Document ID#: 547200610049

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: CLE Panel Presentation Outline

AUTHOR: Brackney, Megan L.
Camp, Professor Bryan
Rothenberg, Lance E.
Seto, Professor Theodore P.

PANEL: Virtual Income or Just Plain Fun: Taxing On-Line Gaming

DATE: 10/20/06

COMMITTEE: Individual and Family Taxation

Virtual Income or Just Plain Fun?
Taxation of Online Gaming

CLE Panel Presentation Outline

Individual and Family Tax Committee
American Bar Association Section of Taxation

October 19, 2006
Denver, Colorado

Moderator:	Megan Brackney	Kostelanetz & Fink, LLP, New York, (212-808-8100)
Panelists:	Bryan T. Camp	Texas Tech U. Sch. of Law, Lubbock (806-742-3990 x269)
	Lance Rothenberg	Fulbright & Jaworski, LLP, New York (212-318-3102)
	Theodore P. Seto	Loyola Law School, Los Angeles (213-736-1154)

This panel discusses tax issues faced by players of various forms of online gaming. The panel is structured into four parts, as follows:

Overview: Factual Background
Issues Regarding Multiplayer Online Role Games (MORGs)
Issues Regarding Online Wagering Games
Issues Regarding Information Returns

Overview: Factual Background

Megan Brackney (Power Point Presentation available)

A. Multiplayer Online Role Games (MORGs).

1. World of Warcraft

2. Second Life

B. Wagering Games

1. PartyPoker.com

2. Worldwinner.com

Issues Regarding MORGs

Three types of Multiplayer On-line Role Game (MORG) activities raise potential income tax issues for the player. First, items within the game are sold and bartered, both in the virtual world ("in-world" transactions) and in the real world ("real-world" transactions). Second, entire player accounts are sold in real-world transactions. Third, all MORGs have in-world mediums of exchange. These units of in-world currency are also sold for real-world money in real-world transactions.

This outline will first lay out the non-tax law doctrines that are mostly likely relevant to MORG legal relationships. It will then lay out the relevant tax law doctrines that are most likely relevant to MORG activities. Finally, it will examine each of the three MORG activities to explore how taxpayers might be taxed.

Although MORG activities occur in the context on online games, the cumulative impact of trading and selling virtual items, player accounts, and currency exchange, has non-trivial economic effects. The economist Edward Castronova, in a widely published 2001 paper, estimated that the real-world GNP of just a single MORG (Everquest, which has a medium-sized base of 240,000 players) was $175 million, making it the 77th richest national economy in the world. *See* Edward Castronova, *Virtual Worlds: A First-Hand Account of Market and Society on the Cyberian Frontier*, CESifo Working Paper Series, Paper No. 618, available at www.ssrn.com. The owner of one of the many online trading sites for MORG game items and currency estimates that his site does over $880 million worth of real-world trades per year. Castronova estimates in-world transactions for all sites total over $1.5 billion. With that kind of money floating around, you can bet some of your clients may have gaming-related tax issues.

Note 1: this portion of the presentation assumes the affected taxpayer is a hobbyist and that the potential income does not arise from a trade or business or section 212 activity. Further, please assume that the hobbyist is either a U.S. citizen or else a permanent resident and so is taxable on his or her worldwide income. That removes sourcing issues.

Note 2: It is doubtful that Article 2 of the UCC applies to trade in virtual items or player accounts. This is because Article 2 applies only to "goods" and UCC 2-103(k) specifically provides that the term "goods" as used in the UCC excludes "information, the money in which the price is to be paid, investment securities under Article 8, the subject matter of foreign exchange transaction, or choses in action." The two most likely non-tax characterization of MORG items, player accounts, or in-world currency are as chose in action or copyrights.

I. Non-Tax Law

A. Copyright Law Basics

1. What is protected.

17 U.S.C § 102 protects "original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."

But

"In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work." Id.

This statutory language is called the idea/expression dichotomy. Only the expression of the ideas is protected, not the ideas themselves. "Copyright assures authors the right to their original expression, but encourages others to build freely upon the ideas and information conveyed by a work." Feist Publications v. Rural Tel. Serv. Co., 499 U.S. 340 at 349 (1985); See Meridian v. Hardin, 426 F. Supp. 2d 1101 (E.D. Ca. 2006)(excellent discussion of dichotomy, in context of deciding whether end user's copying of software help files infringed copyright).

In general, the more abstract and original the expressive component of the work, the broader the protection, but the more the work is just an expression of commonly accessible factual information, the "thinner" is the copyright protection. There are just too few ways to express a telephone directory, for example, to give much copyright protection for them. Feist.

2. Scope of protection

a. Copyright holder has a bundle of rights. Herwig v. United States, 122 Ct. Cl. 493 (1952). 17 U.S.C. § 106 gives the copyright owner the exclusive right to:

- ☞ make copies;
- ☞ distribute copies, either by sale or other transfer of ownership, or by rental, lease prepare , or lending; derivative works based upon the copyrighted work;
- ☞ prepare derivative works based on the copyrighted work;
- ☞ display or perform the copyrighted work publicly, including digital audio transmission. in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly;

b. Copyright protection extends automatically to copyrightable works.

c. "Computer software" is subject to copyright protection. 17 U.S.C. § 101. It is considered a subset of "literary works." House Rep. 94-1476 at 54 (subject matter of copyright includes "literary works" which includes software programs).

d. 17 U.S.C. § 101 defines "Computer Software" as "set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result."

e. The "fixed in any tangible medium of expression" includes storage on computer hard drives or servers or any other machine-readable form. Apple Computer v Franklin Computer Corp. 714 F.2d 1240 (3rd Cir. 1983).

3. Limits on Copyright protection: First Sale Rule

A book is a copy of a writer's authorship. Sale of the book is different than sale of the copyright in the book. While 17 U.S.C. 106 gives the copyright owner the exclusive right to distribute copies, 17 U.S.C. § 109(a) limits that right to the "first sale" of any given copy of the work. Bobbs-Merrill Co. V. Straus, 210 U.S. 339 (1909). After that, the owner of the copy has the right to dispose of his or her copy of the work. See Softman Products v. Adobe Systems, 171 F. Supp. 2d 1075 (C.D. Cal. 2001)(lifting TRO and refusing to grant Adobe a preliminary injunction to enjoin Softman from re-selling unbundled Adobe software programs).

4. Application to MORGs

a. MORG items.

- Second Life items. Player create virtual objects using either lego-like building blocks called "primitives" or else writing a high-level script to program objects. For example, a player could write a short program to create a butterfly that followed his or her avatar around. Although the tools of creation are provided by the game developers and owners, the creation of in-game items is limited only by the imagination of the players. In-game items are, therefore, arguably works of authorship and the players can have a copyright in their expression. Their in-world items are likely considered "literary works" under the Copyright Act.

