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Taxation of Electronic Gaming

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Abstract

At a doctrinal level, the subject of this Article is timely. During this time of the coronavirus pandemic, casinos have been closed and large populations have been subject to stay-home orders from local and state authorities. One can reasonably expect a large increase in electronic gaming and thus an increased need for proper consideration of its taxation. This Article argues for a cash-out rule of taxation.

At a deeper level, the subject of this Article is timeless. Tax law is wickedly complex for a reason. This Article explores that complexity using the example of electronic gaming. It grapples with the source of that complexity: an inherent and unresolvable tension between economic theories of income and the practical needs of administering a system of taxation to a large population in a democracy. That tension led some scholars to argue for a standards-based approach to taxation. This Article considers and rejects that argument. Legal rules are necessary to mediate between theory and practice. Hence, this Article demonstrates the continued relevance and importance of doctrinal analysis in legal scholarship.

 Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He thanks the following folks for their many useful comments: Leandra Lederman, Ted Seto, Bruce McGovern, and Susie Morse. Camp also thanks Charles Blevins for his great help in understanding casino operations. Finally, Camp thanks Texas Tech School of Law for funding this research. Any errors the reader finds are likely due to Camp's intransigence or incompetence, take your pick.

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I. Introduction

When I was young and full of quarters, I became an expert at the video arcade game "Defender." This was a game where you manipulated your spaceship to save humanoids from being abducted by aliens.[1] Saving humanoids and destroying aliens earned you points. You played until your spaceship was destroyed (the aliens shot back). The game started with three ships, and you won a new ship for each 10,000 points you scored. Each ship thus represented a "unit of play."[2] How long that unit of play lasted depended on luck and skill. Successful players won more ships, and thus more "play" for their quarter. After several months and massive numbers of quarters, I reached the point where I could play for hours on a single quarter, amassing forty to fifty ships before heading off to lunch (or class) and letting others take over. I got a lot of play for my money.

No one thought that the extra ships I won counted as gross income under 26 U.S.C. § 61.[3] To be sure, I would have income if I had cashed out by selling the use of those virtual ships to other players. But there was no need to even think about taxes unless and until I engaged in a market transaction trading the virtual units of play for cash.

Electronic gaming has moved far beyond the video arcades of my misspent youth. Players now play, not for virtual lives, but for virtual dollars that can, in some games, be redeemed into real money. Some players play online games of skill, wagering bets on the outcome. The gaming site takes a rake of the virtual pot and the winners' gaming account gets credited for the rest, which they can either redeem for cash or use for more play.

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1. For a more complete description of the game, see *Defender: Classic Arcade Game Video, History & Game Play Overview*, ARCADE CLASSICS, https://perma.cc/8GQ9-Z6BY (last visited Jan. 23, 2020) (on file with the Washington and Lee Law Review).

2. *See id.*(discussing the point rewards system for accomplishments in Defender).

3. All references to statutes and sections in this paper are, unless otherwise noted, to the Internal Revenue Code, codified as Title 26 of the U.S. Code.

Other players visit brick and mortar casinos but still create electronic gaming accounts, receiving plastic Player Cards with magnetic strips or microchips.[4] The gaming accounts not only track play (to determine comps) but also keep a running account of each player's gaming account balance. When players win a pull at the slot machine, they do not receive coins (although the machine makes all those exciting sounds). They instead receive a credit on their gaming account which they can either redeem for cash or use for more play.

In both cases—the online gaming account or the casino Player Card account—the electronic units of play come in the form of game credits, similar to the "extra lives" I used to win. Just as with Defender, successful players win more units of play and thus play on their initial stakes longer than unsuccessful players. Unlike my virtual ships, however, these units of play are redeemable for cash. Casinos and website owners are required, either by contract or law, to allow players to cash out, at fixed rates of exchange. To the Internal Revenue Service (the Service, or IRS) and to commentators, that distinction makes all the difference: redeemable units of play are gross income.[5]

The problem presented by redeemable game credits presents a lovely opportunity to explore the interplay of tax theory and tax practice. That exploration also illustrates the importance of legal doctrine as a subject of academic study. Legal doctrines mediate theory and practice. Getting the legal rules right is important. In the case of redeemable game credits, the wrong legal doctrine (the constructive receipt rule)

4. This Article does not directly address online poker sites such as www.WSOP.com. As of March 2020, five states—Delaware, New Jersey, Nevada, Pennsylvania, and West Virginia—permit online poker sites for "real money." This Article's thesis and analysis, however, should apply equally to such gaming sites. *See* Cliff Spiller, *Is Online Poker Legal in the USA?*, US POKER SITES (Aug. 20, 2010) https://perma.cc/WY9F-GK2P (last updated Jan. 6, 2020) (last visited Mar. 4, 2020) (noting state-by-state legality of online poker) (on file with the Washington and Lee Law Review).

5. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2005-32-025 (May 3, 2005) (stating that a casual game player has income on a per-game basis to the extent the prize won in the game is greater than the entry fee); Theodore P. Seto, *When Is A Game Only A Game?: The Taxation Of Virtual Worlds*, 77 U. CIN. L. REV. 1027, 1043 (2009) (arguing that redeemable credits are gross income when earned).

creates practical and theoretical problems. The correct legal doctrine (a cash-out rule) produces harmony between theory and practice even though it does not fully reconcile one to the other.

Part II presents the background necessary to understand the difficulty current law has in dealing with redeemable game credits. It explains the limitations of current guidance and reviews the two approaches that the Service has taken towards deciding how taxpayers must report income from gaming activities: (1) a per-transaction approach; and (2) a per-session approach.

Part III discusses the practical problems presented by current doctrine. Those problems affect both taxpayers and also tax administration.

Part IV discusses the theoretical problem: should redeemable game credits count as gross income? The answer to that question allows a deep exploration of how the legal meaning of gross income is subject to competing economic and accounting concepts, which have traditionally been reconciled by the practicalities of tax administration in a democracy through legal rules. Realization and imputed income are two legal doctrines relevant to this issue that operationalize the economic theory of income into an administrable legal regime.

Part V considers and rejects the idea that the legal concept of income should be viewed as a standard, as Professors Abreu and Greenstein have suggested.[6] While I am in sympathy with their underlying concern that legal doctrines not be enslaved to economic theory, I believe redeemable gaming credits illustrate how their idea risks giving too much weight to operational considerations. Just as the theory of gross income should be bounded by operational considerations, so should operational considerations be bounded by theory. At bottom, the legal definition of income should be neither purely

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6. *See, e.g.*, Alice G. Abreu and Richard K. Greenstein, *It's Not a Rule: A Better Way to Understand the Definition of Income*, 13 FLA. TAX REV. 101, 104 (2012) [hereinafter *It's Not a Rule*] (discussing the necessity of viewing income as a standard to provide a flexible approach to unforeseen cases); *see also* Douglas A. Kahn, *Exclusion from Income of Compensation for Service and Pooling of Labor Occurring in a Noncommercial Setting*, 11 FLA. TAX. REV. 683, 697 (2011) (considering the exemption of income from noncommercial activities from taxation).

ontological nor purely opportunistic. One needs legal rules to draw appropriate lines. Part VI concludes by explaining why a cash-out rule is the appropriate rule to use in the taxation of electronic gaming.

II. Two Facets of Electronic Gaming

"My problem lies in reconciling my gross habits with my net income."—Errol Flynn[7]

"I must have gone through $10 million during my career. Part of the loot went for gambling, part for horses and part for women. The rest I spent foolishly."—George Raft[8]

The worldwide casual game market is a well-established multi-billion dollar economic segment. The United States is the second largest market, accounting for some $35.5 billion in 2018.[9] In 2018, over 2.3 billion people worldwide were playing casual games.[10] They were spending an average of six hours per week on their games.[11]

A significant part of the general casual game market involves sites that allow players to accumulate redeemable game credits, otherwise known as "real money" games.[12] A single such provider, Worldwinner.com, claims to have over 30

8. *Errol Flynn*, IMDB, https://perma.cc/9ZHU-W9V6 (last visited Jan. 8, 2020) (on file with the Washington and Lee Law Review).

8. *George Raft*, IMDB, https://perma.cc/Q6YZ-GQZ4 (last visited Jan. 8, 2020) (on file with the Washington and Lee Law Review).

9. *See Top 10 Countries/Markets by Game Revenues*, NEWZOO, https://perma.cc/VJZ6-84NX (last visited Jan. 8, 2020) (providing information on annual revenue generated by games for different countries) (on file with the Washington and Lee Law Review).

10. *See* Tom Wijman, *Newzoo's 2018 Report: Insights Into the $137.9 Billion Global Games Market*, NEWZOO, https://perma.cc/2G8W-XB9Q (last visited Jan. 8, 2020) (highlighting the significant portion of the population who play games) (on file with the Washington and Lee Law Review).

11. *See The State of Online Gaming 2018*, LIMELIGHT NETWORKS, https://perma.cc/84VV-2467 (last visited Jan. 8, 2020) (detailing the amount of time different subsets of gamers spent playing games each week) (on file with the Washington and Lee Law Review).

12. *See* Will Yakowicz, *The Booming Business of Cash Prize Gaming*, INC.COM (May 28, 2014), https://perma.cc/MD6B-GVC9 (last visited Jan. 8, 2020) (on file with the Washington and Lee Law Review).

million users worldwide.[13] Independent analytics show an average of 1.5 million visits to Worldwinner per month in 2018 from United States users.[14] Another real money gaming website is Skillz.com.[15] In 2018, Skillz.com, claimed to have 18 million users who played tournaments for cash prizes.[16] Fantasy sports sites attracted some 59 million players in 2017.[17] A market research company put the annual revenue in 2019 at over $8 billion.[18]

Casino play dwarfs casual online gaming. Planes, trains, and buses shepherd flocks of players through casino doors daily, most of whom play for the sheer fun of it. In 2018, the UNLV Center for Gaming Research reported that casinos sheared over $47.8 billion from players.[19]

While casual online gaming differs dramatically from casino play for some purposes—notably for laws governing gambling—these two forms of recreation are very similar for

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13. *See WorldWinner and PopCap Expand Relationship*, GAMES INDUS. (Dec. 3, 2007), https://perma.cc/4BZH-RHHY (last visited Jan. 8, 2020) (on file with the Washington and Lee Law Review).

14. *See WorldWinner.com Traffic Overview*, SIMILARWEB, https://perma.cc/U2LE-EM44 (last visited Jan. 8, 2020) (on file with the Washington and Lee Law Review).

