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A Tax Trifecta

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Abstract
The author reviews several cases dealing with the taxation of income from gambling.

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A TAX TRIFECTA

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Gambling is widely considered to be an irrational activity, uncertain as to result. For this reason, gains and losses due to gambling have not been treated as taxable events, except in very limited circumstances. From time to time, however, a taxpayer attempts to deduct gambling losses or the Commissioner attempts to assess gambling winnings and the question of taxability of gambling is raised again. As often as not gambling gains are uncovered in assets betterment exercises by the Commissioner.

The last half of 1989 saw three tax decisions concerning taxation of gambling. Each decision purported to further define the circumstances under which gambling could be a business, and hence produce taxable income, although none of the cases went so far as to find such a business in existence.

The English case of *Graham v Green* [1] is considered the leading case for the principle that gambling is not assessable. That decision focussed principally on the irrational nature of gambling. It offers Australia little more than the basic principle that the proceeds of casual betting cannot be taxed, since the actual statutory language considered in that case differs greatly from that of the Income Tax Assessment Act.[2] Since *Graham v Green*, however, a line of cases has developed in Australia producing several tests for determining when gambling may be a taxable event. They reveal the necessity to consider both subjective–what did the taxpayer think he was doing–and objective–what does it look like the taxpayer was doing - matters.

In *Jones v Federal Commissioner of Taxation*,[3] the taxpayer considered himself to be in the business of gambling and sought unsuccessfully to deduct his losses. As nothing about his conduct was businesslike and he had no connection with horseracing other than his unsuccessful betting, it was not difficult for the court to find the objective evidence against the existence of a business far outweighed the subjective wish for the contrary.

1 [1925] 2 KB 37.
2 Cf *Federal Commissioner of Taxation v Harris* (1980) 80 ATC 4238, in which Bowen CJ cautions against reliance on English tax cases because of the difference in statutory language. Cf Hill J in *Babka v Federal Commissioner of Taxation* (1989) ATC 4963.
3 (1932) 2 ATD 16.

The same judge had a very different set of facts to consider four years later in *Trautwein v Federal Commissioner of Taxation*[4] where the taxpayer, a successful gambler, owned a successful stud farm and aggressively cultivated 'valuable racing information'. Although he did not keep written records, he was systematic in placing his bets. The court found the taxpayer so absorbed in successful betting that 'it is not possible to find that the element of sport or pastime or amusement either dominated or was the main factor in these transactions'.[5] He was held to be in the business of gambling and his winnings, as proceeds of that business, were taxed.[6]

Other than *Trautwein*, the cases in which gambling has been found to produce assessable income have all involved taxpayers with businesses related to their gambling. In particular, insiders, such as bookmakers or jockeys, who place bets can expect to pay tax on their winnings.[7]

In a few cases where taxpayers owned horses, their gambling was not considered taxable. Like the taxpayer in *Trautwein*, the taxpayer in *Martin v Federal Commissioner of Taxation*[8] owned his own racehorses and used a system in placing his bets. The court felt, however, that the relatively small sizes of his bets, along with the fact that he frequented only one racecourse and only on regular race days, indicated that he was no more than a 'keen follower of the turf'.[9] Similarly, the taxpayer in *Shepherd v Federal Commissioner of Taxation*[10] was found not to be in the business of gambling where she had long been an amateur horse trainer and small time gambler and had only won big in betting on one of her own horses.

The size of the taxpayer's gambling-related activities and the extent to which the betting is organised in a systematic way were important factors in these cases. The same criteria were used and further developed in the three recent cases.

In the first case, *Evans v Federal Commissioner of Taxation*,[11] which has many factual similarities to *Trautwein*, the taxpayer was a Sydney University dropout who apparently enjoyed more success at the track than in academia. He used his gambling winnings from over the years—which he had always noted on his returns as hobby gains—to purchase a variety of businesses, including the hotel he operated during the tax years in question. The taxpayer did not keep precise records but rather roughly calculated his winnings or losses based on the net difference between the value of his assets at the beginning and end of each year.

4 (1936) 56 CLR 196.
5 Ibid 206.
6 The fact that the taxpayer had originally claimed deductions for betting losses from 1915 to 1923 was probably also influential.
7 See, eg, *Commissioner of Taxation V MacFarlane* (1952) 5 AITR 264 (jockey), *Prince v Federal Commissioner of Taxation* (1956) 7 AITR 505 (bookmaker, horse owner/trainer).
8 (1953) 90 CLR 470.
9 Ibid 479.
10 (1975) 75 ATC 4244.
11 (1989) 89 ATC 4540.

He owned several untalented racehorses over the years which were ultimately sold at a loss.