- World of Warcraft (WoW) items. In contrast to Second Life, WoW in-game items are tightly controlled by the game developers and owners. Players simply click their mouse to acquire "skills," and can modify their on-line avatar only by clicking on a limited number of pre-determined options. *See* Lisa Galarneau, "*My Other Self is an Ass-Kicking Supermodel,"* blogged on www.terranova.blogs.com on August 26, 2006 (observing limited clothing options in World of Warcraft). Players do not write code, either by text or by graphical interface; they simply access pre-written code. Accordingly, to the extent that in-game items reside as

specific copies of lines of computer code on some server somewhere, they may be best analogized to copies of the copyrighted work. Unlike a book, however, they are not tangible and cannot be taken out of the in-game environment.

b. Player Accounts.

Player accounts consist of an aggregation of in-world items and avatars. Players may have more than one avatar. Avatars are the virtual representation of a character in-world. They can best be analogized to characters in a work of fiction. They have in-world reputations. Accordingly, given the virtual world complexity, the aggregation of items in a player account and the playing history of the avatars in the account might very well be protected in toto as a work of authorship and protected by copyright.

c. In-game currency.

In both Second Life and WoW, in-game currency ("Lindens" for Second Life and "gold" for WoW) is created by the game developers and owners at their discretion. Players cannot create Lindens (at least not unless they hack).

B. Choses in Action

1. What is it?

A chose in action is a species of intangible personalty that can be owned and transferred. Generally it is "the right to bring an action to recover a debt, money, or thing." Black's Law Dictionary 234 (7th ed. 1999). State laws give you the specifics. For example, under Indiana law a chose in action is "a personal right not reduced into possession but recoverable by suit in law. It is a property right characterized as personalty. The term in its broadest sense encompasses all rights of action whether they sound in contract or tort." Neffle v. Neffle, 483 N.E.2d 767, 771 (Ind. App. 2d Dist. 1985). If I own the car I am driving in, it is my "chose" and I have "possession" of it. It is a chose in possession. But if I lease you my car, you get possession during the lease term and I have a right to get the car back at the end of the lease term. That right is the chose in action. I no longer have a chose in possession. I instead have a chose in action. I have traded by possession of the thing for an action at law for its recovery (or damages or whatever).

2. Application to MORGs

a. MORG items

- It is possible that the best analogy to a player's use and enjoyment of in-game items is that each item represents a separate chose in action. Certainly an in-game item is

intangible. The player does not "possess" it as the player would a book or car. All the player possesses is the "right" to play with the in-game item according to the applicable legal rules, including the terms of the End User License Agreement (EULA) or Terms of Service (TOS). Invariably, those rules permit transfer of in-game items from one avatar to another. If the game developer or owner denies access to an in-game item, the player arguably has the right to bring an action for restitution, injunction, or other relief.

b. Player Accounts

Player accounts are a stronger case for treatment as a chose in action because a player account is made up of a collection of in-game items, including (most importantly) the virtual representations of the player, called the avatar. A player may have more than one avatar. *See* Castronova, supra, noting that in his study of the MORG "Ultima Online," players used an average of 2.4 avatars. Currently, the chose in action would most likely be based on the EULA or TOS. But academics are struggling to come up with theories of how property law would apply to avatars and player accounts.

c. MORG currency

In-game currency might be best thought of as "units of play." So conceived, each unit is a chose in action because players may use in-game currency to purchase other in-game items as well as in-game services. The more in-world currency you have, the more fun you have and the more "play" you get for your real-world monthly fee of $9.95.

B. Role of End User License Agreement (EULA) and Terms of Service (TOS)

1. In general: Scope and Validity of "Shrinkwrap" EULAs

- Origin of EULA's: uncertainty about whether copyright law protected software.

- Are EULA's true licenses or disguised sales? Excellent discussion in: Davidson v. Internet Gateway 334 F. Supp. 2d 1164 (E.D. Mo. 2004)(finding that EULA used by Blizzard Entertainment (developer of World of Warcraft) for Battle.net was true license); Softman, supra, (finding that EULA used by Adobe was sale not license).

- Distinction goes to control of subsequent disposition of the copy. If a sale, then first sale doctrine applies, unless provisions in the contract (a) exist to restrict further distribution of the copy and (b) are valid.

- "Shrinkwrap" EULAs are sometimes contracts of adhesion. See Meridin v. Hardin, Supra, 426 F. Supp. 2d at 1006 (collecting cases). What constitutes a contract of adhesion varies from state to state. For example, New Mexico uses a three-part test:

(1) the agreement must occur in the form of a standardized contract with boilerplate clauses prepared entirely by one party to the transaction; (2) the party who prepared the contract must be in a superior bargaining position such that the weaker party has no realistic alternative to doing business with the stronger party; and (3) the contract must be offered on a take-it-or-leave-it basis with no opportunity for the weaker party to even attempt to bargain. See e.g. Guthmann v. LaVida Llena, 709 P.2d 675 (N.M. 1985). New York uses a different test: adhesion is found when the party seeking to enforce the contract used high pressure tactics or deceptive language in the contract, where there is inequality of bargaining power between the parties, and where the contract inflicts substantive unfairness on the weaker party. In the Matter of Arbitration of Karen Ball, 236 A.D.2d 158, 665 N.Y.S.2d 444, 446 (3d Dep't 1997) (citations omitted). Common to all adhesion cases, however, is the idea that the weaker party has no realistic alternative to agreeing to the contract offered.

2. Validity of MORG EULA and TOS

- Look like licenses, not sales.

- Do not appear to be contracts of adhesion.

II. Tax Law

A. "Income" is almost limitless

At the most basic level, § 61 taxes anything that can be called "income." Despite the recent wobbling by the D.C. Circuit in Murphy v. IRS, 2006 U.S. App. LEXIS 21401 (D.C. Cir. August 22, 2006), courts are firm that "income" means "any undeniable accessions to wealth, clearly realized, and over which the taxpayer[has] complete dominion." Comm'r v. Glenshaw Glass, 348 U.S. 426 (1955). "Income" can be in the form of cash (or cash equivalents), property, or services.

B. Two relevant limits.

1. "Priceless" is not income. Receipt of property is not "income," however, if it has no ascertainable fair market value. For example, §83(a) taxes the grant of certain stock options to employees in exchange for services. The stock options are generally treated as income at the time they vest. But if—for whatever reason—have an ascertainable fair market value at the time of the grant, then the statute and regulations provide that the taxpayer does not realize income until the options are exercised or otherwise disposed of. §83(e)(3), Treas.Reg. 1.83-7.

Bottom line: like the credit card commercial, if you cannot put a value on it, it is not

income.

2. The Cook is not taxed on the meal. Self-created economic value is not "income" when created, but only when (and if) sold. This is often referred to as the "imputed income exception." If a taxpayer creates something of value, then even though that property increases the taxpayer's wealth, it does not constitute "income, fully realized" within the meaning of Glenshaw Glass until there is some realization event. Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934) ("rental value of the building used by the owner does not constitute income within the meaning of the 16th amendment"); Rev. Rul. 79-24, 1979-1 C.B. 60 (distinguishing barter transactions).

-"Imputed income" has been described as "a flow of satisfactions from...goods and services arising out of the personal exertions of the taxpayer on his own behalf." Marsh, *The Taxation of Imputed Income*, 58 Pol. Sci. Q. 514 (1943)

III. Taxation of MORG activity.

A. Amount and Timing of Income

1. In-world sales or exchanges of MORG items: more questions than answers.

a. Do they produce a taxable accretion to wealth?