15. *See* Scott Rayburn, *Skillz Brings Real-Money Gaming to the U.S.*, ADWEEK (Apr. 30, 2013), https://perma.cc/PPK7-JUB6 (last visited Jan. 8, 2020) (describing Skillz.com as a "first-of-its-kind" platform) (on file with the Washington and Lee Law Review).

16. *See* Annie Pei, *Skillz Hands Out over Half a Million Dollars in Prizes Every Day to Mobile Gamers. Here's What That Means for the Future of Esports*, CNBC (Nov. 10, 2018), https://perma.cc/EG2C-LRXR (last visited Jan. 8, 2020) (finding that players of Skillz's games "collectively earn over $675,000 in prizes on average") (on file with the Washington and Lee Law Review).

17. *See Industry Demographics*, FANTASY SPORTS & GAMING ASS'N, https://perma.cc/9LGC-YYH2 (last visited Jan. 8, 2020) (illustrating the widespread popularity of fantasy sports games in North America) (on file with the Washington and Lee Law Review).

18. *See Fantasy Sports Services Industry in the US—Market Research Report*, IBIS WORLD (Dec. 2018), https://perma.cc/ZC5E-UKJ5 (last visited Jan. 8, 2020) (on file with the Washington and Lee Law Review).

19. *See United States Commercial Casino Gaming: Monthly Revenues*, U. NEV. LAS VEGAS (Dec. 2019), https://perma.cc/GFV7-KK8F (last visited Jan. 8, 2020) (summarizing the revenue generated by each state from casino play) (on file with the Washington and Lee Law Review).

tax purposes. This Part will (A) describe each type of gaming, and (B) explain the current tax treatment for losses and gains.

A. Games of Skill

There are multiple opportunities to waste time playing online casual games. Some opportunities also involve wasting money. This Article will focus on www.Worldwinner.com. Players join Worldwinner by creating a player account and agreeing to a Terms of Service (TOS) agreement.[20]

The basic player account is free and allows access to many entertaining games. These include traditional real world games like Hearts, Spades, and Hangman, as well as games created solely for online play, such as Scrabble Cubes, a combination of Boggle and Scrabble. Players may upgrade an account by paying a minimum fee of $10 to Worldwinner (using either a credit card or Paypal). Worldwinner then credits the player's account with ten play dollars, which I shall symbolize as P$.[21] In addition, Worldwinner has various upgrade incentives where it will credit a player's account with additional P$, depending on how much the player initially deposits.

Players with upgraded accounts can choose to play a wider variety of games at a wider variety of levels and they are allowed more robust interaction with other players. More importantly, however, they can enter tournaments where they compete against other players to see who can score the highest

20. *See WorldWinner Terms and Conditions*, WORLDWINNER (Aug. 5, 2019), https://perma.cc/L4WW-DGB5 (last visited Jan. 8, 2020) (specifying how one officially becomes a player on WorldWinner's platform) (on file with the Washington and Lee Law Review).

21. *See id.* Casual Game operators like to promote the idea that game credits are "real money" because they can be redeemed for U.S. dollars. For example, in email correspondence with the author, Worldwinner accounting employees took the position that the credits in the player account are real dollars. That is also the position the company took in its PLR (private letter ruling) request and it is an unstated assumption in the PLR. I explain below the defects in that assumption. Other operators, however, have fun with the idea of virtual currency. I especially like the banana unit of play. *See Earn Bananas*, Bananatic, https://perma.cc/UL9Q-EU2L (last visited Jan. 8, 2020) (using bananas as a currency in gameplay) (on file with the Washington and Lee Law Review).

on a given game at a given level of difficulty.[22] In most games, the players do not compete directly against each other but instead play a game against the computer, with each player's game being of purportedly equal difficulty.

For example, a player might enter a three-person Scrabble Cubes tournament for P$2.50. Each player plays a full game of Scrabble Cubes against the computer. Although the players do not play the exact same Scrabble Cube configuration, Worldwinner attempts to make each Scrabble Cube of equal difficulty. Worldwinner debits P$2.50 from each player's account and then credits the winning player's account P$6.00. The other P$1.50 represents Worldwinner's "rake" in that it represents an amount that can never be cashed out.[23] With some exceptions, Worldwinner allows players to cash out their P$ at any time at a fixed exchange rate of 1US$ per 1P$, subject to various limitations.[24] A player account thus fluctuates as the player wins or loses tournaments. If the online player account balance reaches zero, a player must buy more P$ in order to be able to enter tournaments (i.e. bet on play).

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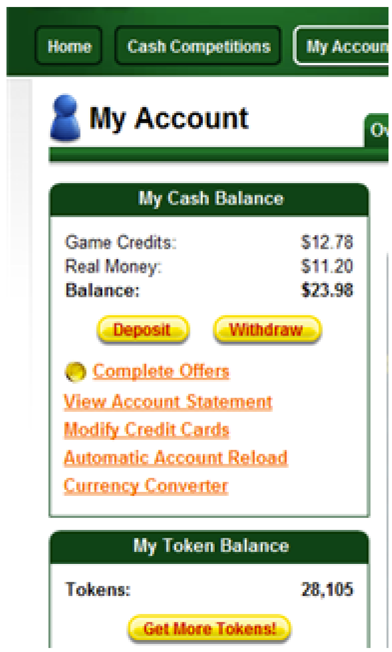
22. *See Playing for Cash 101*, GSN GAMES, https://perma.cc/GSG8-GY82 (last visited Jan. 8, 2020) (promoting the benefits of upgrading Worldwinner accounts) (on file with the Washington and Lee Law Review). Players with upgraded accounts can choose to bet on any number of games, either traditional games like Spades, Hearts, and Backgammon, or games created especially for online play, such as puzzle games like Scrabble Cubes, strategy games like Dynomite, or sports games like 8-ball pool.

23. *See About Compete for Cash*, WORLDWINNER, https://perma.cc/C3QZ-P7NK (last visited Jan. 8, 2020) (stating the rules for competing for cash on Worldwinner platforms) (on file with the Washington and Lee Law Review). I use these figures solely to illustrate the concept. Worldwinner regularly changes the scope and cost of the competitions and has different rate and rake structures for different games. Notice the rake is a huge percentage of the pot, much larger than online casinos charge. For example, as of the date of my example, August 5, 2014, the biggest bet allowed in Scrabble Cubes was a P$50 buy-in to enter a four-person tournament. With a P$175 total payout to the winners, that meant the site operator was taking in a twenty-five percent rake. Smaller pot games had even larger rakes. In "Deal Or No Deal," on that same day, the largest bet permitted was P$1.85 to enter a five-player game. Of the resulting P$9.15 in play, the site operator paid out a total of P$6.50, keeping almost thirty percent. Yes, these rakes are in P$ but that takes those amounts off the redemption table.

24. *See infra* Part VI.

In addition, Worldwinner gives out loyalty awards to players who spend sufficient amounts of money on games. Cash game players accrue "reward points" which can be redeemed for gift cards to stores (e.g. Walmart) or extra game credits. Neither reward points nor game credits can be redeemed for cash. Worldwinner tracks all activity and players can at any time see what their balances are. Here is an example of how Worldwinner presents the information. In the example, the player has a total of P$23.98, composed of $11.20 in redeemable credits (which Worldwinner labels "Real Money") and $12.78 in unredeemable credits (which Worldwinner labels "Game Credits").



B. Gambling

Back when I was dropping quarters into "Defender" many people were dropping quarters into the slot machines in Nevada and New Jersey, then the only two places where casino gambling was legal.[25] By 1995, legal gambling was "a multi-billion-dollar industry that has proliferated across the country."[26] By then the industry had matured to the point where casinos created a national trade organization called The American Gaming Association (AGA).[27]

By far the most popular activity in casinos is slot machine play.[28] A 2010 study found that "a significant majority of gamblers say slot machines are their favorite games to play, and the slot machine's share of the gaming floor at American casinos has grown from about 40 percent in the 1970s to almost 70 percent today."[29]

Industry terminology divides slot machines into two types: Class II and Class III.[30] Class II games are connected to a

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25. *See* FIN. CRIMES ENF'T NETWORK, SUSPICIOUS ACTIVITY REPORTING IN THE GAMING INDUSTRY 2 (2012) (discussing the status of legal gambling in the 1960s and 1970s).

26. *Libutti v. Comm'r*, 71 T.C.M. (CCH) 2343 (1996).

27. *See How We Deliver*, AM. GAMING ASS'N, https://perma.cc/CY2A-WEAL (last visited Jan. 8, 2020) (describing the mission and purpose of the AGA) (on file with the Washington and Lee Law Review).

28. *See generally* Kah-Wee Lee, *Containment and Virtualization: Slot Technology and the Remaking of the Casino Industry*, CTR. FOR GAMING RES. OCCASIONAL PAPER SERIES: PAPER 14 1, 3 (2012); Cristina Turdean, *Computerizing Chance: The Digitization of the Slot Machine (1960–1984)*, CTR. FOR GAMING RES. OCCASIONAL PAPER SERIES: PAPER 15 1, 1 (2012).

29. David Stewart, *Demystifying Slot Machines and Their Impact in the United States*, AMERICAN GAMING ASSOCIATION WHITE PAPER 1 (July 2010). *See also* MICHAELA D. PLATZER, CONG. RESEARCH SERV., R44680, INTERNET GAMBLING: POLICY ISSUES FOR CONGRESS (2016).

30. *See, e.g.*, *Slot Machines by Country*, WIKIPEDIA, https://perma.cc/9SUX-U284 (last updated Oct. 16, 2019) (last visited Jan. 9, 2020) (discussing the difference in game characteristics between different classes of slot machines) (on file with the Washington and Lee Law Review). The definition of slot machines for interstate commerce regulation purposes in 15 U.S.C. § 1701 (2018), however, makes no attempt to create classes of machines. And the classification created by the Indian Gaming Regulatory Act (IGRA), Pub. L. No. 100-497, 102 Stat. 2467 (1988), which applies only to Indian casino operations, creates classifications of types of games, not just slot machines. Still, the Class II and Class III games described in the IGRA do have a rough correspondence to the different types of slot machines. Professor Kevin Washburn explains the connection in *Agency Conflict and Culture: Federal Implementation of the Indian Gaming Regulatory Act by the National Indian Gaming Commission, the Bureau of Indian Affairs, and the Department of Justice*, 42 ARIZ. ST. L.J. 303, 316 (2010). When IGRA was enacted, it divided profitable forms of gaming into two categories: Class II

centralized computer system that is programmed to deliver a set amount of prizes within a set amount of pulls, or bets. In this way, Class II slots operate like scratch-off lottery tickets: each machine has an equal chance of winning a series of limited prizes and there are set numbers of tickets issued. After the set amount of pulls is reached, the system resets. As with scratch-off tickets, there are no repeated combinations. Once a pull is used up, it won't repeat until the system resets. Thus, one game is dependent on previous games. A previous loss uses up one of the pre-set losses and a previous win uses up one of the pre-set wins. This arrangement essentially makes players compete against each other for a common prize. There may or may not be any player skill element in this kind of machine. Video poker machines are a typical example of Class II machines.