In spite of the fact that the court found that Evans 'clearly financed his lifestyle out of his gambling wins',[12] it was quick to distinguish *Trautwein* on the basis of the stud farm and Trautwein's systematic approach to his betting, which factors had put Trautwein beyond the realm of a 'mere punter'. Hill J held that while Evans was 'addicted' to gambling, he was not a professional punter. He lacked sufficient system or organisation.[13]

Hill J listed '[p]rofit motive, scale of activity, whether ordinary commercial principles are applied characteristic of the line of business in which the venture is carried on, repetition and a permanent character, continuity, and system' as 'indicia to be considered'.[14] He then cited the ever-present element of chance to discount the possibility of a business, intimating that mitigation of the element of chance through use of a system might make a difference. Finally, however, the fact that the taxpayer, who did not use a computer, maintain an office, use inside information, or study the racing form extensively, was not using a system or operating in a systematic manner led to the determination that no business was being carried on.[15]

The court also noted that the taxpayer made his bets without knowledge of the odds and frequently placed bets on 'trifectas, quinellas and other exotic kinds of bets' and concluded that the taxpayer gambled for the thrill of gambling.[16]

Although Hill J observed that gambling in connection with another related business is more likely to be a business itself, it also found that the taxpayer's ownership of racehorses was not a business, as his prime motivation appeared to be not profit but 'the pleasure and prestige of winning races with his own racehorses'.[17] Certainly the fact that the taxpayer's ownership of racehorses had been a 'financial disaster' and the evidence that the taxpayer knew nothing about horses, aided the court in reaching this conclusion.

The second decision, *Babka v Federal Commissioner of Taxation*,[18] also by Hill J, further developed the notion that the objective facts are dispositive in determining whether an avid punter is in the business of gambling. The taxpayer in *Babka* was a retired public servant who 'played the ponies' regularly. Like Jones, he did not own any horses or have any other connection with the profession. He did, however, keep 'meticulous' records of the horses he bet on, the odds on them and the results of his bets which became for him an 'encyclopaedia' which was used for reference when placing subsequent bets. He also admitted that he 'placed

12 Ibid 4557.
13 Ibid 4558.
14 Ibid 4554.
15 Ibid 4548.
16 Ibid 4548.
17 Ibid 4550.
18 (1989) 89 ATC 4963.

bets in accordance with a number of guiding principles'.[19] The taxpayer frequently bet doubles, trifectas and quinellas, although he usually hedged his bets by placing a number of different combinations.[20]

The court first dealt with whether 'mere punting'—placing bets but having no other connection to the profession—could actually be considered a business activity. After marshalling the arguments pro and con, Hill J decided that in light of modern technology it would indeed be possible to be 'so organised, systematic and businesslike' in one's betting that it could be a business activity, although he added that 'the intrusion of chance into the activity as a predominant ingredient at least in the outcome of the race itself does suggest to me that it will be a rare case where a court will conclude that the activity is a business.[21] *Babka* was not that rare case.

The court felt that the taxpayer's reliance on 'judgment and instinct' in addition to his other 'guiding principles' negated[d] the concept of system and organisation which is the hallmark of a business'.[22] It also found that the taxpayer's encyclopaedic notebook was not maintained for the purpose of financial recordkeeping, thereby eviscerating its importance. The time spent by the taxpayer at his betting was also discounted; 'a pastime does not turn into a business merely because the person who engages in it has retired from a previous full-time profession'.[23] Noting that the way Babka bet 'was not greatly different from the way other persons who bet at the racecourse for pleasure go about it', the court concluded that the facts 'fall short of showing that the taxpayer carried on a business'.[24]

In the third case, *Brajkovich v Federal Commissioner of Taxation*,[25] the taxpayer retired at age 36 from his other endeavours in order to concentrate on gambling. He owned a number of racehorses, regularly attended the races, bet on credit, and also played cards and two-up. He considered himself to be in the business of gambling and sought then to claim his gambling losses as deductions.

The court identified six principal criteria by which the existence of a gambling business could be determined:[26]

1 whether the betting is conducted in a systematic, organised and 'businesslike' way;

2 its scale: ie the size of the wins and losses;

3 whether the betting is related to, or part of, other activities of a businesslike character, eg breeding horses;

4 whether the bettor appears to engage in his activity principally for profit or principally for pleasure;

19 Ibid 4966.
20 Ibid 4970.
21 Ibid 4969.
22 Ibid 4970.
23 Ibid 4971.
24 Idem.
25 (1989) 89 ATC 5227.
26 Ibid 5233.

5 whether the form of betting chosen is likely to reward skill and judgement or depends purely on chance;

6 whether the gambling activity in question is of a kind which is ordinarily thought of as a hobby or pastime.

