own account to determine whether a full-time gambler is involved in a trade or business.[18] In *Snyder v. Commissioner*,[19] which dealt with margin trading and capital gains, the Court held that an investor merely trading to increase his own holdings was not engaged in a trade or business unless a major portion of the taxpayer's time was devoted to transacting for the purpose of earning a living.[20]

The Court in *Groetzinger* also considered *Deputy v. Du Pont*,[21] a case dealing with the same issue, where the Court assumed that the taxpayer was engaged in a trade or business in determining whether carrying charges on short sales of stock were deductible business expenses.[22] Justice Frankfurter, in his concurring opinion, left the question of whether the taxpayer was engaged in a trade or business open for determination. He did, however, take the position that section 23(a) required the selling of goods or services to constitute a trade or business.[23]

The Court in *Groetzinger* also reviewed *Higgins v. Commissioner*,[24] (*"Higgins"*), where the Court unanimously held that salaries and other expenses incurred to manage one's own investments are not deductible as business expenses pursuant to section 23(a) of the Revenue Act of 1932.[25] The Court in *Higgins* disallowed deductions for such expenses because the taxpayer was not engaged in a trade or business, but was merely increasing the value of his personal investments. Within three months of the *Higgins* case, the Court in *City Bank Farmers Trust v. Helvering*[26] and in *United States v. Pyne*[27] held that estate and trust fees were also not deductible as business expenses based on the *Higgins* case.

The Court then discussed *Snow v. Commissioner*,[28] which addressed the definition of a trade or business in the context of partnerships, to determine whether the ruling in *Snow* applied to non-partnership activities such as gambling. In *Snow*, the Court allowed a taxpayer-partner to

18. *Id.*
19. 295 U.S. 134 (1935).
20. *Id.*
21. 308 U.S. 48 (1940).
22. *Id.*
23. *Id.* at 499 (Frankfurter, J., concurring).
24. 312 U.S. 212 (1941).
25. *Id.* Ordinary and necessary expenses are allowed as deductions only if they are incurred or paid in carrying on any trade or business. *Id.* I.R.C. § 23(a) (1932) (recodified as I.R.C. § 162(a) (1986)).
26. 313 U.S. 121 (1941).
27. 313 U.S. 127 (1941).
28. 416 U.S. 500 (1974).

deduct a pro rata share of the partnership loss pursuant to section 174(a)(1) of the 1954 Code.[29] The taxpayer had invested capital in the partnership for the development of an invention and was permitted to deduct appropriate expenses related to the activity. The Court stated that the business requirement under section 162[30] is more narrowly written than in section 174,[31] which explained why the taxpayer in *Snow* was entitled to business deductions without satisfying the selling of goods or services requirement mentioned in the *Du Pont* case by Justice Frankfurter.[32]

Although the Court in *Groetzinger* noted that there is little case law or statutory guidance for defining trade or business, the Court made the following observations regarding the term based on the cases discussed above: (1) The concept of trade or business is broad and comprehensive; (2) expenses incurred in maintaining the taxpayer's estate are not deductible as business expenses regardless of the full-time involvement of the taxpayer; (3) an opposite result may be reached for a full-time trader; (4) the requirement of a business to sell goods or services discussed by Justice Frankfurter in *Du Pont* was not adopted by the Court; and (5) the Court recognized that the definition of business is vague and used the term "adumbration" to describe it.[33]

The Court in *Groetzinger* formally rejected Justice Frankfurter's requirement of offering goods or services in order for an activity to constitute a trade or business.[34] Groetzinger's argument that he was selling goods or services not only to himself, but also to the gambling market convinced the Court that Justice Frankfurter's test was not stringent enough. The Court reasoned that a test that anyone can pass is useless.[35]

In order to resolve the issue without any authoritative guidance, the Court focused on a common sense concept of trade or business. It reasoned that taxing Groetzinger for his gambling losses was distinctly inconsistent with the Code. The more he lost, the more minimum tax he would have been required to pay. Based on this reasoning, the Court

29. *Id.*

30. I.R.C. § 162(a) (1986). Section 162(a) provides in relevant part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." *Id.*

31. I.R.C. § 174(a)(1) (1954). Section 174(a)(1) provides in relevant part: "A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenditures which are not chargeable to capital account." *Id.*

32. Snow v. Commissioner, 416 U.S. 500, 503 (1974).

33. Commissioner of Internal Revenue Service v. Groetzinger, 107 S. Ct. 980, 986 (1987).

34. *Id.* at 987.

35. *Id.*

held that Groetzinger was engaged in a trade or business, stating that gambling is to be considered a trade or business if such activities are pursued in good faith with regularity on a full-time basis for the purpose of earning a living.[36] The fact that Groetzinger was not successful in his activities was not controlling. The Court explicitly stated that it was not overruling the holding in *Higgins*,[37] since *Higgins* required an independent examination based on specific facts.[38] In *Groetzinger,* the Court adopted the test developed in *Higgins* and applied the test to determine whether gambling activities constituted a trade or business based on the specific facts of the case.