Class III machines—sometimes referred to as "Vegas style slots" are the stereotypical machines. They operate independently from a centralized computer system and from each other. Each has a random number generator and is programed to pay out only when a certain number is hit on the pull. Thus, a player's chance of winning any payout is the same with every play because the winning number's chance of occurring remains unaffected by previous pulls. Each game is independent of any previous games.

Both classes of slot machines come in three flavors: coin, token, and electronic. Coin slots operate by the player dropping a coin (or coins) into the machine and pulling the handle or the tab. If the machine pays out, it returns the payout in coins. Token machines work similarly, with players inserting tokens that they buy at the casino cage. If the machine wins, it pays

games, such as bingo and pull-tabs; and Class III games, which is a residual category including all other forms of gaming. Importantly, Congress indicated that bingo is a Class II game "whether or not electronic, computer, or other technological aids are used in connection therewith." IGRA § 4, 102 Stat. at 2468. However, Class II gaming explicitly does not include "electronic or electromechanical facsimiles of any game of chance or slot machines of any kind." *Id.* at 2469. Therefore, such devices necessarily fall into Class III. Because of the fluidity of the terms used and because of the very nature of technology, the line between a Class II "electronic, computer, or other technological aid" to bingo and a Class III "electronic or electromechanical facsimile or slot machine of any kind" is not crystal clear.

out tokens, which, as with casino chips, players must take to the cage to convert to money.

Electronic machines are also known as "cashless" because players use loadable player cards to play. That is, players have long been able to sign up for Player Accounts, which the Casinos use to monitor play and give "comps" to those who play enough.[31] Computer technology has enhanced Casinos' ability to track play and, since about 2005, Casinos have given players the option of plastic cards with a magnetic strip across the back that have the look and feel of a traditional credit card.[32]

A player loads money into their Player Account at a cage or self-service kiosk.[33] The player uses the card by inserting it into the slot machine and entering a security PIN that allows the machine to access the account and load account balance information into the machine. When the player is done at that machine, the player presses a button to end play and the machine transfers the play data back to the Player Account. The player can then remove the card and go to another slot machine, or perhaps a table game. When the player is ready to cash out, the player must return to the cage or a self-service terminal to convert the account balance into cash or refunds to a credit card.

31. For an excellent and detailed description of how casinos tracked players in the pre-electronic card days, see *Barbiero v. Comm'r*, 64 T.C.M. (CCH) 59, 61 (1992).

32. For an interesting history of player tracking systems, see Carolan Pepin, *Player Tracking: You've Come a Long Way, Baby*, GLOBAL GAMING BUS. MAG. (June 6, 2011), https://perma.cc/8H3Z-F6RF (last visited Jan. 9, 2020) ("Player tracking now stands as one of the most powerful applications of the overall casino system.") (on file with the Washington and Lee Law Review). As with other aspects of Casino operations, player cards and player accounts are heavily regulated. For example, Casinos may be required to create secure systems, protect player data, disclose the terms and conditions of the player accounts to players, etc. *See, e.g.*, 25 C.F.R. § 543.17 (2020) (stating the minimum internal control system regulations for patron deposit accounts and cashless systems).

33. This paragraph is drawn from personal observation and from promotional materials distributed by a manufacturer of casino player card systems. *See, e.g.*, *Overview*, ADVANSYS, https://perma.cc/B6XS-U8W6 (last visited Jan. 9, 2020) (explaining how the card software operates) (on file with the Washington and Lee Law Review).

III. Current Doctrine: Knowns and Unknowns

It's complicated. Taxation requires proper treatment of income items and deduction items. The law is clear on the treatment of deduction items for gaming costs, but is unclear on the treatment of income from gaming. This Article's thesis is that proper taxation requires the proper netting alignment of income to costs. In the area of gaming, current doctrine creates a misalignment. Let's look at how and why.

A. The Alice and Myra Hypotheticals

To illustrate current doctrine, to explain its problems, and to propose solutions, I will draw upon two hypothetical players, Alice and Myra. Each spends $20 to have fun and uses up that $20.

Alice opens a player account with Worldwinner and uses a credit card to put in P$20 and upgrade her status. Pursuant to an incentive, Worldwinner adds P$20 to her account. It thus shows her account as divided between P$20 "real money" (i.e. redeemable credits) and P$20 "game credits" (i.e. non-redeemable credits). Both types of game credits can be used equally to enter tournaments, but players may not choose which group is used. Instead, Worldwinner programming uses up each group pro-rata. In addition, Alice's play earns her loyalty points which she can redeem for various comps, such as gift cards.

Assume Alice plays a series of three-person Scrabble Cubes games over some period, putting up P$2.50 each time for a prize of P$6.00. If Alice wins every third game (for a net loss of P$1.50) her account balance will drop to P$2.00 after she plays (and loses) her sixty-eighth tournament. At that point she will no longer be able to enter any P$2.50 tournaments.[34] Over the course of play, however, Alice will have won twenty-two games for a total of P$132 in cumulative winnings, which cost her P$55 in entry fees. She will have

34. She will have lost P$1.50 for every set of three tournaments. At the end of her 22nd set of three tournaments (66th game) she will have a balance of P$7.00, good enough to enter and lose two more tournaments, leaving her with P$2. Essentially, Alice will have gotten sixty-eight "plays" for her $20. If she won the first of every set of three games she would get seventy-six plays and have P$1 after the 76th game.

spent an additional P$115 in entry fees for her forty-six losing tournaments. Thus, her entry fees total P$170.[35] Yet she walks away $18 poorer.

Myra opens a Player Account at a Casino, call it the Rose Garden Casino. She obtains a "Flower Power" player card which allows her to accumulate loyalty points and associated comps, such as gift cards. Myra uses a credit card to put P$20 on her player account. Pursuant to an incentive program, Rose Garden Casino adds P$20 to her account. Assume Myra uses the card to play the slots over some period, betting P$2.50 on every pull. Assume the same facts as Alice: by the end of the period Myra has won P$6.00 on every third pull and thus, after her sixty-eighth pull, Myra's player card has only P$2.00 on it. During course of play, her twenty-two winning pulls brought total winnings of P$132, which cost her P$55 in bets. In addition, Myra spent an additional P$115 in bets on her forty-six losing pulls. Thus, just like Alice, Myra's bets total P$170.[36] And, just like Alice, Myra has lost $18.

B. Gaming Deductions: Me nem nesa[37]

To understand the problem presented as to whether redeemable game credits constitute gross *income*, the reader must first understand the applicable tax rules to gaming *deductions*—including deductions for gaming losses and for other expenses (such as travel costs, entry fees, etc.). The deduction rules are known. We should start with them to properly understand the true practical stakes of the income question.

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35. In addition, by the time she has run her original $20 down to P$2.00, Alice has accumulated 340 loyalty points. The tax consequences of these loyalty points are beyond the scope of this Article. However, I will note that they are operationally like any other type of loyalty program, which means they will likely be viewed as a reduction of Alice's cost rather than an accretion of income.

36. Like Alice, Myra will also have accumulated loyalty points and, as with Alice, the tax consequences of loyalty points are beyond the scope of this Article.

37. Dothraki for "It is known." *See Dothraki*, GAME OF THRONES WIKI, https://perma.cc/DZ7F-5UV7 (last visited Jan. 9, 2020) (providing translations for common English phrases in Dothraki) (on file with the Washington and Lee Law Review).

1. What Is Allowed

Congress generally permits taxpayers to deduct from their income the money it takes to produce that income. One sees this general policy at work in the concept of Cost of Goods Sold (COGS) found in § 471, in the § 162 rules for trade or business deductions, in the § 165 rules for losses and in the hobby loss rules in § 183. There is no principled distinction between netting expenses against gross receipts to arrive at gross income and netting expenses against gross income to arrive at net income: all reflect a Congressional choice to tax income net of associated costs.[38]

Section 471 permits taxpayers to account for inventory costs by reducing their gross receipts for goods sold by an amount reflecting the cost of the goods sold. The rules are complex but the statute explicitly recognizes they may be "necessary in order clearly to determine the income of any taxpayer."[39]

Section 162 permits deductions for the ordinary expenses needed to carry on a trade or business. For businesses that sell goods, these deductions apply only to the income calculated by subtracting COGS from gross receipts. Section 212 permits similar deductions for activities engaged in "for the production of income" but which are not a trade or business.[40] Section 183 permits similar deductions for the ordinary expenses of producing income, even when the income results from a hobby and not from a trade or business. The effect of all three deduction sections is that Congress taxes only net income from the qualified income-producing activity.

Thus, the income subject to the income tax is not just the raw gross receipts a taxpayer receives. It is instead that gross

38. For a lovely explanation of the deep theory, see Joseph Dodge, *The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress from Disallowing Such Costs*, 27 VA. TAX REV. 297, 299 (2007) (advocating a computational netting approach to the treatment of contingent attorney's fees).

39. § 471(a).

40. § 212(1). For a good explanation, see *Surasky v. United States*, 325 F.2d 191, 194 (5th Cir. 1963) (discussing deductible items under Section 212).

number reduced by certain associated costs.[41] It may also result from capitalization of other costs, creating basis. Basis is then netted against either future income (through depreciation) or ultimate disposition.[42]

Section 165 reflects a Congressional decision that losses should be treated the same as other ordinary expenses. Thus, 165(a) permits deductions to losses "sustained during the taxable year and not compensated for by insurance or otherwise." Congress limits the deductions as to individual taxpayers, however, in subsection (c), which permits deductions only for those losses "incurred in a trade or business" of an individual or those losses an individual incurs "in any transaction entered into for profit, though not connected with a trade or business." Thus, losses from one income-producing activity may generally be netted against profits from a different income producing activity.

