

Taxation of Gambling Income

By Eric Smith

Thanks to legalized sports gambling, U.S. casinos generated a record amount of gaming revenue in 2018. As might be expected, it is becoming increasingly common for individuals to have questions regarding the taxation of gambling income and losses, and these questions will almost certainly be more complex if the individual is a professional gambler. This article aims to help CPAs answer these questions for taxpayers.

Casual Gambling Income and Losses

Gambling winnings are fully taxable and must be reported by individuals as income on their tax returns regardless of the size of the winnings. Gambling income includes, but is not limited to, winnings from casino gambling (e.g., slots, blackjack, craps, roulette), lotteries, raffles, and horse and dog races. Noncash prizes such as cars and trips are normally includible in gross income at the fair market value of such prizes.

If the individual's gambling winnings exceed a certain threshold (\$600, or 300 times the amount of the wager for most types of gambling winnings), the individual will usually be issued a Form

type of game and ending when the same patron completes the last wager on the same type of game before the end of the same calendar day.

Nonprofessional gamblers report winnings as "other income" on line 21 of their tax returns. Gambling losses are deductible only to the extent of gambling winnings and are reported as itemized deductions on Schedule A that are not subject to the 2%-of-adjusted-gross-income threshold; therefore, deductions for gambling losses are not among the miscellaneous itemized deductions suspended by the Tax Cuts and Jobs Act of 2017 (TCJA). If a taxpayer does not itemize, however, gambling losses cannot offset gambling winnings. Any unused deduction for gambling losses is lost forever (i.e., the losses cannot be carried forward or back).

To substantiate their gambling winnings and losses, taxpayers are required to keep an accurate diary or similar record. The diary or record must contain the following information:

- The date and type of the specific wager or wagering activity
- The name and address or location of the gambling establishment
- The names of other persons present with the taxpayer at the gambling establishment
- The amounts won or lost.

It is extremely rare for a recreational gambler to maintain this type of detailed information. As a result, the IRS will generally also accept other evidence of gambling winnings and losses, such as printouts from the casino.

Nonresident alien individuals are also required to report their U.S.-source gambling winnings as income; however, deductions for nonresidents are only allowed if they are connected with income that is effectively connected with a trade or business. Accordingly, recreational gamblers who are nonresidents are unable to deduct their gambling losses to offset their gambling winnings.

Professional Gambling Income and Losses

Determining whether an individual is engaged in the trade or business of gambling is based on the facts and circumstances. In *Comm'r v. Groetzinger*, 480 U.S. 23 (1987), the Supreme Court concluded that "if 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." Courts have considered the following factors in assessing whether a taxpayer has the necessary profit motive (no single factor of which is controlling):

- Manner in which the taxpayer carries on the activity



W-2G from the gambling establishment reporting the income and the amount of withholding of taxes. The gambling establishment will also send a corresponding Form W-2G to the IRS.

Gambling winnings and losses are determined on a session basis rather than a per-bet basis. The IRS defines a session of play as beginning when a patron places the first wager on a particular

- Expertise of the taxpayer or his advisors
- Time and effort expended by the taxpayer in carrying on the activity
- Expectation that assets used in the activity may appreciate in value
- Taxpayer's success in carrying on similar activities
- Taxpayer's history of income or losses with respect to the activity
- Amount of occasional profits, if any, that are earned
- Taxpayer's financial status
- Elements of personal pleasure or recreation.

A professional gambler reports gambling income on Schedule C. In computing business income from gambling, the individual can net all wagering activity but cannot report an overall wagering loss. In addition, the individual can deduct any ordinary and necessary business expenses, which can include travel and meal costs, legal and accounting fees, and subscriptions to gambling magazines or services. In contrast to the rule for recreational gamblers who are nonresident aliens, professional gamblers who are nonresidents can deduct their gambling losses to offset their gambling winnings.

Prior to the TCJA, the Tax Court held that a professional gambler with business expenses in excess of net gambling winnings could report a business loss, which would generate a net operating loss. The TCJA reversed this favorable treatment for tax years beginning after 2017 and before 2026. Under the TCJA, losses from any wagering transaction during those years include any expenses incurred by the individual in connection with the conduct of gambling activity. Accordingly, a professional gambler with business expenses in excess of net gambling income would report a net profit of zero on Schedule C.

Potential Withholding Issues

Certain professional gamblers—especially poker players—will enter into “staking agreements” with benefactors, in which the benefactor financially sponsors the professional gambler and, in exchange, receives

as a return a percentage of the winnings. Such relationships can raise questions regarding the gambler's withholding and reporting requirements, especially if the benefactor is a foreign individual.

A payment to a foreign individual or entity is subject to a 30% withholding tax if the payment is fixed or determinable annual or periodical income (FDAP) from sources within the United States. The Treasury Regulations broadly define FDAP, which courts and the IRS have held to include gambling winnings. A payor of FDAP is treated as a withholding agent and is required to file Form 1042-S, reporting withholding payments to each recipient, and Form 1042, summarizing all of its

professional gamblers making payments under staking agreements to foreign payees should withhold on such payments regardless of whether the games occurred within or outside the United States.

If the payee of the staking agreements is also a professional gambler, he may be able to claim that the payments are effectively connected with his U.S. trade or business and thus exempt from withholding. Alternatively, the payee can claim that the payments are subject to reduced or no withholding based on an applicable income tax treaty between the United States and his country of residence. In either circumstance, the payments under the staking agreement may be exempt from withhold-

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Forms 1042-S. Both forms must be filed with the IRS for each calendar year by March 15 of the following year.

Payments made to a foreign person under a staking agreement would be treated as gambling winnings and thus subject to withholding if sourced in the United States. Payments made pursuant to these staking agreements for games played in the United States would be U.S.-source income generally subject to 30% withholding. Payments made under a staking agreement for games played by a U.S. person outside the United States could arguably be sourced outside the United States and thus exempt from withholding; however, there is no clear authority stating whether the site of the game or the residence of the payor is the decisive factor here. Accordingly,

ing if the payee provides the appropriate withholding certificate.

The Downside of Winning

The tax consequences to an individual with gambling income and losses can vary significantly depending upon whether the individual participates in the gambling activities on a recreational basis or as a professional gambler. CPAs whose clients have gambling income and losses will need to understand the specific manner in which those clients engage in such activities and, in certain circumstances, whether they have additional reporting and withholding requirements. □

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