The court commenced to apply these six criteria to the taxpayer's activities, finding that the taxpayer had not kept distinct records or otherwise behaved in a 'businesslike' way, that the gambling had been extensive, that the taxpayer had kept racehorses—although he claimed to have regarded that as ancillary to his gambling, and that the taxpayer and his family were supported from a trust account remnant of an earlier real estate business so that they were not reliant on profits from the gambling, since indeed there were none. At this point, however, the court's analysis dries up. It observes that two-up is clearly a game of pure chance but does not discuss any skill the taxpayer may have had in punting or card games.

There is also no discussion of the pastime aspect of the type of gambling engaged in by the taxpayer. Instead of discussing the last two criteria, the court reverts back to *Graham v Green* for the proposition that gambling winnings are not assessable income and concludes with its own opinion: 'gambling, unconnected with what might ordinarily be regarded as commercial activity, has no tax implications unless it is of itself, or is an aspect of, a business'.[27] This is the point at which the court began its consideration. As such, it begs the question and offers very little guidance for future cases.

The general rule prior to the decisions in the three 1989 cases was that only an insider—someone closely related to the profession like a bookmaker or jockey—could expect his winnings to be taxed. This rule continues to hold.[28] These cases have not presented any new criteria to consider in determining the existence of a business of gambling. Rather they have simply assembled the criteria.

The principles for identifying the nature of the taxpayer's undertaking have been delineated by *Evans* and summarised by *Brajkovich*. The systematic and organised manner of the betting, its scale, the taxpayer's other involvements in the profession, and whether the form of betting used requires skill are all quantifiable, objective criteria. Complete financial recordkeeping and other systematic and organised businesslike behaviour as well as the use of computers to minimise the risk involved in betting are facts that would indicate a business.

The remaining principles outlined in the 1989 cases, namely whether the gambler's principal goal was profit or pleasure and whether the activity is one ordinarily considered a pastime, require subjective assessments by the court. The courts' application of the latter principles and their reliance on those two factors in passing judgment show a strong

27 Ibid 5234.

28 *Trautwein* remains an anomaly and it is, perhaps, noteworthy that the judge in *Trautwein* was not a punter himself, admitting that he gained his knowledge of the sport from the Commissioner's cross-examination of the taxpayer: 56 CLR at 210. Perhaps he is the exception, rather than the rule among judges.

tendency to adhere to their own preconceived notion that gambling proceeds are not assessable income. Perhaps they would do well to give more consideration to substance over form, particularly where it is clear that the taxpayer's quality of life, ie his livelihood, depends on the gambling proceeds.

Courts in other jurisdictions have shown willingness to do this. In New Zealand, as in Australia, gambling winnings are taxable if part of a larger business. See eg *Commissioner of Taxation v MacFarlane*[29] (taxpayer was a jockey). In *MacFarlane*, however, Stanton J noted that 'it is difficult on any logical ground to justify the distinction between systematic betting by a mere punter with no racing background and similar betting by a person associated with racing activities'.[30] Cooke J used this in *Duggan v Commissioner of Internal Revenue (NZ)*[31] to find taxable the gambling winnings of a wool and skin buyer with no business connection to racing who regularly attended races, and regularly placed bets. There was no discussion of gambling as a pastime or whether the taxpayer might have enjoyed his gambling venture, although the court did note that the taxpayer depended on his winnings to support his family.

The reluctance of Australian courts to find a taxpayer to be in the business of gambling may be due to concern about the long-range ramifications of such a finding, which could open the way for a flood of claims to deduct gambling losses.[32] The gist of the decisions thus far, however, is that an unsuccessful gambler will have a much more difficult time proving the operation of a business.

It would seem that in the 1989 cases the courts have closed, but not locked, the door to the notion that gambling can be a business and hence, taxable. Unfortunately for the unsuccessful gambler, there is a strong implication that he will never be found to be in the business of gambling. In spite of that, the taxability of the successful gambler has also been limited to the extreme case of a very successful gambler with impeccable records, other strong connections to the game being gambled on and no sources of income unrelated to the gambling. Certainly a gambler with other income sources, who makes 'exotic' bets and at least gives off the appearance of betting for fun, need not be too concerned at this point.

29 [1952] NZLR 349.

30 Ibid 377; cf CCH, *New Zealand Income Tax Law and Practice* 2061.

31 (1973) 73 ATC 6001.

32 In the US, where gambling winnings are assessable and indeed 20% is withheld when a winner is paid, losses are deductible only to the extent of winnings. See generally, Bittker, Stone and Klein, *Federal Income Taxation* (6th edn Little, Brown & Co 1984). While this may, at first blush, seem inequitable, it avoids the recordkeeping and proof problems inherent with deductibility of losses. Of course, the courts cannot go so far as to construct a rule such as this without appropriate legislative directive, but it is interesting to note this approach when considering how the problem should be treated.

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