Congress forbids taxpayers from deducting losses arising from a taxpayer's hobby activity. Hobbies are personal consumption and § 262 creates a general rule disallowing the deduction of the costs of personal consumption. Section 183 trumps that restriction, however, and allows taxpayers to deduct expenses of a hobby against any income produced by the hobby, but only up to the total amount of income produced by the hobby activity.

Taxpayers have never been allowed to deduct "hobby losses" (i.e. when expenses exceed income) against other sources of income. When Congress codified this idea in 1969, it

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41. Congress sometimes chooses to allow less netting. For example, § 280E prohibits deductions and credits for any trade or business activity that "consists of trafficking in controlled substances . . . which is prohibited by Federal law . . . engaged in the production of drugs." Although such businesses are allowed the COGS netting, they are denied the § 162 netting. That caused some taxpayers to complain that taxation of marijuana dispensaries went beyond Congress's constitutional powers. The Tax Court rejected that argument in *N. Cal. Small Bus. Assistants Inc. v. Comm'r*, 153 T.C. No. 4 (Oct. 23, 2019). *See* Bryan Camp, *Lesson from the Tax Court: 280E Does Not Violate the Eighth Amendment*, TAXPROF BLOG (Oct. 28, 2019) https://perma.cc/4BTG-SHXG (last visited Mar. 4, 2020) (on file with the Washington and Lee Law Review).

42. *See* Dodge, *supra* note 38.

had long been the rule applied by the Service with judicial blessing.[43] It is known.

Section 165(d) creates a limitation similar to § 183 for a certain class of losses: "losses from wagering transactions." The good news here is that Congress has permitted deductions for these types of losses, regardless of whether or not the wagering activity is the taxpayer's business. Whether a taxpayer is engaged in gaming for pleasure or profit, as a business or as a hobby, § 165(d) allows a deduction for "losses from wagering transactions." So even though a wager itself is not the kind of expense allowed by either § 162 or § 183, the loss of that wager is a loss deduction permitted by § 165(d). That is good news indeed.

The bad news, however, is that § 165(d) limits the deductions of "losses from wagering transactions" to the amount of "gains from such transactions." That is so even if the losses would otherwise be permitted by subsections (a) and (c).[44] Thus, so far as the question "what is allowed" goes, taxpayers who are in the trade or business of gambling get the same treatment for wagering loss deductions as taxpayers who are hobbyists.[45]

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43. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, 213, 83 Stat. 487, 571–72 (explaining and defining permissible deductions). *See generally* Michelle B. O'Conner, *The Primary Profit Objective Test: An Unworkable Standard?*, 27 LOY. U. CHI. L.J. 491, 498–99 (1996)

> Thus, § 183 operates as an allowance provision authorizing limited deductions with respect to an activity that does not fall within the classification of a "trade or business." In this way, section 183 represents a continuation of judicial doctrine and Internal Revenue Service ("IRS") policy permitting taxpayers to deduct certain expenses incurred in connection with an activity that did not constitute a "trade or business." (citations omitted).

44. Humphrey v. Comm'r, 162 F.2d 853, 855 (1947), *cert. denied*, 332 U.S. 817 (1947) (holding that wagering losses were a separate class of expenditures deductible under the special rule in § 165(d) and so were not deductible under § 162(a) or the general rules of § 165).

45. This is even more true after 2017, when Congress expanded the definition of "losses from wagering transactions" to include "any deduction otherwise allowable under this chapter incurred in carrying on any wagering transaction." § 165(d) (2018). That language was added by § 11050(a) of the legislation commonly called the Tax Cut and Jobs Act, Pub. L. No. 115–97, 131 Stat. 2054, 2087 (2017).

2. Where Taken: Above vs. Below the Line

Determining "what is allowed" does not complete the deduction analysis for many taxpayers. If the deductions permitted by § 165(d) are attributable to the taxpayer's trade or business, then § 62(a)(1) directs those deductions to be taken from gross income to determine the adjusted gross income (AGI) line on a return. We call those "above the line" deductions. However, if § 165(d) deductions are attributable to a hobby or to a § 212(1) activity for production of income, then § 62 does not direct them to be taken above the line. The deductions are instead subtracted from AGI to determine taxable income. We call those "below the line" deductions.

The rules allowing trade or business deductions to go above the line while requiring hobby deductions to go below the line create two unhappy consequences for taxpayers whose electronic gaming activity is not a trade or business but is instead a hobby. Taken together, the consequences produce a significant violation of the principle that taxpayers with similar incomes should be taxed similarly.

The first consequence comes in what I call a fight between the standard deduction and the § 165(d) deduction. The standard deduction was an innovation created due to Word War II (WWII). Generally, a taxpayer must prove entitlement to each item of deduction claimed on the return.[46] That was uniformly true for all deductions up until WWII when Congress extended the income tax to the great mass of middle income taxpayers.[47] Recognizing that the new income provisions would now apply to ordinary folks who may not

46. *See* Indopco, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) ("[A]n income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer." (citation omitted)).

47. *See* Individual Income Tax Act of 1944, Pub. L. No. 78–315, 58 Stat. 231; *see also* Carolyn C. Jones, *From Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685, 686 (1988) (stating that the WWII legislation dramatically increased the number of taxpayers from seven million to forty-two million); Alan L. Feld, *Fairness in Rate Cuts in the Individual Income Tax*, 68 CORNELL L. REV. 429, 433–34 (1983) ("When the number of households covered by returns is considered, the coverage of the tax system was extended from about 5% to 74% of the population.").

keep needed records, the tax writers made simplification a chief goal of their legislative efforts.[48] As part of this effort, Congress created the standard deduction, giving taxpayers a standard amount they could deduct, without having to prove anything or keep records.[49]

The problem occurs when taxpayers must choose between itemizing their below-the-line deductions and taking the standard deduction. Taxpayers would much prefer to take their itemized deductions *plus* the standard deduction. They would prefer to take all the deductions that they can prove above the line rather than be forced to choose between the itemized *or* the standard deductions. Taxpayers whose electronic gaming activity is their trade or business get the best of both worlds: their § 165(d) deductions go above the line *plus* they can take the standard deduction. Their § 165(d) deductions do not fight against the standard deduction.

Hobbyist taxpayers, however, have to fight the standard deduction. Allowed deductions for hobby activities are not listed in § 62 and so are taken below the line.[50]

As applied to gaming activity that is considered gambling, that means the gains from wagering transactions must all be included as part of gross income, but the associated loss deductions are separated and taken later (if at all) below the

48. *See* H.R. REP. NO. 78–1365, at 1 (1944).

49. *See* Feld, *supra* note 47, at 439 ("Using the standard deduction, a taxpayer computed his tax from a table of income and dependency levels, so that a taxpayer whose only income consisted of compensation could file a return with minimal computation.").

50. The argument that gambling losses *should* be allowed above the line is strong: unlike most personal expenses, such losses directly relate to the production of income. Most of the expenses allowed to be taken above the line are those that relate to activities that produce income items, whether the activity is a trade or business or a non-business activity such as rental of real estate. That makes AGI function as a proper measure of the taxpayer's net profit for the year and, hence, ability to pay the imposed tax. In contrast, the expenses allowed below the line are, generally, those that relate to personal expense that Congress allows for policy reasons unrelated to the measurement of net profit. Given that § 165(d) disallows taxpayers the benefit of deducting net wagering losses against other income, the § 165(d) deduction looks much more like a deduction for a cost incurred in producing income rather than a personal cost.

line, as an itemized deduction.[51] This placement of the deduction below the line makes it very difficult to truly offset gaming winnings because it must first fight with the standard deduction.[52] This inability to directly offset gaming income with gaming losses distorts the hobbyist's income.[53]

For example, say a taxpayer engaged in electronic gambling activity in 2019 as a hobby. The standard deduction for a person filing singly in 2019 was $12,200.[54] If the taxpayer had wagering gains of $8,000 and wagering losses of $16,000, § 165(d) would permit deduction of the losses up to $8,000. However, § 62 would send that deduction below the line where it would fight with, and lose to, the standard deduction, assuming other itemized deductions were no greater than $4,200. For this taxpayer it is as if there were no deduction allowed for wagering losses.

If the taxpayer's gaming was not gambling, the situation is worse, at least through 2025. That is because the $16,000 in losses would be deductible as § 183 hobby expenses and not as § 165(d) gambling losses. That makes them subject to the rules in § 67. Section 67(a) gives a general rule that miscellaneous itemized deductions may only be deducted to the extent that they aggregate to more than two percent of a taxpayer's AGI. Section 67(b) defines the term "miscellaneous itemized deductions" as being all itemized deductions *not* listed in § 67(b).[55] Hobby expenses are not listed in § 67(b). Thus, traditionally, § 67(a) would only permit so much of the $8,000

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51. *See* Lamb v. Comm'r, 105 T.C.M. (CCH) 1882, 1886 (2013) (noting that an itemized deduction is allowable for wagering losses in certain circumstances).

52. *See* Christine Manolakas, *Taxation of Gamblers: The House Always Wins*, 70 OKLA. L. REV. 553, 594–95 (2018) (stating that "the gambler effectively cannot deduct gambling losses and, thereby, offset gambling wins" when competing with the standard deduction).

53. For a real-life example, see *Viso v. Comm'r*, 114 T.C.M. (CCH) 178, 179–80 (2017) (explaining that a taxpayer who had to report over $5,000 in slot machine wins was unable to deduct corresponding losses because $5,000 was less than the applicable standard deduction for joint return filers).

54. Rev. Proc. 2018-57, 2018-49 I.R.B. 827.

55. *See* Whitten v. Comm'r, 70 T.C.M. (CCH) 1064, 1067 (1995) ("[W]e conclude that wagering losses must be accounted for and reported separately from the expenses incurred by the taxpayer . . . .").

that exceeded two percent of AGI to qualify for deduction. That amount would then be capped by the § 183 hobby loss rules. For tax years 2018 through 2024, however, Congress has prohibited any deduction at all for miscellaneous itemized deductions.[56]

The second unhappy consequence for being forced to take deductions below the line is the effect on AGI. Congress ties a variety of tax benefits to AGI which it uses as a proxy for ability to pay.[57] As AGI goes up, tax benefits go down, reflecting a policy that higher income taxpayers have less need for the given tax benefits than lower income taxpayers.[58] For example, § 68 reduces the amount of itemizable deductions when an individual's AGI exceeds $250,000. Similarly, a taxpayer's AGI will affect eligibility for a variety of tax credits with such credits being reduced as the taxpayer AGI rises and, ultimately, denied when the AGI rises above certain cut-offs.[59] By separating income from deductions, the law thus distorts the true ability to pay.