- Is there an ascertainable fair market value for item received?

- Can imputed income exception apply?

b. Is there actual or constructive receipt? Constructive receipt is when the item of income is "credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time." However, "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." Treas.Reg. 1.451-2. MORG items cannot be taken out of world.

c. Is there a realization event?

d. What is effect of EULA? Cf. Second Life with World of Warcraft

2. Real-world sales or exchanges. Use § 1001: Amount Realized - Basis = Gain. The major issue will be determination of proper basis.

a. MORG items: like the sale of a copy (in WoW) or like a license of a copyright (in Second Life).
b. MORG accounts: like an exclusive license of a copyright. If so, then treated as a sale. Rev. Rul. 60-226, 1960-1 C.B. 26.

c. MORG currency: like the sale of a chose in action, the right to play.

3. Treatment of Expenses

a. § 263A Uniform Capitalization rules not apply to hobbyists. 263A(c)(1).

b. § 183 limitations apply.

c. Query whether one-time costs to acquire items or accounts differ from recurring costs (monthly fees) to maintain account and play the game.

B. Character of Income

1. General Rule: Capital gain treatment is given to income realized from (a) the sale or exchange of (b) a capital asset which is © held for more than 1 year.
§§ 1221, 1222, 1223.

2. In-world transactions of MORG items.

3. Real-world transactions.

a. MORG items: may be sale of a copy (in WoW) or may be like a license of a copyright (in Second Life). If former, can be capital; if latter, then must be taken as ordinary income. If the license is non-exclusive, it is ordinary because it is a royalty payment, § 61(a)(6). If the license is an "exclusive and perpetual grant of any one of the 'bundle of rights' which go to make up a copyright," then will be treated as a sale or exchange but will still be ordinary because it is excluded from the definition of a capital asset. Herwig v. United States, 122 Ct. Cl. 493 (1952); § 1221(a)(3).

b. MORG accounts: like an exclusive license of a copyright. If so, then treated as a sale. Rev. Rul. 60-226, 1960-1 C.B. 26. Cannot be capital because not a capital asset. § 1221(a)(3).

c. MORG currency: like the sale of a chose in action, the right to play. Can be capital, but query determination of holding period.

Issues Regarding Wagering Games

I. Before exploring rules specific to gambling, it may be useful to review how income from on-line gaming that is not subject to any such provisions would be taxed. In the case of a U.S. citizen or resident, the answer depends on whether taxpayer is engaged in gaming as (1) a trade or business, (2) an income-producing activity that does not rise to the level of a trade or business, or (3) a personal activity.

A. Trade or Business

1. If taxpayer engages in on-line gaming as a trade or business, her winnings are includible in her gross income. In addition:

_ Current expenses are deductible above-the-line.
_ Capital expenses may be expensed under IRC §179, depreciated under IRS §168, or amortized under IRC §197.
_ Deductions are not subject to the 2-percent floor on miscellaneous itemized deductions of IRC §67.
_ Deductions are not subject to the overall limitation on itemized deductions of IRC §68.
_ Deductions are fully deductible for alternative minimum tax (AMT) purposes under IRC §§55-59.
_ Deductions in excess of gross income from on-line gaming can offset income from other sources.
_ Deductions in excess of total gross income generate net operating losses under IRC §172 that can carry over to shelter income of all types.

2. Determination of whether an activity constitutes a trade or business. In *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the Supreme Court held that gambling could constitute a trade or business for federal income tax purposes:

"[I]f one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business …"

A practicing attorney may simultaneously engage in the trade or business of "greyhound racing wagerer." *Barrish v. Comm'r*, T.C. Memo. 1984-602.

B. Income-Producing Activity

1. If taxpayer engages in on-line gaming as an income-producing activity that does not rise to the level of a trade or business, her winnings are includible in her gross income. In addition:

- Current expenses are only deductible below-the-line. Rev. Rul. 83-130, 1983-2 C.B. 148.
- Capital expenses may be depreciated under IRS §168 or amortized under IRC §197, but may not be expensed under IRC §179.
- Deductions are subject to the 2-percent floor on miscellaneous itemized deductions of IRC §67.
- Deductions are subject to the overall limitation on itemized deductions of IRC §68.
- Deductions are disallowed completely for alternative minimum tax (AMT) purposes under IRC §§55-59. The AMT therefore applies to taxpayer's gross income from the activity.
- Deductions in excess of gross income from on-line gaming can still offset income from other sources.
- Deductions in excess of total gross income generate net operating losses that can only carry over to shelter income not derived from a trade or business. IRC §172(d)(4).

2. Determination of whether an activity is engaged in for profit. IRC §183(d) provides in relevant part:

"If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit."

Treas. Reg. §1.183-2 then lists nine factors relevant to the determination. Of particular relevance to on-line gaming may be Factor 9: Elements of personal pleasure or recreation:

"The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. … An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to

make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph."

One notable feature of on-line gaming is that many on-line games can be played in either of two modes – with the possibility of winning something (typically requiring an entry fee or some other payment) or just for fun (typically for free). The fact that taxpayer pays extra for the possibility of winning suggests a profit motivation for doing so.

C. Personal Activity

1. If taxpayer engages in on-line gaming as a personal activity, her winnings are includible in her gross income. In addition:

- Current expenses are only deductible to the extent of her winnings from the activity under the rules of IRC §183.
- Capital expenses may be depreciated under IRS §168 or amortized under IRC §197 to the extent permitted by IRC §183, but may not be expensed under IRC §179.
- Deductions may only be taken below-the-line. Rev. Rul. 83-130, 1983-2 C.B. 148.
- Deductions are subject to the 2-percent floor on miscellaneous itemized deductions of IRC §67.
- Deductions are subject to the overall limitation on itemized deductions of IRC §68.
- Deductions are disallowed completely for alternative minimum tax (AMT) purposes under IRC §§55-59. The AMT therefore applies to taxpayer's gross income from the activity.
- Deductions in excess of gross income from the activity are completely and permanently disallowed under IRC §183.

2. Definition of "activity" for purposes of IRC §183. Treas. Reg. §1.183-1(d)(1) provides in relevant part:

"In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various

undertakings. *Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities.* The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case." (emphasis added)

In most circumstances, all of a taxpayer's on-line gaming will likely constitute a single activity for purposes of IRC §183. Even a taxpayer engaged in on-line gaming as a personal activity should therefore be able to deduct the costs of that activity against any income from that activity.

II. Code Provisions Specific to Gambling

A. IRC §165(d) and related provisions

IRC §165(d) provides: "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

Treas. Reg. §1.165-10 clarifies that this limitation is to be applied annually: "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. …"

IRC §67(b)(3) excludes "losses described in section 165(d)" from the definition of "miscellaneous itemized deductions" subject to the 2-percent floor imposed by that section.

IRC §68(c)(3) excludes "losses described in section 165(d) from the definition of "itemized deductions" subject to the overall limitation on itemized deductions imposed by that section.