The dissenting Justices, however, argued that the Tax Equity and Fiscal Responsibility Act of 1982, by explicitly excluding gambling losses from the minimum tax base which is calculated from the adjusted gross income, made clear that gambling is not a trade or business.[39] The dissent reasoned that the exclusion of gambling losses from the minimum tax base will in effect allow a double deduction for business gambling losses, because business losses in general are deducted prior to calculating the adjusted gross income. Since gambling is recognized as a trade or business, gambling losses would be used to offset any winnings to deter-

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36. *Id.* at 988.

37. *Id.*

38. Higgins v. Commissioner, 312 U.S. 212, 215 (1941).

39. *Groetzinger,* 107 S. Ct. at 988 (White J., dissenting). In computing the alternative minimum tax, certain itemized deductions are deducted from the adjusted gross income. These deductions are known as alternative minimum itemized deductions. These deductions consist of: (1) gambling losses; (2) charitable contributions; (3) medical expenses in excess of 10 percent of adjusted gross income; (4) certain estate tax deductions; (5) qualified housing interest; (6) portion of casualty losses and (7) other interest to the extent of net investment income already included to compute the alternative minimum tax. I.R.C. § 55 (1982).

After the adjusted gross income is reduced by the alternative minimum itemized deductions, preference items are added back to determine the alternative minimum taxable income from which certain exemptions are deducted to calculate the alternative minimum tax. Preference items include: (1) accelerated depreciation on real property in excess of straight-line depreciation; (2) bargain element of certain exercised stock options; (3) excess depletion deduction in excess of the adjusted basis of the property; (4) amortization of certified pollution control and child care facilities in excess of depreciation normally allowed; (5) depreciation of leased personalty in excess of straight-line depreciation; (6) dividends excluded and (7) tax free "All-Savers" interest. Note that gambling losses are no longer a preference item. *Id.* § 57.

If professional gambling losses are deductible from professional gambling winnings to calculate the adjusted gross income, a taxpayer subject to the alternative minimum tax can then deduct gambling losses once again as an alternative minimum itemized deduction to calculate the minimum tax. Since gambling losses are deductible as an alternative minimum itemized deduction, the dissent argued that it must not have been the intent of Code sections 55 and 57 to allow gambling losses as a trade or business expense prior to deducting the same expenses as an alternative minimum itemized deduction, since that would constitute a double deduction. This is the result the dissent in *Groetzinger* wanted to prevent. *Groetzinger,* 107 S. Ct. at 988 (White J., dissenting).

mine profits in order to compute the adjusted gross income, just as any other business does. Then, gambling losses would be deducted again from the adjusted gross income to calculate the minimum tax base to determine the alternative minimum tax. Thus, the dissent concluded that Congress could not have intended gambling to be considered a trade or business since the result would be a double deduction for gambling losses.

The dissent recognized that arguments could be made that gambling was a trade or business prior to the 1982 changes. However, the dissent insisted that the Court should not alter the meaning of trade or business with reference to the pre-1982 years merely to avoid a harsh result in this case.[40]

The dissent's concerns regarding the advantage a taxpayer may get by deducting the gambling losses twice are no longer applicable for tax years beginning with 1987, after the passage of the Tax Reform Act of 1986. Under the new law, the alternative minimum tax calculation does not require an adjustment for gambling losses.[41] Gambling losses are deducted only once when calculating taxable income. Therefore, for tax years beginning with 1987, the alternative minimum tax will not be affected by the designation of gambling activities as a trade or business.

However, after *Groetzinger,* it is still possible that this issue may arise in the area of self-employment taxes levied on gambling profits.[42] In *Gentile v. Commissioner,*[43] the tax court rejected the position of the IRS that a professional gambler was subject to self-employment taxes because the taxpayer did not hold himself out as a provider of any goods or services. That tax court decision was overruled in *Ditunno v. Commis-*

40. *Groetzinger,* 107 S. Ct. at 988 (White J., dissenting).

41. I.R.C. §§ 56(b)(1)(A)(i), 67(b) (1986). The alternative minimum tax is more broadly based after the Tax Reform Act of 1986. The new law increased the number of preference items and limited the use of certain itemized deductions in order to increase the difficulty of excessively reducing the tax liability through the use of tax deductions. *Id.* § 56(b). However, gambling losses are not included in the calculation of the revised alternative minimum tax. *Id.* §§ 56(b)(1)(A)(i), 67(b)(3). Under the revised code, miscellaneous itemized deductions are generally added back to taxable income to calculate the alternative minimum tax. *Id.* § 56(b)(1)(A)(i). Gambling losses are specifically excluded as a miscellaneous itemized deduction and are not required to be added back to taxable income to calculate the alternative minimum tax. *Id.* § 67(b)(3). The revised code prevents gambling losses from being deducted twice in calculating the alternative minimum tax. Professional gambling losses would be deducted from gross income and recreational gambling losses would be deducted as itemized deductions without any adjustment to gambling losses to compute the revised alternative minumum tax.