Together, these two consequences diminish horizontal equity.[60] Consider what happens if the taxpayer's gaming activity is a trade or business and not a hobby. While both § 183 and § 165(d) ostensibly operate to deny losses by limiting deductions to the amount of income, § 62 now permits this deduction to be taken above the line, directly against wagering gains. Thus, the business taxpayer's AGI will be $8,000 less than the hobbyist taxpayer, even though they both have the

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56. § 67(g).

57. *See* Mark J. Cowan, *Assignment of Income at the Ivory Tower: Relaxing the Tax Treatment of Services Donated to Charities by Their Employees*, 40 J.C. & U.L. 1, 38 (2014) ("The government uses AGI to gauge a taxpayer's income level for purposes of limiting tax benefits . . . .").

58. *See* Vada Walters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 42 (2001) (arguing for increased tax benefits to lower income taxpayers to restore progressivity in the federal income tax system).

59. *See, e.g.*, § 21(a)(2) (limiting household and dependent care service credit); § 23(b) (limiting adoption credit); § 24(b) (limiting child credit); § 25A(d) (limiting "Hope" and "Lifetime Learning" credits).

60. *See* Ira K. Lindsay, *Tax Fairness by Convention: A Defense of Horizontal Equity*, 19 FLA. TAX REV. 79, 80–81 (2016) (defining horizontal equity as the principle that individuals with identical tax bases should pay the same in taxes).

same items of income and items of deduction. Additionally, the lower AGI may entitle the business taxpayer to tax benefits denied to the hobbyist.[61]

Being in the trade of gambling helps align the expenses of the activity with the income the activity produces.[62] In addition to taking wagering losses above the line, professional gamblers have been allowed to deduct the other ordinary and necessary expenses allowed by § 162 in addition to their wagering loss deductions.[63] While Congress has now disallowed such deductions, that disallowance sunsets in 2025.[64]

3. Application to Alice and Myra Hypotheticals

Alice and Myra both put $20 of U.S. currency into play. At the end of the play they have lost $18, having only $2 still in their electronic account. Interstitially, however, they have each won P$132 in redeemable game credits, at a cost of P$170 in total bets. If we assume, for the moment, that those

61. This violation of horizontal equity is reduced when both taxpayers have non-§ 165(d) below-the-line deductions that exceed the standard deduction amount. *See* Kathleen DeLaney Thomas, *Taxing the Gig Economy*, 166 U. PA. L. REV. 1415, 1462 (2018) (discussing the standard deduction's effect on horizontal equity). But, the inequality remains because their AGIs will still be different. *See supra* note 60 and accompanying text.

62. *See* Manolakas, *supra* note 52, at 589–90 (noting that because professional gamblers are able to deduct net gambling losses, the tax code treats these expenses like other business-related losses).

63. *See* Generic Legal Advice Memo (GLAM) 2008-013 *Professional Gambler's Wagering Losses and Business Expenses* (Dec. 10, 2008) (collecting cases and arguing for a consistent litigating position that does not read § 165(d) as preventing deductions otherwise allowed by §162). Interestingly, the Office of Chief Counsel group that wrote the GLAM appears to have had no influence when the exact same issue arose in litigation. *See* Mayo v. Comm'r, 136 T.C. 81, 96–97 (2011). There the government argued for exactly the opposite position than the one set out in the GLAM. The Tax Court, however, sided with the taxpayers, essentially adopting the GLAM position, albeit with no mention of the GLAM. *See id.* at 97 (holding that the petitioner was entitled to deduct his business expenses related to professional gambling under § 162(a)).

64. Section 165(d) currently reads: "in the case of taxable years beginning after December 31, 2017, and before January 1, 2026, the term 'losses from wagering transactions' includes any deduction otherwise allowable under this chapter incurred in carrying on any wagering transaction."

redeemable game credits constitute gross income, then the standard analysis will turn on whether their gaming activity is a trade or business or a hobby.

If their gaming is a business, then the answer is a happy one. They will be able to deduct their § 165(d) losses above the line. In addition, after 2025, they can also take other § 162 deductions above the line, even if the deductions exceed the amount of income from their gaming activity.[65]

In fact, if both Alice and Myra engage in gaming activity as a business, Alice might be better off than Myra because while Myra is engaged in wagering, Alice may be engaged in a skills-based activity, at least according to the analysis in private letter ruling (PLR) 2005-32-025.[66] That means her losses are non-wagering losses and not subject to the restrictions on § 165(d). She could deduct the total of her gaming losses *and* her other business expenses against her gaming wins. The key analytical move here would be that Alice does not have any gains or losses from "wagering transactions" because the games are based more on skill than luck. So, all deductions become § 162 deductions and are not limited.

It is not clear how much weight the PLR analysis will carry. On the one hand, it addressed a gaming website owner's reporting requirements and so did not directly interpret the phrase "losses from wagering transactions" in § 165(d). Early tax decisions held that betting on bridge was "wagering," and it is difficult to say that bridge is much different than the

65. *Cf.* § 165(d) (limiting deductions under this provision to the amount of wagering gains). Because these deductions under § 162(a) are separate from those taken under § 165(d), they can be greater than the amount of wagering gains.

66. *See* I.R.S. Priv. Ltr. Rul. 2005-32-025 (May 3, 2005) (providing guidance for recording income from online gaming tournaments). The idea that Worldwinner games are skill-based is how Worldwinner gets around the anti-gambling laws of most states, as does its start-up competitor, Skillz. *See* Will Yakowicz, *The Booming Business of Cash Prize Gaming*, INC.COM (May 28, 2014), https://perma.cc/PX5F-H9VP (last visited Jan. 2, 2020) (describing the legal team built by Skillz to advise them on laws related to their platform in various states) (on file with the Washington and Lee Law Review); Benny Evangelista, *Skillz Lets Game Players Win Real Money*, SFGATE.COM (May 28, 2014, 4:02 AM), https://perma.cc/T3JM-MW6J (last visited Jan. 2, 2020) (explaining that Skillz provides way other than casino-style games for individuals to win money) (on file with the Washington and Lee Law Review).

games played on Worldwinner.[67] Current tax decisions hold that wins and losses in tournament poker are "wagering transactions."[68]

On the other hand, the basic rule in most jurisdictions is that activities are not gambling activities when skill predominates over luck.[69] Hence, what may look like wagering becomes simply "investing." Worldwinner takes great pains to explain that it ranks players by skill and only allows players to compete against others of the same skill level.[70] Further some state courts decisions do treat poker and similar games as games of skill.[71] Finally, the legislative history to § 165(d) suggests that the term "losses from wagering transactions" was intended to apply to traditional types of gambling, like roulette, slots, and pull-tabs, which are of a far different character than word games or poker.[72]

Putting both hands together, it is possible, if not likely, that Alice may escape the rule in § 165(d) and deduct, without

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67. *See* Heide v. Comm'r, 2 B.T.A. 451, 452 (1925) (deciding that playing bridge for stakes is wagering).

68. *See, e.g.*, Tschetschot v. Comm'r, 93 T.C.M. (CCH) 914, 916 (2007) ("[I]t is clear that while there are differences between tournament poker and other types of poker, none rise to the level of meaningful, substantive differences that would warrant different tax treatment under the current Internal Revenue Code.").

69. *See* Josh Chumley, Comment, *Follow the Yellow Chip Road: The Path to Legalizing Internet Poker*, 36 S. ILL. U. L.J. 547, 558–60 (2012) (explaining the "dominant factor test" which is used in most jurisdictions to determine whether an activity is one of skill or luck).

70. *See* Yakowicz, *supra* note 66 (noting the CEO of Worldwinner, in an interview, stressed the importance of having players of similar skill compete against one another by analogizing the unfairness of pairing him against Tiger Woods in golf).

71. *See* George Remennik, Note, *Mrs. Tschetschot's Busted Hand, Poker, and Taxes: The Inconsistent Application of Tax Laws on a Game of Skill*, 8 CARDOZO PUB. L. POL'Y & ETHICS J. 485, 494–96 (2010) (collecting state court cases).

72. *See* H.R. REP. NO. 73-704, at 22 (1934); 1939-1 C.B. (Part 2) 554, 570

> Existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under the interpretation of the courts, illegal gambling losses can only be taken to the extent of the gains on such transactions. A similar limitation on losses from legalized gambling is provided for in the bill.

restriction, all losses from gaming activity, if it is a business activity. She will be lucky to have her skill recognized.

If Alice and Myra are hobbyists, however, the news is grim. Myra will still be able to deduct losses from slot machine play, but will have to deduct them below the line and may only deduct her "losses from wagering transactions" to the extent of her "gains from such transactions."[73] This means Myra's AGI will be inflated, with the variety of unpleasant consequences detailed above.

If both are hobbyists, Alice now might even fare worse if her Worldwinner activity is deemed not to be wagering transactions. First, the answer to the question "what is allowed?" will be the same as Myra. While § 165(d) will not apply, she will be subject to the same limitation, courtesy of the hobby loss rules in § 183.[74] Second, however, the answer to the question "where does it go?" will be much different. Now her gaming losses will be treated as miscellaneous itemized expenses subject to the two percent floor, with the consequence that she will not be able to deduct any of her hobby expenses for tax years 2018–2025, courtesy of § 67(g).

If we *assume* that redeemable game credits constitute gross income, we then know the tax consequences because the treatment of the expenses associated with that income are known.[75] The interesting question, however, is why and when do redeemable game credits count as "gross income" within the definition of that term in § 61? The answer to that is not known.

73. *See* Treas. Reg. § 1.165-10 (1960) (stating wagering losses are limited to wagering gains regardless of whether the activity is a business or non-business); Spencer v. Comm'r, T.C. Summ. Op. 2006-95, 2006 WL 1755510, at *2 (2006) (finding losses from hobby gambling must be taken below the line). A silver lining here is that the term "gains from wagering transactions" includes comps. *See* Libutti v. Comm'r, 71 T.C.M. (CCH) 2343, 2347 (1996) (concluding taxpayer was allowed to deduct gambling losses against fancy car and vacation comps).

74. *See* Boneparte v. Comm'r, 114 T.C.M. 381, 384 (2017) (determining that Boneparte's non-wagering gambling expenses fell into § 183(b)(2)).

75. *See* I.R.S. Priv. Ltr. Rul. 2005-32-025, at 6 (May 3, 2005) (finding that $600 or more of gaming credits constitute income).