IRC §56(b)(1)(A) provides, in relevant part, that "No deduction shall be allowed for any miscellaneous itemized deduction (as defined in section 67(b)) …"

1. IRC §165(d) overrides the general rules of deductibility for all losses to which it applies.

Even if losses would otherwise be deductible as trade or business expenses under IRC §162 or as expenses for the production or collection of income under IRC §212, if they are "losses from wagering transactions," they are only allowed to the extent of gains from such transactions. *Boyd v. U.S.*, 762 F.2d 1369, 1372 (9th Cir. 1985); *Nitzberg v. Comm'r*, 580 F.2d 357 (9th Cir. 1978); *Skeeles v. U.S.*, 95 F. Supp. 242, 246-47, 118 Ct. Cl.

362, *cert. denied*, 341 U.S. 948 (1951).

Conversely, even if losses would otherwise be disallowed as personal expenses under IRC §262, if they are "losses from wagering transactions," they are allowed to the extent of gains from such transactions. *Humphrey v. U.S.*, 162 F.2d 853 (5th Cir. 1947). IRC §165(d) probably overrides IRC §183 with respect to losses to which it applies to the extent they are inconsistent.

It follows that if taxpayer's on-line gaming constitutes "wagering" within the meaning of IRC §165(d), her "losses" from such transactions are allowable to the extent of gains from such transactions, and only to that extent, regardless of whether her gaming constitutes a trade or business, an income-producing activity, or a personal activity.

Similarly, losses from wagering transactions to the extent of gains from such transactions are deductible without regard to the 2-percent floor on miscellaneous itemized deductions or the overall limitation on itemized deductions and are deductible for AMT purposes, again regardless of whether taxpayer's gaming constitutes a trade or business, an income-producing activity, or a personal activity.

Two consequences continue to turn on whether taxpayer's activity is a trade or business, on the one hand, or an income-producing or personal activity, on the other: (1) whether deductions are allowed above- or below-the-line, and (2) whether expensing is permitted under IRC §179. If taxpayer's on-line gaming constitutes a trade or business, her deductions will be allowed above-the-line and the costs of Section 179 property may be expensed to the extent permitted by that section. If taxpayer's on-line gaming constitutes an income-producing or personal activity, her deductions will be below-the-line, Rev. Rul. 83-130, 1983-2 C.B. 148, and expensing will not be permitted under IRC §179.

As a result of IRC §165(d), however, no obvious consequences turn on whether taxpayer's gambling activity is undertaken for the production of income, on the one hand, or for personal reasons, on the other. One effect of IRC §165(d), therefore, is to make it unnecessary to determine whether taxpayer's gambling is undertaken with an income-producing motive. This evidentiary problem remains, by contrast, in the case of on-line gaming not subject to IRC §165(d).

Given that taxpayer's losses in excess of gains will be permanently disallowed under IRC §165(d), even taxpayers engaged in on-line gambling as a trade or business may wish to consider not electing to

expense under IRC §179. Indeed, a taxpayer engaged in on-line-gaming as a trade or business or income-producing activity may wish to consider electing less accelerated depreciation under IRC §168.

IRC §183, as elaborated in Treas. Reg. §§1.183-1(b)(1)(iii) and 1.183-1(b)(2), disallows depreciation or amortization and suspends any resulting basis reduction to the extent that losses from a personal activity exceed gains. IRC §165(d) is not inconsistent with this aspect of IRC §183. The basis reduction suspension rules of IRC §183 therefore probably continue to apply if taxpayer's on-line gaming constitutes both "wagering" and a personal activity.

2. Definition of "losses from wagering transactions." For purposes of IRC §165(d), some courts have held that the term "losses from wagering transactions" includes all expenses incurred in connection with such transactions, including, *e.g.*, AMT charges, office supplies, transportation expenses, travel mileage, meals and lodging, and admission fees. *Estate of Todisco v. Comm'r*, 757 F.2d 1 (1st Cir. 1985); *Offutt v. Comm'r*, 16 T.C. 1214 (1951); *Kochevar v. Comm'r*, T.C. Memo 1995-607; *Valenti v. Comm'r*, T.C. Memo 1994-483; *Kozma v. Comm'r*, T.C. Memo 1986-177; *Castagnetta v. Comm'r*, T.C. Summ. Op. 2006-24. In addition, the First Circuit has held that "losses from wagering transactions" include state income taxes on gambling income, *Estate of Todisco*, *supra*, while the Third Circuit has held that lottery ticket dealers could only deduct the cost of unsold lottery tickets to the extent permitted by IRC §165(d), *Miller v. Quinn*, 792 F.2d 392 (3d Cir. 1986). In each of these cases, a taxpayer engaged in the trade or business of gambling was thereby prevented from deducting trade or business expenses in excess of his income from wagering transactions.

In *Whitten v. Commissioner*, T.C. Memo 1995-508, by contrast, taxpayer did not claim to be engaged in the trade or business of gambling. Instead, he asserted that IRC §165(d) allowed him to deduct all expenses incurred in connection with transactions asserted to be wagering transactions up to the amount of his gains from such transactions. The Tax Court effectively retreated from the above-cited cases, holding that "losses from wagering transactions" should be limited to losses from such transactions and that expenses related to the activity should be deducted or not without regard to IRC §165(d).

The current scope of the term is therefore unclear.

B. Withholding at source

IRC §3402(q)(1) requires any person making payment of "winnings which are subject to withholding" to withhold an amount equal to the product of the third lowest rate of tax applicable to single taxpayers and such payment. IRC §3402(q)(5) provides that: "The tax imposed under paragraph (1) shall not apply to winnings from a slot machine, keno, and bingo."

IRC §3402(q)(3) defines "winnings which are subject to withholding" to include: (1) "proceeds of more than $5,000 from a wagering transaction, if the amount of such proceeds is at least 300 times as large as the amount wagered…," (2) "proceeds of more than $5,000 from a [state] lottery…," and (3) "proceeds of more than $5,000 from a wager placed in a [nonstate] sweepstakes, wagering pool, or lottery … or a wagering transaction in a parimutuel pool with respect to horse races, dog races, or jai alai if the amount of such proceeds is at least 300 times as large as the amount wagered."

IRC §3402(4) provides that, for purposes of IRC §3402, "proceeds from a wager shall be determined by reducing the amount received by the amount of the wager, and proceeds which are not money shall be taken into account at their fair market value."

These compliance provisions, although not the topic of this outline, are nevertheless relevant to understanding the Code's substantive provisions in that they may shed light on the meaning of the terms "wagering transaction" and "wager" as used in those substantive provisions.

C. IRC §§4401-4424

IRC §4401 imposes an excise tax of .25 percent on any wager authorized under state law, and an excise tax of 2 percent on any wager unauthorized under state law. The tax is imposed on each person who is engaged in the business of accepting wagers.

IRC §4402 excludes from imposition of this tax (1) "any wager placed with, or … any wager placed in a wagering pool conducted by, a parimutuel wagering enterprise licensed under State law," (2) "any wager placed in a coin-operated device …," or (3) "any wager placed in a sweepstakes, wagering pool, or lottery which is conducted by an agency of the State …."

