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## Gambling with your Taxes

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During the recent summer Olympic Games we learned that Canadians, Americans and athletes from other countries receive a financial bonus for each medal they win, the size of the bonus depending upon the colour of the medal.<sup>1</sup> This income is also taxed, a fact that is stirring legislators in the U.S. this fall to propose a tax exemption for Olympians. Some decry another tax break for multi-millionaire NBA professional basketball players and other heavily-sponsored athletes. If these earnings are taxable, what deductions might be claimed to earn this income?

Also circulating is the myth that American athletes are even taxed on the metallic value of those same medals. While this is a reasonable technical interpretation of the U.S. *Tax Code*,<sup>2</sup> and the Canadian *Income Tax Act*, this is not happening, if only because the economic value of the mineral content in the medals is rather paltry. In the lead-up to the 2000 Olympics in Sydney, it was also feared that Australian tax authorities would levy tax on these bonuses as income derived from performance that took place in Australia. That did not happen either.

Tax policy ignites passions and debates because, in the process of raising money for public purposes, incentives and disincentives toward various economic activities are created. Infrequent events, such as skill-based Olympic medals or luck-based lotteries can be ramped up from occasional “prizes” to something akin to a regular business. This article examines the Canadian tax treatment of income from winning and losing – not from athletic competition but from gambling.

In 2010, according to Statistics Canada, \$13.7 billion in net revenue was generated from government-run gaming activities,<sup>3</sup> rendering gambling the largest entertainment industry in this country. It is useful, therefore, for taxpayers to understand how gambling income and losses are taxed under the *Income Tax Act* of Canada.

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## Income from Gambling

Are gambling winnings a “prize” under the *Income Tax Act*? Money received as scholarships and bursaries or “a prize for achievement in a field of endeavour ordinarily carried on by the taxpayer” is taxable (s.56). What the *Act* calls “windfalls” – occasional lotteries and sweepstakes, for example – are *not* taxable. “Prescribed prizes” awarded for meritorious achievement in the arts, sciences or public service are also exempt from taxation. This explains why income from a Nobel or literary prize would be non-taxable, but Olympic income (which is not art, science or public service) is taxable.<sup>4</sup>

Canadians who gamble seriously, even for a living, could have their winnings taxable as “prizes” (although no judicial decisions yet confirm that) or more likely as income from *business*. Taxable income encompasses total income from four sources – office, employment, business and property (s.3 (a)). While notions of office, employment and property do not readily apply to gambling activity, *business* is defined as “a profession, calling, trade, manufacture or undertaking of any kind whatever . . .”(s. 248(1))

When gambling is business, one’s “income (and loss) for a taxation year from a business . . . is the taxpayer’s profit (and loss) from that business . . . for the year.” (ss.9(1) and 9(2)) Given the broad definition of a business, what is the basis for determining when a gambling activity is in fact and in law a business?

## Governing Principles: “Reasonable Expectation of Profit” or “Pursuit of Profit”?

The Supreme Court of Canada stated in the 1978 case of *Moldowan v. The Queen*:

*In order to have a “source of income” the taxpayer must have a profit or a reasonable expectation of profit. . . . Whether a taxpayer has a reasonable expectation of profit is an objective determination to be made from all of the facts. The following criteria should be considered: the profit and loss experience in past years, the taxpayer’s training, the taxpayer’s intended course of action, the capability of the venture as capitalized to show a profit after charging capital cost allowance. The list is not intended to be exhaustive. The factors will differ with the nature and extent of the undertaking.*

This “REOP” test determined if a taxpayer could deduct losses from business. A problem arose because the REOP test did not distinguish between regular business activities and personal hobbies. This “type of activity” issue, which relates to taxation of gambling gains and losses, was resolved a decade ago in the 2002 Supreme Court of Canada case of *Stewart v. Canada*.