C. Gaming Income: It Is Not Known

Current law is unclear about why redeemable game credits constitute gaming income in the first place. There is a dearth of case law and IRS guidance. In *Boneparte v. Commissioner*,[76] Judge Morrison gives a seemingly straightforward explanation of gaming gains and losses in the context of a gambling case:

> A wagering transaction results in a gain if the winning exceeds the cost of the wager. A wagering transaction results in a loss if the cost of the wager exceeds the winning. The gains for all wagering transactions for which there is a gain are totaled. These are the gains from wagering transactions within the meaning of section 65(d).[77]

In a footnote, however, Judge Morrison notes that the amount of a wagering gain is not the *gross* amount of the winning, but is instead that amount *net of the bet*:

> Calculating the gain from each wager by subtracting the cost of the wager is consistent with the holdings in cases in which the Court, drawing an analogy between wagering winnings and the recovery of a capital investment, has held that a casual gambler's gross income from a wagering transaction should be calculated by subtracting the bets placed to produce the winnings, not as a deduction in calculating adjusted gross income or taxable income, but as a preliminary computation in determining gross income.[78]

Judge Morrison thus believes that some netting is proper.[79] The problem of calculating the gains, however, is deciding the scope of the netting. What amounts should count in Judge Morrison's "preliminary computation?"

Existing guidance gives two answers to that question: the per-transaction method and the per-session method.[80] This Part examines how each of those methods might apply to our

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76. 114 T.C.M. 381 (2017).

77. *Id.* at 383 (citation omitted).

78. *Id.* at 388 n.3.

79. *Id.* at 388.

80. *See* I.R.S. Priv. Ltr. Rul. 2005-32-025, at 6 (May 3, 2005) (exemplifying the per-transaction method); CCA 2008-11, at 4 (Dec. 5, 2008) (exemplifying the per-session method).

two taxpayers, Alice and Myra. It is this Article's thesis that both methods are wrong.

1. The Per-Transaction Method

Alice and Myra might have to report the redeemable game credits arising from each winning transaction as income (less the fee or wager made to win). Each would thus report $77 income ($6.00 won in each of the 22 winning transactions less the $2.50 bet). They would then account for the $115 in losses by deducting those losses per § 165(d), taking those losses either above the line (if their gaming activity is a business) or below the line (if it is a hobby). This is the idea in Judge Morrison's *Boneparte* opinion. It is supported by both IRS guidance on a related topic, and academic commentary.

First, IRS guidance comes in PLR 2005-32-025, which addressed the question of how a gaming website operator indistinguishable from Worldwinner must fulfill its obligations under § 6041.[81] Section 6041(a) requires all persons engaged in a trade or business "making payment in the course of such trade or business to another person . . . of $600 or more in any taxable year" to report those payments to the Service. Treasury Regulation 1.6041-1(a)(2) requires the reports be made on Form 1099. Treasury Regulation 1.6041-1(g) extends the reporting requirement to "any payment . . . made in property other than money," in which case the payor must report the fair market value of the property as the amount of the payment.

Worldwinner sought guidance on how it should calculate winnings to determine when it had paid a player more than $600.[82] It offered the Service a choice of three methods: a method with no netting, a method with a per-transaction

81. *See* I.R.S. Priv. Ltr. Rul. 2005-32-025 (holding that a casual game site operator must report as "payments" online credits made to the taxpayer's gaming account, when credits performed same function as casino chips and the taxpayer had not yet cashed out). The PLR was actually in response to a request from Worldwinner. Although the PLR does not mention Worldwinner by name, company employees confirmed the identity to me in telephone conversations.

82. *See id.* at 1 (referring to the requirement in § 6041 of the Code).

netting, and method with yearly netting.[83] The Service answer was "per-transaction."[84] Its description mirrors Judge Morrison's approach in *Boneparte*:

> 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. 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 section 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 take all applicable deductions on their individual tax returns. There is no authority allowing Taxpayer to effectively take a deduction on behalf of a player by reporting the net amount to the Service on a Form 1099.[85]

One might ask how a PLR addressed to reporting obligation under § 6041 relates to the issue of whether redeemable game credits are income. The answer is § 74. The applicable regulation requires Worldwinner to report if it made payments of "prizes and awards *that are required to be included in gross income* under § 74."[86] Section 74(a), in turn, explicitly provides that the term "gross income includes amounts received as prizes." Accordingly, if redeemable game credits count towards the $600 reporting limit because they are "prizes" within the meaning of § 74, that means they must be income to the taxpayer as the PLR itself implicitly acknowledges in the quote given above. Importantly, like all

83. *See id.* at 2–3. The PLR describes these as the "gross method," "net method" and "cumulative net method." What it terms "net method" is what I term "per-transaction method."

84. *Id.* at 6.

85. *Id.* (emphasis added).

86. Treas. Reg. § 1.6041-1(d) (2017) (emphasis added).

other income, prizes can be in the form of cash, property, or services.[87]

Second, academic commentary uses the doctrine of constructive receipt to support a per-transaction approach. Generally, cash method taxpayers must report only that income which they actually receive during the yearly accounting period.[88] The doctrine of constructive receipt is an exception to that general rule. Treasury Regulation 1.451-2(a) provides that even if a taxpayer has not actually received some item of income, it will be "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." Similar regulations have existed since at least 1918.[89] The thrust of the doctrine is that if a taxpayer (1) has a right to money and (2) the payor was ready, willing, and able to make the payment, then (3) the taxpayer must report that amount as income because the failure to receive the money is simply the exercise of the taxpayer's own control.[90] In contrast, "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."[91]

The most comprehensive academic commentary on redeemable game credits comes from Professor Ted Seto, who created the helpful taxonomy of redeemable and

87. Treas. Reg. § 1.74-1(a)(2) (1960).

88. *See* § 451(a) ("The amount of any item of gross income shall be included in the gross income for the taxable year in which *received* by the taxpayer . . . ." (emphasis added)).

89. *See* Adams v. Comm'r, 20 B.T.A. 243, 245 (1930) (discussing constructive receipt in Treasury Regulations dating back to the Revenue Act of 1918).

90. *See* Treas. Reg. § 1.451-2(a) (as amended in 1979).

91. *Id*. This language would arguably give Alice (but not Myra), at least, a peg on which to argue that the game credits are not income to her until actually cashed out because Worldwinner charges $1.75 to extract any amount below P$10.00 (per the Terms of Service § 2.16), even in the form of a credit back to a credit card. Since, according to the PLR's per-transaction analysis, each P$6.00 credited to Alice's account for a win represents a return of $2.50 capital and income of $3.50, then, at least in the scenario posited in the text, she is never winning more than P$10.00 at one time. Of course, the real reason Alice will not cash out is that she wants to keep playing.

nonredeemable game credits in the first place.[92] He concluded that the constructive receipt doctrine supports, if not indeed mandates, the per-transaction method for redeemable game credits earned by players like Alice and Myra:

> In general, amounts credited to players' accounts in worlds with redeemable currencies or game credits are constructively received when credited if, as a practical matter, the players can "draw upon [them] at any time." Whether "substantial limitations or restrictions" exist is a practical question, not one to be resolved by hyper-technical analysis of a world's terms and conditions.[93]

2. The Per-Session Method

Alice and Myra might be able to report their redeemable game credits in a different way. If we treat the $20 adventure as a discrete event over a specified time period—call it a session—they might be able to net out all their gains and losses from that event. That would mean that instead of reporting $77 income above the line, they would report zero income. Although the PLR rejected the notion that Worldwinner could simply net gross game credits won against total bets over the year, the Service has adopted an alternative position for taxpayers, first through internal guidance issued by the Office of Chief Counsel, and more recently in formal guidance that reacts to court opinions. The position is called the per-session method. I will first explain the internal guidance, then the court cases and conclude with the regulation.

Internal memos, whether from one Chief Counsel office to another or from one Chief Counsel office to an IRS office, are meant for internal use but are publicly available thanks to § 6110 and persistent litigation by Tax Analysts, Inc.[94] Over

92. *See* Seto, *supra* note 5, at 1042–48 (discussing redeemable versus nonredeemable game credits).

93. *Id.* at 1049 (alteration in original).

94. *See* § 6110 (requiring memos to be made publicly available). Tax Analysts is a non-profit organization that has sued the government multiple times to secure the release of "secret" law in the form of internal memoranda. *See History of Tax Analysts*, TAX ANALYSTS, http://perma.cc/Z4AH-TAGW (last visited Jan. 29, 2020) (providing background on the organization) (on file with the Washington and Lee Law Review).

time, these memos have carried a wide variety of labels. At one time, memos designed to be generally circulated on a widely encountered legal issue were denominated General Counsel Memorandums (GCM). Later such memos came to be known as "Chief Counsel Advice" (CCA). However denominated, Chief Counsel memos are given unique identifying numbers that represent the year and document number. Thus, CCA 2008-11 ("*Reporting of Wagering Gains and Losses*") was the eleventh such memo published in 2008.[95]

In CCA 2008-11, the Office of Chief Counsel considered how a casual casino gambler should track and report income and losses from slot machine play. The CCA considered a hypothetical taxpayer who made discrete visits to casinos and, on each visit, bought $100 worth of slot machine tokens, and then redeemed the tokens (if she had any left) at the end of each visit. The CCA took the position that the taxpayer should calculate "losses from wagering transactions" and "gains from such transactions" by netting out her wins and losses from each session. For example, "a casual gambler who enters a casino with $100 and loses the entire amount after playing the slot machines has a wagering loss of $100, even though the casual gambler may have had winning spins of $1,000 and losing spins of $1,100 during the course of play."[96] Thus, players look to see whether they have income only when the total wins from a single playing "session" exceeded their total losses.

The heart of the CCA's analysis was the observation that the word "transactions" in § 165(d) was plural, not singular:

> A key question in interpreting § 165(d) is the significance of the term "transactions." The statute refers to gains and losses in terms of wagering transactions. Some would contend that transaction means every single play in a game of chance or every wager made. Under that reading, a taxpayer would have to calculate the gain or loss on every transaction separately and treat every play or wager as a taxable event. The gambler would also have to trace and

95. It was published on December 5, 2008. Concurrently, a different type of guidance document, Chief Counsel Generic Legal Advice Memo (GLAM) was published as GLAM 2008-13 (Dec. 10, 2008). The GLAM dealt with a professional gambler's ability to deduct non-wagering business expenses.