IRC §4411(a) imposes a special tax of $500 per year on "each person who is liable for the tax imposed under section 4401 …"

IRC §4421 provides that, for purposes of Chapter 35, the term "wager"

means (1) a "wager with respect to a sports event or a contest placed with a person engaged in the business of accepting such wagers," (2) a "wager placed in a wagering pool with respect to a sports event or a contest, if such pool is conducted for profit," and (3) a "wager placed in a lottery conducted for profit." The term "lottery" includes "the numbers game, policy, and similar types of wagering." It does not include (1) "any game of a type in which usually the wagers are placed, the winners are determined, and the distribution of prizes or other property is made, in the presence of all persons placing wagers in such game," or (2) any drawing conducted by an organization exempt from tax under IRC §§501 and 521. These provisions are potentially relevant to individual on-line gamblers for two reasons: First, there is some possibility that a taxpayer engaged in on-line gambling as a trade or business is "in the business of accepting wagers" within the meaning of IRC §4401© (requiring collection of the excise tax) and is therefore subject to the special tax imposed by IRC §4411. Second, they may be relevant to the definition of "wagering" as used elsewhere in the Code. PLR 20053205, for example, invokes the regulations under IRC §4421 to assist in determining whether the on-line gaming transactions there described constitute "wagering" or "prizes" for purposes of IRC §6041 information reporting purposes.

III. Definition of "wagering transaction" or "wager"

Whether an activity constitute a "wagering transaction" or "wager" is therefore potentially critical to how it will be taxed. Unfortunately, there is no clear general definition of these terms. Neither term is defined in the Code or Regulations. In the physical world, this has generally not raised problems, since bricks-and-mortar gambling establishments are almost always clearly labeled. On-line, however, gaming providers have almost infinite flexibility in structuring the terms of play. On-line gaming, therefore, is likely eventually to force a resolution of the question. To date, at least four approaches or factors have been used in determining whether an activity is a "wagering transaction" or "wager" for federal income tax purposes.

A. Common Usage

First, courts and the IRS have looked to common usage for a definition. Allen v. U.S. Gov't Dept. of Treasury, 976 F.2d 975 (5th Cir. 1992) ("as neither the Code nor Treasury Regulations define the term 'wagering transaction,' we accord those words their ordinary meaning"); Boyd v. United States, 762 F.2d 1369,1372 (9th Cir. 1985) (accord).

Standard casino games, lotteries, pari-mutuel betting, and the like, are clearly wagering in ordinary usage. In the absence of special

arrangements, board and computer games are typically not thought of as involving gambling.

Consistent with this approach, in *Whitten v. Comm'r*, T.C. Memo. 1995-508, taxpayer asserted that his participation in the game show "Wheel of Fortune" constituted a wagering transaction, that his expenses in connection with that participation were "losses from wagering transactions," and that he therefore should be allowed to deduct those expenses to the extent of his gains from wagering transactions (e.g., his winnings on the show) under IRC §165(d). The court stated: "The parties have devoted a substantial amount of time and effort debating the issue of whether a contestant's appearance on the 'Wheel of Fortune' game show constitutes a wagering transaction governed by the provisions of section 165(d). In our opinion it does not. However, we need not definitively decide this …"

B. Whether Taxpayer Risks a Loss

Courts and the IRS have both suggested that a transaction is not a wagering transaction unless taxpayer places something at risk.

In *Allen v. U.S. Gov't Dept. of Treasury*, 976 F.2d 975 (5th Cir. 1992), the Court held that tokes received by casino dealers were not "gains from wagering transactions." In so holding, the Court observed: "the dealer receiving a toke cannot elect to take the amount wagered on his behalf by the patron in lieu of the proceeds (if any) of the wager. The dealer has no part in deciding to make the wager, and *stands to lose nothing by it*." (emphasis added).

Similarly, in Rev. Rul. 55-754, 1955-2 C.B. 471, in construing the scope of the IRC §4401 tax on wagers, the IRS stated: "A wager is an amount risked on an uncertain event. Therefore, the tax on wagers is applicable to the amount actually risked by the bettor …"

Applying this rationale in Rev. Rul. 72-481, 1972-2 C.B. 581, again construing the scope of the IRC §4401 tax, the IRS held that the use of free plays that could not be converted into value of any other sort did not constitute taxable wagers.

Intuitively, requiring that "wagering transactions" be limited to transactions in which taxpayer places something at risk makes sense. It is easy to envision situations, however, in which such a requirement would come into conflict with both common usage and the need for administrable rules.

Consider, for example, a state lottery that awards, among other possible prizes, free lottery tickets. The holder of those free tickets is not risking anything in the next lottery. If she wins, is it really the case that her winnings are not payments from a "wager" or gains from a "wagering transaction," subject to IRC §165(d), withholding at the source under IRC §3402(q), the IRC §6041 information reporting rules specific to wagering, and so forth?

Or similarly, from time to time Nevada casinos offer promotional packages to induce potential patrons to come, stay, and gamble. Such packages often include an initial stake of chips. These chips, however, are subject to special restrictions: They may not be redeemed for cash. Instead, any chips presented for redemption are first credited against the initial stake; only chips presented in excess of the initial stake can be redeemed for cash. Assume that a customer plays with these special chips. If we limit "wagering" to transactions in which taxpayer has something at risk, the casino will have to treat some blackjack winnings as gains from a "wagering transaction," and some not – an administrative nightmare.

C. Skill vs. Chance

Whether victory depends on skill or chance is a third criterion sometimes used to distinguish between "wagering" and other games.

In Rev. Rul. 57-395, 1957-2 C.B. 781, the IRS used this criterion to distinguish between prizes and gains from wagering transactions awarded to users of coin-operated devices. The IRS reasoned:

"The determination of whether a coin-operated device is an amusement or gaming device cannot be made solely on the fact that prizes are awarded in connection with its operation. If the successful operation of a coin-operated device, with respect to which prizes are awarded, depends on the application of the element of chance, the machine is considered a gaming device. Generally, with respect to this type of device, the player after inserting the coin in the machine has no further control over the final result, which is attained by the element of chance, such as pulling a lever, setting reels into action, activity of dice, or, in the case of `pin-ball' machines, propelling a ball over the playing surface by means of a plunger."

"On the other hand, where the insertion of a coin merely releases the machine for manual play and the successful operation thereof depends entirely on the skill of the player in operating the device, such as the propelling of pucks, the machine is considered an amusement device

even though prizes may be awarded to some or all of the players. However, where a device of this type includes a feature whereby its successful operation, for which prizes are awarded, depends on the element of chance, it is considered a coin-operated gaming device. …. An example of a coin-operated bowling game which would fall within this classification is one where a player is awarded a prize in the event the last digit in his score matches a digit which is illuminated on the device after the game is completed."

The IRS used the same criterion in PLR 200532025 to determine whether an on-line tournament in which the prize was fixed in advance constituted a "lottery" and therefore a "wagering transaction." The ruling stated:

"[A] lottery is a scheme to distribute prizes to participants who pay to win the prize by chance. Taxpayer argues that because, (1) it does not allow players of dissimilar skills to play in the same tournament and (2) it uses its game rating analysis software play, the element of chance has been minimized in its tournament play and, as such, the tournaments lack a key requirement for them to be considered as lotteries. Based on these representations, we believe that the tournament games lack the essential element of chance and cannot be classified as a lottery."