42. I.R.C. § 1401 (1986).

43. Gentile v. Commissioner, 65 T.C. 1 (1975).

sioner[44] when the court rejected the requirement of offering goods or services to qualify as a trade or business.

Self-employment taxes are assessed on profits generated by an individual engaged in a trade or business.[45] A gambler engaged in a trade or business will be subject to self-employment taxes when gambling winnings exceed ordinary and necessary gambling costs, including gambling losses; in other words, when he makes a profit. In the present case for example, although the Court concluded that Groetzinger was in the business of gambling, he would not have been subject to any self-employment taxes since he did not generate any gambling profits in 1978.

Even though the IRS failed in its attempt to assess Groetzinger with the minimum tax, the Court, by recognizing that gambling activities can be considered a trade or business, increased the revenue raising potential of the IRS. By rejecting the position of the IRS with regards to the minimum tax, the Court prevented the IRS from assessing the minimum tax but instead subjected professional gamblers to self-employment taxes. Thus, the Court's holding indirectly favored the IRS. With the possibility of being subject to self-employment taxes by engaging in gambling as a trade or business, successful gamblers in the future will try to avoid qualifying as professional gamblers under the test set forth in *Groetzinger.* The IRS, contrary to its position taken in *Groetzinger,* will now be on the look-out for professional gamblers.

The Court's holding in *Groetzinger* left one important issue unresolved, the applicability of Code section 165(d)[46] to professional gamblers. Since not all businesses are profitable, especially during the start-up years, the IRS has traditionally allowed business losses to reduce income from non-business sources to help reduce the overall tax burden.[47] This rule prevents taxpayers from having to pay taxes when business losses exceed non-business income. Otherwise, taxpayers would be subject to taxes while operating unprofitably.

However, under Code section 165(d), gambling losses can only be used to offset income to the amount of gambling winnings.[48] The issue, then, is whether the section's limitation is consistent with the fact that gambling may constitute a trade or business.

The holding in the present case did not indicate whether gambling losses in excess of gambling winnings are deductible. The Court did not

44. Ditunno v. Commissioner, 80 T.C. 362 (1983).
45. I.R.C. § 1402(a) (1986).
46. *Id.* § 165(d). *See supra* note 6 for text of section 165(d).
47. *Id.* § 62(a)(1).
48. *Id.* § 165(d).

have to resolve the issue in the present case since Groetzinger, although he lost more than he won, did not deduct any gambling losses in excess of his winnings.

There is a strong indication that the limitation of gambling losses to the extent of gambling winnings under section 165(d) was not intended to apply to "business" activities. The fact that "non-business" gambling losses incurred by a taxpayer not engaged in the business of gambling are only deductible from adjustable gross income as itemized deductions,[49] indicates that this section was intended to apply only to non-business, recreational gambling losses. The statute was probably enacted to limit the use of recreational gambling losses because there is an element of personal consumption associated with gambling activities engaged in by the majority of the population.

Other allowable itemized deductions which are personal in nature will support the proposition that itemized deductions were intended for personal, non-business expenditures. These itemized deductions include medical and dental expenses,[50] state and local income taxes,[51] real estate taxes,[52] home mortgage interest[53] and casualty losses.[54] Business losses, on the other hand, are deducted directly from gross income.[55] This procedural difference strongly indicates that section 165(d), limiting gambling losses, was intended to apply only to recreational gambling losses.

In conclusion, the court in *Groetzinger* held that gambling can constitute a trade or business based on the factual circumstances of the taxpayer. The case dealt specifically with the applicability of the minimum tax based on the determination of whether the taxpayer's gambling activities were extensive enough to be considered a trade or business. This narrow holding in relation to the minimum tax is no longer applicable after the Tax Reform Act of 1986 took effect.

However, the possibility that gambling activity can be extensive enough to constitute a trade or business may now give rise to self-employment taxes for professional gamblers. Professional gamblers, like other self-employed taxpayers conducting a trade or business, will be subject to self-employment taxes on their profits. But by qualifying as a trade or business, professional gamblers, like other self-employed taxpayers, should be allowed to deduct their business losses from non-business

49. *Id.* § 63(d).
50. I.R.C. § 213 (1986).
51. *Id.* § 164(a)(3).
52. *Id.* § 164 (a)(1).
53. *Id.* §§ 163(a), 163(h)(2)(D).
54. *Id.* § 165(h).
55. *Id.* § 62(a)(1).

income. Thus, a professional gambler, such as Groetzinger, who lost more than he won, will not be subject to any self-employment taxes and should be able to deduct his net professional gambling losses from other income such as wages, investment interest, and dividends.

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