As an experienced real estate investor (which some say is itself a form of gambling), Brian Stewart borrowed large sums of money to purchase four condominium units as rental properties in 1986. Owing to unfavourable economic conditions, his rental income was less than projected. Stewart claimed losses of \$27,814, \$18,673, and \$12,306 between the years 1990 and 1992, representing significant interest expenses on his loans. His claims were disallowed by the Canada Revenue Agency, based on the REOP test. The courts concluded that Stewart’s flawed investment model did not have a reasonable chance of earning a profit.

The Supreme Court of Canada ruled that the “REOP test is problematic owing to its vagueness and uncertainty of application; this results in unfair and arbitrary treatment of taxpayers. As a result, ‘reasonable expectation of profit’ should not be accepted as the test to determine whether a taxpayer’s activities constitute a source of income” (para 47). The Court adopted a new two-part approach, known as “the pursuit of profit test”:

- (i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour? This first stage of the test searches for a source of income; and
- (ii) If it is not a personal endeavour, is the income source a business or property? This second stage categorizes the source as either business or property (para 50).

Applying the pursuit of profit test, the Court ruled Stewart was entitled to claim his losses because his real estate investment was undertaken solely for the pursuit of profit even if his business model was flawed.

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## Application of the Pursuit of Profit Test to Gambling

When is gambling undertaken in pursuit of profit and when is it a mere personal endeavour? There is a clear personal entertainment return on gambling which may outweigh the realistic expectation of winning, but thrill and pleasure are sought in business too.

In the 2006 case of *Leblanc v. The Queen*, the Leblanc brothers won an average of \$650,000 per year between 1996 and 1999 by gambling on sports lotteries in Ontario and Quebec. The brothers wagered \$10 to \$13 million per year, developed a computer program to analyse bets, and negotiated a 2-3% discount from ticket retailers. The Canada Revenue Agency treated this gambling operation as a business, “because it was managed and organized with the object of realizing a profit (para 7).” However, the Tax Court, acknowledging “that certain types of gambling can in some circumstances be a business but it is a rare circumstance (para 36),” characterized these gambling activities as a personal endeavour (para 48):

*The appellants [the Leblanc brothers] are not professional gamblers who assess their risks, minimize them and rely on inside information and knowledge and skill. They are not like the racehorse-owner, who has access to the trainers, the horses, the track conditions and other such insider information on which to base his wagers. Nor are they seasoned card players or pool players who prey on unsuspecting, inexperienced opponents. Rather, they are more accurately described as compulsive gamblers, who are continually trying their luck at a game of chance.*

The same result obtained in 2011 for Stephen Cohen in a Tax Court of Canada decision in Toronto. Cohen claimed that he was engaged in the full-time business of poker playing and ought to be entitled to claim losses of \$121,991.43 during the 2006 taxation year. He had logged more than 2,500 hours of playing time, entered frequently into tournaments, and studied the game through books and seminars. The Tax Court judge denied Cohen the deduction of his poker losses on what was arguably a mistaken application of the *Stewart* “pursuit of profit” test – that there was an element of personal consumption to the gambling. The judge said that poker, “generally recognized as a gambling activity, is not an activity that I or many courts before me, could find has no personal element. (para 18)” It probably did not help Cohen’s case that he was also working for at least part of the year as a lawyer at a “large Toronto law firm” and had been a hobby poker player for a dozen years prior.

The last judicial decision, by the Federal Court of Appeal in the case of *Tarascio v. Canada*, was issued in January of 2012. Giuseppe Tarascio, a technician in the employ of Bell Canada in Toronto, said he earned income through a wide range of gambling activities (“horses, slots, casino games, and lotteries”) undertaken during evenings and weekends. In his income tax returns in 2002 and 2003, he claimed net business losses of \$40,950 and \$56,000 respectively after deducting gambling losses from his winnings. These deductions were disallowed because the gambling activities did not constitute a business.

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Three reasons were given for denying business status to Tarascio's gambling.

- While he had books and records of his gambling activity, these records were prepared to support his position in Tax Court. They were, therefore, "of little value in proving that he was conducting a business."
- Secondly, it was not a business "because he loved the thrill of gambling."
- Finally, he had "little by way of a systematic method for gambling and spent no time practising his skills." His appeals to the Tax Court and the three-judge Federal Court of Appeal were dismissed.