By itself, the criterion of skill vs. chance is not terribly helpful. Poker is a game of skill, but clearly constitutes "wagering." AOL offers players the opportunity to play "Bejeweled" for cash prizes; Bejeweled requires little skill.

D. Source of the Prize Money

In PLR 200532025, the IRS used the source of the prize money to determine whether an on-line tournament constituted a "wagering pool." The IRS reasoned:

"[A] wagering pool is an arrangement to pool bets into a common fund, which are wagered on a sports event or contest, with the successful bettor (or bettors) receiving the pool proceeds, subject to the pool sellers commission. That contrasts with a situation where monies are received as entrance fees in order to compete for a preestablished prize offered by a third party that must be awarded in any case. … Here, the minimum winnings or prizes of property are predetermined and must be awarded irrespective of the number of participants or the total of the entrance fees collected."

This criterion has some intuitive appeal. It fails, however, in the

implementation. One of the tournaments described in the PLR operated as follows: "2. ***: These tournaments do not have a limited number of players, but will terminate at a specified date and time. Minimum prizes are pre-established. The number of players competing and the size of potential prizes can increase over the period of competition. If the tournament does not fill before it is closed, the leader of the tournament is awarded the stated minimum prize." In other words, if the tournament attracts enough players, the prize grows as the number of players grows. In effect, there is a pooling. If it does not, there is a stated minimum prize. It would be difficult, on these facts, to determine whether the prize should be treated as preestablished or as the result of a pooling. The IRS held, in effect, that if there was a stated minimum prize the tournament should be treated as a game, not a wagering transaction.

IV. Tax Accounting for Wagering Transactions

A. Rejection of Two-Step Accounting

At one time, the Service advocated a so-called "two-step" approach to casino chip accounting. GCM 35796. Under this approach, the conversion of cash or credit into chips and the disposition of the chips were treated as separate steps with independent tax significance.

The Tax Court, the Nevada U.S. District Court, and the Ninth Circuit, however, have all rejected the two-step approach, requiring instead an accounting approach that disregards the conversion of cash or credit into chips and treats the disposition of the chips as a disposition of the underlying cash or credit itself. *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 937 (D. Nev. 1980), *aff'd*, 664 F.2d 1387 (9th Cir.), *cert. denied*, 459 U.S. 1036 (1982); *Desert Palace, Inc. v. Commissioner*, 72 T.C. 1033, 1049-50 (1979), *rev'd mem. on other grounds*, 698 F.2d 1229 (9th Cir. 1982), *cert. denied*, 464 U.S. 816 (1983). *But see Zarin v. Comm'r*, 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990) (using the two-step approach but denying treatment of chips as "property" for purposes of IRC §108(e)(5)). *See generally* Theodore P. Seto, *Inside Zarin*, 59 SMU L. Rev. (2006) (forthcoming), available on-line at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=885361.

In the on-line context, it would be even less plausible to treat virtual chips as property having independent tax significance.

B. Winnings as a Recovery of Capital

Notwithstanding rejection of the two-step approach, courts and the IRS

have concluded that a gambler's gross income from a wagering transaction equals her winnings less the value of her bet. The Tax Court has even suggested that this result is required as a matter of constitutional law.

In *Hochman v. Comm'r*, T.C. Memo. 1986-24, the Court held that taxpayer's gross income from a ticket representing a bet placed on a horse races was limited to the amount in excess of the amount paid for the ticket. The Court stated:

"Although the power of Congress to tax income is very broad, and although section 61 is intended to reach and tax all income, from whatever source derived, … and although deductions are a matter of legislative grace, to be bestowed or withheld by Congress, … gross income still does not include the return of capital. The latter is an exclusion from gross receipts, and its allowance is not a matter of legislative grace, but rather a matter of determining the true gross income which constitutionally may be taxed. [citing *Eisner v. Macomber*] To the extent that the cost of his winning ticket is included in the payoff which petitioner receives at the cashier's window on a winning race, therefore, petitioner has only recovered his capital, and is entitled to exclude the amount of that winning ticket from his gross receipts in order to arrive at gross income within the meaning of section 61."

Consistent with this rationale, in Rev. Rul. 55-638, 1955-2 C.B. 35, the IRS held that the proceeds of a sweepstakes ticket acquired by gift before it becomes a winning ticket are includible only to the extent they exceed the value of the gift.

Similarly, in Rev. Rul. 83-130, 1983-2 C.B. 148, the IRS held that a taxpayer who purchased a raffle ticket for $100 and won a house worth $100,000 had $99,900 of gross income.

IRC §3402(q), which requires withholding at the source for certain gambling winnings, is consistent with this rationale as well. IRC §3402(q)(4)(A) provides:

"For purposes of this section … proceeds from a wager shall be determined by reducing the amount received by the amount of the wager."

Finally, in PLR 200532025 the IRS applied the same logic in construing the information reporting rules of IRC §6041 as applied to on-line gaming. The IRS stated:

"In Taxpayer's situation, prizes are made possible by a player having paid the entry fee to that tournament. Therefore, when the player wins a prize by successfully competing in one of Taxpayer's sponsored tournaments, the entry fee to that tournament is a return of capital. [citing Rev. Rul. 55-638] …Therefore, the amount of the prize includible in gross income is the prize amount net of the fee. Accordingly, only such net amounts are considered income for purposes of § 6041. Entry fees for tournaments where a player does not receive a prize, however, are not a return of capital, and cannot be subtracted by Taxpayer when determining the income paid to a player. Although it is possible that individual players may be entitled to deduct on their respective returns entry fees they paid to Taxpayer, the Code requires the individual players to report all of their income and to take all applicable deductions on their individual tax returns."

C. Constructive Receipt

Individual gamers and gamblers are almost always cash method taxpayers with respect to their gaming and gambling activities. As a result, they include income in "the taxable year in which actually or constructively received." Treas. Reg. §1.446-1(c)(1)(I).
In the context of casino gambling, this rule is generally easy to apply. A winner gets chips, which generally may be converted into cash at the winner's option.

In the context of on-line gambling, however, more difficult issues may be presented. Many gaming and gambling sites place restrictions on cashing out. As a result, amounts may be credited to a taxpayer's account, but remain executory promises to pay subject to limitations. In such circumstances, taxpayers should not be required to report income until those amounts are actually or constructively received.

Treas. Reg. §1.451-2(a) provides, in relevant part:

"Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

It follows that a cash method gamer or gambler should not be required to report such winnings until any such limitations or restrictions are removed.