96. CCA 2008-11 (2008) at 5.

> recompute the basis through all transactions to calculate the result of each play or wager. Courts considering that reading have found it unduly burdensome and unreasonable. Moreover, the statute uses the plural term "transactions" implying that gain or loss may be calculated over a series of separate plays or wagers.
>
> The better view is that a casual gambler, such as the taxpayer who plays the slot machines, recognizes a wagering gain or loss at the time she redeems her tokens. We think that the fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens and can definitively calculate the amount above or below basis (the wager) realized.[97]

The Tax Court adopted the CCA's reasoning in *Shollenberger v. Commissioner*.[98] There, the taxpayers had one really lucky visit to a casino, hitting a $2,000 slot machine jackpot. The taxpayers had taken $500 to the casino and, after hitting the jackpot, proceeded to continue playing until they had $1,600 left. They then quit and went home.

On audit, the Service, using only the $2,000 winnings reported by the casino on Form W-2G, dinged the taxpayers for $2,000 in unreported income. This would be close to the right result under the per-transaction method outlined in PLR 2005-30-025, except that the taxpayers would not have to report as income the return of the amount they bet to win the $2,000 jackpot. It may well be that the Revenue Agents used that method. The omission of $2,000 income was, at least, the basis for the deficiency notice.[99]

Tax Court Judge Michael Thornton rejected the per-transaction approach and adopted the per-session method outlined in CCA 2008-11:

> Applying this methodology, respondent concedes that if we find, as we have found, that on March 29, 2005, petitioners entered the casino with $500 and took home $1,600 of winnings, the amount of gambling income which petitioners should have reported on their 2005 return was $1,100.[100]

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97. *Id.* at 4–5.
98. 98 T.C.M. (CCH) 667 (2009).
99. *Id.* at 668.
100. *Id.*

The Tax Court, however, rejected any broader concept of netting. The taxpayers had also proved up an additional $2,264 in other losses from wagering transactions during the tax year. They argued that they should be able to net these losses against the jackpot earnings. Judge Thornton rejected that argument:

> Insofar as petitioners mean to suggest that section 165(d) permits their gross income from slot machine play to be calculated by netting all their 2005 slot machine gains and losses, we disagree . . . . To permit a casual gambler to net all wagering gains or losses throughout the year would intrude upon, if not defeat or render superfluous, the careful statutory arrangement that allows deduction of casual gambling losses, if at all, only as itemized deductions, subject to the limitations of section 165(d).[101]

In addition to Tax Court, other federal courts have adopted the per-session method. In *Park v. Commissioner*,[102] the D.C. Circuit rejected the Service's attempt to apply the per-transaction method to non-resident aliens.[103] Writing for the court was then-Judge Kavanaugh. He relied upon the reasoning in CCA 2008-11 to hold that the Service had to apply the per-session position it had adopted there to all taxpayers, domestic and foreign.[104]

The Service formalized a version of the "per-session" approach in Notice 2015-21, which proposed a Revenue Procedure (to date unwritten) that would allow taxpayers to use a per-session approach as a safe harbor method for determining wagering gains from electronic slot machine play.[105] Just as the Service's guidance to Worldwinner on its *reporting* obligations had implications for the question of when redeemable credits must be accounted for as income, so does the Notice likewise have implications for casinos' reporting

101. *Id.* at 669.

102. 722 F.3d 384 (D.C. Cir. 2013).

103. *Id.* at 387.

104. *See id.* ("On the question actually before us—the meaning of 'gains'—we are persuaded that the per-session approach and not the per-bet approach is the better approach for the reasons the IRS itself persuasively explained with respect to U.S. citizens [in CCA 2008-11]."). For some reason, Judge Kavanaugh mis-cited the CCA as "AM2008-11." *Id.* at 386. Don't judge. IRS internal guidance nomenclature is ever-changing.

105. I.R.S. Notice 2015-21, 2015-12 I.R.B. 765.

obligations. Thus, on the same day it issued Notice 2015-21, the Service proposed modifications to Treasury Regulation § 1.6041-1(a) to conform a casino's reporting requirement to the Notice's safe harbor method.[106] That regulation was finalized in 2016.[107]

What is not known here is how the concept of session contained in the Notice and Regulations will apply to redeemable game credits. Our hypothetical players Alice and Myra simply do not have an identifiable "session" like the Shollenbergers or the Parks did. My hypothetical did not say whether Alice and Myra played all their sixty-eight games in one day or one week or one month. That is because an electronic account does not necessarily get redeemed as do casino chips and tokens at the end of a single playing session. Instead, an electronic account is continuous. Thus, both Alice and Myra might have played their sixty-eight games over any time period. And, of course, both might have added money to their player accounts during one day and then carried whatever balance was on the player account forward into a different day or week or month.

The proposed IRS position, however, is that a "session" is at most one calendar day.[108] It is difficult to see the logic to that conclusion. In contrast, one can easily see the logic of Professor Seto's argument to support a per-transaction approach. Consider Myra and her casino play. If Myra were dropping $2.50 in quarters into the slot machine and winning $6.00 in solid, tangible, quarters, that would be actual cash money. No one would doubt that Myra has received income. If Myra chose to scoop up the $6.00 in quarters and pop them right back into the slots, well, that was her choice on how to

106. *See* Information Returns; Winnings from Bingo, Keno, and Slot Machines, 80 Fed. Reg. 11,600, 11,600–11,607 (Mar. 4, 2015) (to be codified at Treas. Reg. § 1.6041-10) (amending Title 26 of the Code of Federal Regulations to reflect the safe harbor provision).

107. *See* Information Returns; Winnings from Bingo, Keno, and Slot Machines, 81 Fed. Reg. 96,374, 96,374 (Dec. 30, 2016) (to be codified at Treas. Reg. § 1.6041-10) (final regulation).

108. *See* I.R.S. Notice 2015-21, 2015-12 I.R.B. 765 ("A session of play is always determined with reference to a calendar day (24-hour period from 12:00 a.m. through 11:59 p.m.) and ends no later than the end of that calendar day.").

use her income. The per-transaction logic is that the receipt of the prize in the form of a credit to her player account ought to make no difference because she has it completely within his control to take the $6.00 in quarters by taking the player card to the cage and withdrawing the $6.00.

Similarly, Alice's win of $6.00 in redeemable game credits looks like income because it is, literally, "credited to [her] account."[109] While the Worldwinner Terms of Service charges a $1.75 fee to redeem amounts of less than $10, Professor Seto puts that aside as being a "hyper-technical analysis."[110] Instead he sticks with the theory that Alice can redeem the $6.00 and so should be held to have constructively received that amount net of the wager.[111]

Thus, as of this writing, it is not clear whether the per-session or the per-transaction approach will predominate. The next two sections explore how both approaches impose practical costs on the administration of tax and undermine the current legal conception of income.

IV. Current Doctrine Is Problematic in Practice

Notice 2015-21's definition of session is not consistent with CCA 2008-11 or with *Shollenberger*. Neither outcome turned on the taxpayer entering and exiting the Casino on a single day. The idea was a single session. For example, the Shollenbergers could have entered the casino at 10 p.m. on March 29th with $500 and then exited at 2 a.m. on March 30th with the $1,600 and there is no indication that would have changed the result. Yet Example 2 of the Notice suggests that, like some fairy tale, the stroke of midnight separates

109. *Terms of Service*, WORLDWINNER, https://perma.cc/XR8A-ZKPQ (last updated Aug. 5, 2019) (last visited Jan. 6, 2019) (on file with the Washington and Lee Law Review).

110. Seto, *supra* note 5, at 1049.

111. *See id.* (advocating for the per-transaction method which would account Alice's $6.00 when she constructively received it). I suspect Professor Seto would agree to let Alice net out a deemed $1.75 cost to the deemed redemption. If one does that and then also allows Alice to net out the P$2.50 wager, then the deemed income drops from $6.00 to $1.75.

sessions.[112] It would change the *Shollenberger* result when a taxpayer physically enters the casino on one day and physically leaves on another. The final regulation on information reporting abandons midnight as the inviolate magic hour and instead permits casinos to create a twenty-four hour gaming day for their reporting convenience.[113] But it keeps the rule that a session cannot last longer than twenty-four hours.[114] When one has an electronic gaming account, such a rule is arbitrary.

This current state of tax rules is problematic for taxpayers and tax administration when it comes to taxing electronic gaming. Both the per-session approach (with "session" defined as a day) and the per-transaction approach create practical problems. The problems for taxpayers, discussed above, come about because of the separation of income items from the costs associated with producing the income items. Those problems for taxpayers, however, also create problems for tax administration because taxpayers feel pressure to game the tax system.

One quickly sees the game gamers must play. They can avoid below-the-line deductions only if they make their gaming activity a business and not a hobby. And any activity can be a "trade or business" if the taxpayer pursues it with sufficient regularity and with the objective of making a profit.[115] The § 183 regulations set out a non-directive multi-factor test to determine whether a taxpayer is so genuinely engaged in an activity that it crosses the line from hobby to business.[116] That

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112. *See* I.R.S. Notice 2015-21, 2015-12 I.R.B. 765 (providing an example in which play that all occurred in one trip would be divided into two sessions because half occurred after 11:59 p.m.).

113. *See* Treas. Reg. § 1.6041-10(b)(2) ("An information reporting period is a 24-hour period.").

114. *Id.*

115. *See* Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987) (finding that an unemployed marketer who spent an entire year at dog tracks, winning $70,000 and losing $72,000, was engaged in the business of gambling).

116. *See* Treas. Reg. § 1.183-2(b). Those factors include: manner in which the activity is carried out, expertise of the taxpayer, time and effort expended in carrying out the activity, expectation of assets used appreciating, success of the taxpayer in carrying out the activity, taxpayer's history of income or losses with respect to the activity, amount of profits

means that a taxpayer's chances of being found to be engaged in a hobby or a business depends, to a non-trivial degree, on the luck of the draw: luck in avoiding audit in the first place, luck in drawing a sympathetic Revenue Agent, and luck in drawing a sympathetic judge or jury.