## Conclusion

The *Income Tax Act* and the judicial decisions interpreting and applying it fail to provide a predictable framework for analysing the taxability of gambling wins and losses in the context of a business. This is not surprising, since the "pursuit of profit test" was not developed with gambling businesses in mind. The three cases described in this article all involved taxpayers seeking to deduct gambling losses and it was easy to deny all of them.

The reasons for denying "business" status to occupation gamblers were variable and deviated from the "pursuit of profit test," which admittedly is itself highly subjective. All business activity presumably enjoys a combination of both "pursuit of profit" and "personal endeavour" elements. Investment in real estate – while risky, speculative and by nature a gamble – is consistently viewed as a traditional business. Casino or card gambling, on the other hand, regardless of the risk, is not generally viewed as a business, as much as it is seen as a diversion or entertainment.

This leads to distorted analysis and double standards. Some forms of gambling are arguably as tactical and strategic as some forms of business. Imagine any other commercial venture been disqualified as a business simply because the business person maintained poor books and records, "loved the thrill of" the business too much, or was not "systematic," spending too little "time practising his (business) skills."

We predict that if and when the Canada Revenue Agency someday seeks to tax significant gambling *winnings* of which it is aware, it will discover greater interpretative ease to designate these net winnings as *income from a business*. In doing so, a new analytical precedent will be created, nuanced perhaps around the dichotomy of chance versus skill. For example, lotteries and slot machines, being essentially games of chance, might be non-taxable personal endeavours. Poker and other card games may be more skill-based (but this is debatable) and tax-worthy.<sup>5</sup> In any event, the line-drawing here will be a complex and inherently arbitrary exercise.

Until then, the Agency and the tax courts remain secure in the knowledge that more gamblers over the long term lose money

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than make it. They will disregard occupational gamblers seeking tax deductions as “compulsive gamblers, who are continually trying their luck at a game of chance”, imply that authentic business gamblers must “prey on unsuspecting, inexperienced opponents” (*Leblanc*), or dismiss them as “hobbyists” (*Cohen*) or mock them with language like “lifelong gambler . . . he says that gambling is his calling” (*Tarascio*). They will continue to deny the deduction of significant, documented gambling losses on the unarticulated grounds that gambling is insalubrious, unproductive and not to be encouraged as a matter of policy, except as a potentially-ruinous, highly regulated (barely legal) entertainment activity. This conceptual approach logically holds that losses voluntarily incurred in *gambling*, itself still a pejorative pursuit, should not be subsidized by other Canadian taxpayers.

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To conclude, today in Canada gambling winnings and losses are unlikely to be characterized by the tax authorities and courts as prizes or income or loss from *business*. Consequently, they are neither taxable nor deductible. This is good news for those few taxpayers who do gamble and end on the positive side of the ledger.

Indeed, that is a happier tax result than winning an Olympic medal.

## Notes

1. For Canadian medalists: \$20,000 (gold), \$15,000 (silver) and \$10,000 (bronze). American medalists receive \$5000 more for each gold medal. Singapore pays \$1 million for a gold medal (not yet won). That country has won only 4 medals in its history, two of which (both bronze, paying \$250,000 each) were earned in London 2012 in table tennis by a foreign-born athlete. In the U.K., gold medalists get their faces on a postage stamp which, while much harder to tax, seems to have served as adequate incentive for Team G.B.
2. Reg. § 1.74-1(a)(2). See also: *Commissioner v. Wills*, 411 F.2d 537 (9th Cir. 1969)
3. [Canada, Gambling 2011](#)
4. See Lindsay Tedds, “Faster, Higher, Richer: Should Olympic Medal Winners be Taxed?” *Globe and Mail*, August 13, 2012.
5. [Croson R., Fishman P., and Pope D. Poker Superstars: Skill or Luck?](#)

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