V. Taxation of Transnational Gaming and Gambling

A. Consequences to U.S. Citizens and Residents

The United States taxes U.S. citizens and residents on their world-wide income under the ordinary rules of IRC §1. It then allows them a credit against their U.S. tax liability for foreign income taxes paid under IRC §§901 and 903. This "foreign tax credit" is limited by IRC §904, however, to a percentage of taxpayer's pre-credit U.S. tax liability equal to a fraction the numerator of which is taxpayer's foreign source taxable income and the denominator of which is taxpayer's total taxable income. U.S. citizens and residents therefore commonly care whether income is U.S. source or foreign source. They typically prefer to maximize their foreign source incomes and thereby maximize their IRC §904 limitation amounts and allowable foreign tax credits.

B. Consequences to Nonresident Aliens

The United States imposes two taxes on nonresident alien individuals. IRC §871(b) imposes the ordinary tax rules of IRC §1 on income effectively connected with the conduct of a U.S. trade or business. It is unclear what kind of on-line gaming or gambling activities of a nonresident alien individual would constitute the conduct of a U.S. trade or business of gaming or gambling unless taxpayer conducted that business from the United States or in connection with a particular U.S. gaming or gambling establishment. A nonresident alien individual engaged in such a U.S. trade or business would be taxed like a U.S. citizen or resident with respect to income effectively connected with that trade or business – in other words, in accordance with the rules described in parts I-IV above.

IRC §871(a)(1)(A) imposes a 30-percent withholding tax on specified types of U.S. source income paid to nonresident alien individuals, excluding primarily income from sales and income subject to the IRC §871(b) tax. Most U.S. source gaming or gambling income would probably be subject to this 30-percent withholding tax. IRC §871(j) then provides that:

"No tax shall be imposed under paragraph (1)(A) subsection (a) on the proceeds from a wager placed in any of the following games: blackjack, baccarat, craps, roulette, or big-6 wheel. The preceding sentence shall not apply in any case where the Secretary determines by regulation that the collection of the tax is administratively feasible."

In addition, IRC §872(b)(5) provides that: “The following items shall not be included in gross income of a nonresident alien individual, and shall be exempt from taxation under this subtitle: Gross income derived by an nonresident alien individual from a legal wagering transaction initiated outside the United States in a parimutuel pool with respect to a live horse race or dog race in the United States.”

IRC §1441(a) generally requires that the payor of any item subject to tax under IRC §871(a) deduct and withhold the 30-percent tax and remit it to the IRS. IRC §1441(c)(11) provides that:

“No tax shall be required to be deducted and withheld under subsection (a) from any amount exempt from the tax imposed by section 871(a)(1)(A) by reason of section 871(j).”

IRC §3402(q)(2) provides that if such winnings are subject to withholding under IRC §1441(a), they are not subject to withholding under IRC §3402(q)(1).

Like U.S. citizens and residents, but for different reasons, nonresident alien individual therefore generally prefer to minimize their U.S. source income. In the context of on-line gaming or gambling, they would generally prefer for prizes, awards, or winnings to be foreign source.

C. Source of Prizes or Winnings from On-Line Gaming or Gambling

1. Source of Prizes

In Rev. Rul. 89-67, 1989-1 C.B. 233, the IRS ruled that a prize paid to the winner of a puzzle-solving contest should be sourced by reference to the residence of the payor, provided that the recipient was not required to perform services for the payor.

By Treasury Decision 8615, 60 FR 44274-44275 (Aug. 25, 1995), the Treasury finalized new Treas. Reg. §1.863-1(d), which specifies the source of, among other things, prizes and awards. The new regulations follow the logic of Rev. Rul. 89-67, providing that prizes and awards are to be sourced by reference to the residence of the payor. Treas. Reg. §1.863-1(d)(2).

The Ruling, Treasury Decision, and new regulations represent a change in position. Previously, prizes for contests requiring an act of skill (like puzzle-solving) had been sourced to the country in which the act was performed. Rev. Rul. 66-291, 1966-2 C.B. 279,

revoked, Rev. Rul. 89-67, 1989-1 C.B. 233.

The new sourcing rule applies broadly. Treas. Reg. §1.74-1 defines "prizes and awards" in the following terms: "Prizes and awards … include (but are not limited to) amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types …"

On-line gaming income, other than income from wagering transactions, should therefore be sourced according to the residence of the payor. Many non-gambling gaming providers are located within the United States. Prizes or awards paid by such providers are likely to be U.S. source.

2. Source of Winnings from Wagering Transactions

The Code and regulations do not set forth any source rule for winnings from wagering transactions. In such a circumstance, the courts and the IRS generally source items by analogy to existing source rules. *Bank of America v. U.S.*, 680 F.2d 142 (Ct. Cl. 1982); Rev. Rul. 2004-75, 2004-2 C.B. 109 ("When the source of an item of income is not specified by statute or by regulation, courts have determined the source of the item by comparison and analogy to classes of income specified within the statute.")

Winnings from wagering transactions in a physical gambling establishment have been sourced to the location of the establishment. *Barba v. U.S.*, 83-1 USTC ¶9404 (Cl. Ct. 1983). Lottery winnings have been sourced to the payor's place of business. Rev. Rul. 89-67, 1989-1 C.B. 233.

Language in S. Rep. 108-192 to the Jumpstart Our Business Strength (JOBS) Act, which added IRC §872(b)(5), offers yet another possibility:

"With respect to gambling winnings of a nonresident alien resulting from a wager initiated outside the United States on a pari-mutuel event taking place within the United States, the source of the winnings, and thus the applicability of the 30-percent U.S. withholding tax, depends on the type of wagering pool from which the winnings are paid. If the payout is made from a separate foreign pool, maintained completely in a foreign jurisdiction (e.g., a pool maintained by a racetrack or off-track betting parlor that is showing in a foreign country a simulcast of a horse race taking place in the

United States), then the winnings paid to a nonresident alien generally would not be subject to withholding tax, because the amounts received generally would not be from sources within the United States. However, if the payout is made from a 'merged' or 'commingled' pool, in which betting pools in the United States and the foreign country are combined for a particular event, then the portion of the payout attributable to wagers place in the United States could be subject to withholding tax."

The Senate Report implies that the source of the winnings depends, literally, on the source of the winnings. If the winnings are drawn from a pool of bets placed in part by U.S. bettors, the Report implies, they are U.S. source in the same proportion. The Report justifies then-proposed IRC §872(b)(5) on this basis.

A source rule that looks to the composition of the pool out of which winners are rewarded might be administrable in some circumstances in connection with the 30-percent withholding tax on U.S. source FDAP, since the payor has access to the relevant information and computers can be programmed to do almost anything. It would be completely unadministrable, however, in the foreign tax credit context. Almost every bet involves a different pool with a different source composition; there would be no practical way for U.S. citizens and residents (or the IRS) to determine the source of winnings under such a rule.

In the context of on-line gambling, the source rules are presently unclear. If courts reason by analogy, then pursuant to the logic of Rev. Rul. 89-67, it seems more likely that winnings will be sourced to the payor's place of business. Since on-line gambling providers are generally located off-shore, this means that winnings paid by such providers are likely to be foreign source.

3. Implications

U.S. citizens and residents with no foreign tax credit issues should be indifferent to the location of their on-line gaming and gambling providers.

U.S. citizens and residents with foreign tax credit issues should prefer to use off-shore providers so as to maximize their foreign source income and thereby maximize their allowable foreign tax credits. This is probably a small fraction of U.S. on-line gamers and gamblers.

Nonresident alien individuals, however, should strongly prefer to use off-shore providers of both gaming and gambling services. The providers themselves should similarly prefer to be located off-shore, all else being equal, to avoid withholding problems with respect to nonresident alien customers. To avoid potential problems under Senate Report 108-192, those off-shore providers should create separate gambling pools for U.S. and foreign gamblers, if possible.

Procedural Issues
Lance Rothenberg

I. Information Returns.

A. I.R.C. § 6041, Information at Source.

1. Under § 6041, game service providers may be required to file an information retur

2. In general, when a person (the "payer") who is engaged in a trade or business makes a payment of $600 or more, in the normal course of that trade or business, to another person (the "payee"), the payer must file an information return with the Secretary of the Treasury. *See* § 6041(a).

- This is a broad requirement and the term "payment" includes rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income that are of $600 or more. *See* § 6041(a).

- The information return furnished by the payer must be "true and accurate" and must set forth the amount of such payments along with the name and address of the payee. *See* § 6041(a).

- The payer must also provide the payee with a written statement setting forth its contact information (including its name, address and phone number) along with the aggregate amount of payments shown on the information return. *See* § 6041(d).

- This payee statement must be furnished to the payee on or before January 31 of the year following the calendar year of payment.
See § 6041(d).

B. IRS Information Reporting Program.

1. The Information Reporting Program ("IRP") "is a critical component of the Service's compliance strategy directly impacting voluntary compliance levels, as well as compliance enforcement activities. Efficient operation of IRP is dependent on the receipt of timely filed and accurate information from third party payers." *See* I.R.M. § 4.6.1.1.

2. Once an information return is filed with the IRS, under the IRP, the Service will attempt to match a taxpayer's tax return with any information returns received from third parties. Therefore, the information reported by a payer on an information return must be accurate.

C. I.R.S. Priv. Ltr. Rul. 200532025 (Aug. 12, 2005).

The significance of the role of information returns in this context is well illustrated by this recent PLR. The IRS ruled that a particular taxpayer, an operator of a website conducting online game tournaments, must report a player's net winnings of $600 or more pursuant to § 6041.

II. What to Do When a Taxpayer Receives an Incorrect Information Return.

A. Contact Payer.

A taxpayer who receives an information return that she believes to be incorrect (or who fails to receive an information return that she is expecting) should first contact the payer seeking a corrected return.

Pursuant to the Taxpayer Bill of Rights 2, all payee statements required to be furnished after December 31, 1996 must include the payer's telephone number in addition to its name and address. The inclusion of the payer's telephone number was intended to facilitate necessary corrections.

B. Contact IRS.

If the payer fails to adequately correct the information return, a taxpayer should contact the Service to file a complaint.

1. The IRS can send the payer (as well as the payee) a Form 4598, "Form W-2, Form 1098 or Form 1099, Not Received, Incorrect, or Lost." *See* I.R.M. § 21.3.6.4.7.

2. Form 4598 is a complaint form, which the taxpayer may attach to her return. Note that Forms 1098/1099 are not required attachments to file a return. I.R.M. § 21.3.6.4.7.

3. The payer must respond to the IRS within 10 days of receipt of a Form 4598.

C. File Return, Disclose Position.

If the payer does not timely respond or if the taxpayer continues to disagree with the

payer, then the taxpayer should file her tax return by making a good faith estimate of any payments received from the payer (as well as any federal income tax withheld if applicable). *See* I.R.M. § 21.3.6.4.7.

1. A taxpayer should maintain all records related to the information return, the payments received and those reported in order to substantiate the return position in the event of a later dispute. *See Hall v. Commissioner*, T.C. Summ. Op. 2004-31 (2004) (finding that taxpayer did meet initial burden of asserting a reasonable dispute with respect to income reported on an information return, but failed to meet burden of persuasion in part because he failed to maintain adequate books and records); *see also* § 6001.

2. In addition to considering whether to attach a Form 4598, a taxpayer should consider whether to make an additional disclosure (using Form 8275) on her tax return explaining how she arrived at the estimate, and why the estimate differs from the information return.

Having a reasonable basis and making an adequate disclosure may constitute a defense to the accuracy-related penalty imposed by § 6662 (but only for substantial understatement of income tax for non-tax shelter items as well as for disregard of a rule).

3. If a corrected information return is ultimately furnished by the payer after a taxpayer has filed her tax return, and if the corrected information return is believed to be correct and differs from the return position, then the taxpayer must file an amended return. *See* I.R.M. § 21.3.6.4.7.

D. Do Not Ignore an incorrect information return.

Pursuant to the Service's Information Return Program, the Service can detect mismatched items of income, which may lead to an audit. *See Baptiste v. Commissioner*, 77 T.C.M. (CCH) 1606 (1999). In *Baptiste*, a taxpayer failed to report certain income reported on a Form 1099-MISC, because he believed the form was incorrect. Although the Court agreed the form was inaccurate, it determined the taxpayer nevertheless underreported his taxes and was liable for the accuracy-related penalty for negligence. *See also Mangels v. Commissioner*, T.C. Summ. Op. 2002-40.

E. Consider legal action against the payer.

1. S*ee Ward v. AFLAC*, -- F. Supp. 2d --, 2006 WL 1389816 (D.S.C. May 16, 2006). In the *Ward* case, a taxpayer-insured filed suit against an insurer for breach of a settlement agreement where the insurer had filed a Form 1099-MISC reporting certain payments made to the insured pursuant to a settlement

compensating the insured, at least in part, for physical injuries.

- The Form 1099-MISC reported the settlement payments as "other income," but the taxpayer-insured did not report any of the payments on his tax return, believing the payments were non-taxable compensation.

- The Court granted summary judgment to the insurer after determining the settlement agreement did not preclude the filing of a Form 1099, the insurer faced potential penalties for not filing an information return, and, "the ultimate decision of taxability rests with the IRS and not with the Defendant."

2. However, "if any person willfully files a fraudulent return with respect to payments purported to be made to any other person, such other person may bring a civil action for damages against the person filing such return." § 7434.

III. Payers Face Potential Penalties For Failure to File Correct Information Return.

A. Section 6721 imposes a penalty upon payers for failing to file with the Treasury correct information returns. This includes a failure to timely file the return as well as either a failure to include all of the required information or the inclusion of incorrect information. The provision carriers a penalty of $50 per return not to exceed $250,000 per calendar year. If the failure is the result of an intentional disregard of these requirements, then the penalty increases from $50 to $100 per return without an annual limitation.

B. Section 6722 imposes a penalty upon payers for failing to furnish correct payee statements. This includes a failure to timely file the statement as well as a failure either to include all of the required information or the inclusion of incorrect information. The provision carries a penalty of $50 per statement not to exceed $100,000 per calendar year. If the failure is the result of an intentional disregard of this requirement, then the penalty increases from $50 to $100 per statement without annual limitation.

C. Section 6723 also imposes a penalty upon payers for failing to comply with any specified information reporting requirement. The provision carries a penalty of $50 per failure not to exceed $100,000 per calendar year.