Hobbyists try hard to win the game and be put in the "trade or business" box. This has led, for example, to cases finding that slot-machine gambling is a trade or business.[117] Further, because taxpayers may simultaneously engage in multiple businesses, courts have at times found wage-earners to also be professional gamblers, entitled to treat their gaming activity as a trade or business.[118]

Losing the game has serious consequences, as illustrated by *Shollenberger*.[119] There, a couple claimed that their slot machine activity was a business and so took their losses above the line. They claimed only the standard deduction below the line. The Tax Court held their slot machine activity to be a hobby and not a business and so denied the claimed deduction for wagering losses.[120] That left them unable to use their slot machine losses because they could not undo their election to

earned, taxpayer's financial status, and elements of personal pleasure or recreation. *Id.*

117. *See, e.g.*, Chow v. Comm'r, 99 T.C.M. (CCH) 1193, 1196 (2010) ("This is a close case . . . . We conclude, however, that petitioner was a professional gambler during 2004 and 2005 . . . ."); Le v. Comm'r, T.C. Summ. Op. 2010-94, 2010 WL 2813420, at *3 (2010) ("We find petitioner's gambling activity was a trade or business that was pursued in good faith, with regularity, and for the production of income . . . ."); Myers v. Comm'r, T.C. Summ. Op. 2007-194, 2007 WL 4117442, at *7 (2007) ("[W]e conclude that petitioner engaged in the gambling activity with the actual and honest objective of making a profit in 2003.").

118. *See, e.g.*, *Myers*, 2007 WL 4117442, at *7 (concluding that a taxpayer who owned and operated a truck stop in Reno was also in the trade or business of professional slot machine gambling); Barrish v. Comm'r, 49 T.C.M. (CCH) 115, 119 (1984) (holding that a practicing attorney was also in the trade or business of a "greyhound racing wagerer").

119. *See* Shollenberger v. Comm'r, 98 T.C.M. (CCH) 667, 668–69 (2009) (finding petitioners were not in the business of gambling and therefore had $1,100 in unreported income for the year of 2005).

120. *See id.* ("Because petitioners were not engaged in the trade or business of gambling, their gambling losses are allowable only as itemized deductions.").

use the standard deduction.[121] The result was they could take no deduction for their slot machine losses.[122]

Thus, the current state of the law puts pressure on taxpayers to think up ways to move gaming losses above the line in order to achieve what intuition says is a proper reflection of income. That pressure causes taxpayers to characterize their gaming activity as a trade or business on their returns, regardless of the facts. Websites even target such taxpayers with promises to help hobbyists disguise themselves as businesspeople.[123]

One practical problem this pressure creates is less tax revenue.[124] Taxpayer mischaracterization of a hobby as a business can only be uncovered by personal audits.[125] The current audit rate is only about 1 in 200 returns.[126] The audit lottery leads less scrupulous taxpayers to simply lie and

121. *See id.* at 669 (finding that the limitations period had elapsed).

122. *Id. See also Le*, 2010 WL 2813420, at *3. In *Le* the taxpayers had interstitial slot machine winnings of over $800,000 and losses of over $1 million. *Id.* at *1. Reporting the activity as a business, the taxpayers took the losses above the line and so reported no net income. *Id.* On audit the Service decided the taxpayers' activity was not a business, thus forcing them to take the losses below the line. *Id.* at *2. The massive increase in their AGI resulted in the application of § 68 restrictions on certain personal deductions. *Id.*

123. *See, e.g.*, Colin M. Codym, *Looking for Tax Deductions?* PROFESSIONALGAMBLERSTATUS.COM, https://perma.cc/P2HH-KAYJ (last updated Nov. 9, 2019) (last visited Jan. 6, 2020)

> Professional Gambler Status until recently has been rarely seen on federal income tax returns, because frankly there were very few people who earned their living traveling from casino to casino. But with the onsurge of online gaming, the number of IRS filed tax returns showing Professional Gambler Status is expected to increase dramatically over the coming years.

(on file with the Washington and Lee Law Review).

124. *See* Zoe Prebble & John Prebble, *The Morality of Tax Avoidance*, 43 CREIGHTON L. REV. 693, 725 (2010) (explaining the impact tax avoidance and fraud have on tax revenue).

125. *Cf.* Jay A. Soled, *Implications of Discovering Unreported Income, Improper Deductions, and Hidden Assets upon a Taxpayer's Death*, 44 GA. L. REV. 697, 721–22 (2010) (discussing how audits uncover improper deductions).

126. *See* INTERNAL REVENUE SERV., INTERNAL REVENUE SERVICE DATA BOOK, 2018, Table 9a (showing an overall audit rate of 0.5%).

uncertain taxpayers to try and stretch the truth, leaving honest taxpayers sucker-punched.[127] That is not good tax administration.

A second practical problem this pressure creates is disproportionate use of resources. It requires determination of whether a taxpayer's gaming activity is a business or a hobby. As with decisions about intent in the gift exclusion area, such a determination about motivation is messy, based on "life in all its fullness" and "the mainsprings of human conduct."[128] Reading the various cases cited in this Article leaves one with the firm and definite impression that both the Service and courts use up a lot of resources to decide the business or hobby question. Yet, those resources do not produce much tax revenue. Consider again the case of *Le v. Commissioner*[129] in which the taxpayers churned over $1.8 million in slot machine wins and losses. The audit resulted in a tax deficiency of $10,000. That may be a lot for many taxpayers, but it is very little for the government. How little? Well, it is likely below the threshold for the government to pursue tax collection by lawsuit.[130]

A third practical problem is that courts sometimes confuse the "business" of playing slot machines with addiction. For example, in *Myers v. Commissioner*,[131] the taxpayer ran her truck stop business from the time she woke until 1 or 2 p.m., then she would go play slots in the casino until between 2 a.m. and 6 a.m.[132] She would then return home and sleep a little before getting up to run the truck stop. She started this

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127. *See* Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 193 (1996) (noting how often taxpayers who play the audit lottery do not face penalties).

128. *See* Comm'r v. Duberstein, 363 U.S. 278, 289 (1960) (discussing the difficulties in determining motive).

129. T.C. Summ. Op. 2010-94, 2010 WL 2813420 (2010).

130. One finds the limit in the Service's Law Enforcement Manual (LEM), which is not a public document, but contains many such informal policies. *See, e.g.*, Church of Scientology Int'l v. Comm'r, 845 F. Supp. 714, 722–23 (C.D. Cal. 1993) (refusing to require the Service to disclose LEM content about church audits in the context of a FOIA litigation). The last time I read the LEM was before 2001.

131. T.C. Summ. Op. 2007-194, 2007 WL 4117442 (2007).

132. *Id.*

routine after the death of her husband and kept it up despite the concerns of her children for her safety. The court stated: "Petitioner's children, who had lost their father in an automobile accident, were extremely worried about petitioner's early morning drives home from the casino, particularly in the wintertime. Nevertheless, petitioner gambled and made these late-night trips home nearly every day."[133]

The Court's description of Mrs. Myers' behavior suggests behavior driven more by compulsive need than desire for profit. But the tax consequences to her if the activity were merely a hobby would have been brutal. So, the court cut her a break that another, less sympathetic, taxpayer may not have received: it held her gambling was a business.[134] Similarly, in *Le v. Commissioner* the Tax Court appears to make a generous decision that that the taxpayer's use of Feng Shui to determine his lucky days was a legitimate business action.[135] Had the Les not been in the "business" of playing slots, their AGI would have been some $800,000 more than what they reported, which would have triggered § 68, among other difficulties.[136]

A fourth practical problem is that decisions about motivation are inherently intrusive into a taxpayer's personal life. For example, in *Myers*, we learn intimate details about the taxpayer's personal tragedies and family situation as part of the process of deciding whether her gaming activity was a business or was personal. That kind of intrusiveness is suboptimal tax administration and is to be avoided if reasonably possible. Current doctrine encourages it.

In sum, separation of deduction items from the income that produces them creates additional burdens and costs not only for taxpayers but also for tax administration. Those burdens would disappear if gaming expenses were properly

133. *Id.* at *1.

134. *See id.* at *7 (concluding that Mrs. Myers had engaged in gambling with the "actual and honest objective of making a profit in 2003").

135. *See Le*, 2010 WL 2813420 at *3 ("We accordingly conclude that petitioner was engaged in the trade or business within the meaning of section 162 and that his gambling losses are not itemized deductions reportable on Schedule A.").

136. *See id.* at *2 (explaining that the Les had earnings of $852,230 in 2006).

aligned with gaming income. Neither the per-transaction approach nor the per-session approach makes that proper alignment. While Congress could solve the practical problems by allowing all gaming losses (whether hobby or gambling) to go above the line, that solution would not solve the theoretical problem of treating redeemable game credits as income in the first place. Let's look at the theory.

V. Current Doctrine Is Problematic in Theory

In addition to practical problems, the phenomenon of redeemable game credits renews a long-standing theoretical problem in tax: to what extent should the *legal* definition of income align with or depart from an *economic* conception of income. Both the per-transaction and per-session approach illustrate the dangers of aligning too closely with the economic models.

The foundational legal concept of the Tax Code is "gross income." Section 1 imposes tax on "taxable income." Section 63 defines that term as "gross income minus the deductions allowed by this chapter." And it is § 61 that unsatisfactorily defines "gross income," as "all income from whatever source derived." Section 61, however, leaves single word "income" undefined, leaving it the focus of much controversy, both in the courts and in the commentary.

The relevant regulations state a rule that income is *anything* of economic value, regardless of its form as cash, property, or services.[137] It is then up to the taxpayer to show why an item of economic income is not or should not be legal income.[138] The Supreme Court's decision in *Glenshaw Glass v.*

137. *See* Treas. Reg. § 1.61-1 (1957) ("Gross income includes income realized in any form, whether in money, property or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash."); Treas. Reg. § 1.61-2(d)(1) (as amended in 2003)

> [I]f services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation.

138. *See* Commissioner v. Schleier, 515 U.S. 323, 327–28 (1995) (stating that economic income "constitutes gross income unless it is expressly excepted by another provision in the Tax Code"). That case and others speak

Commissioner[139] is routinely cited as aligning the legal definition of income to an economic conception of income.[140]

The theoretical problem is to explain why tax law does not sweep everything of economic value into the legal definition of income. My prior work answers this question by claiming that the explanation comes from the operation of an income tax in a democracy.[141] Congress has written exclusions in the Tax Code, and courts have created common law exclusions, for items that fit the economic theory but, for reasons grounded in democratic values, ought not to be taxed. Thus the legal meaning of income is not ontological but operational, limited by operational rules written both in other tax statutes and by

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in terms of construing income items broadly and exclusions from income narrowly. *See id.* (explaining that the corollary to § 61(a)'s broad construction is the "default rule of statutory interpretation that exclusions from income must be narrowly construed" (citation omitted)); *see also* United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 583 (1991); Comm'r v. Jacobson, 336 U.S. 28, 49 (1949). The operational translation of that approach is found in situations when there is a dispute between the Service and the taxpayer over the propriety of inclusion. *See Schleier*, 515 U.S. at 327–28. Tax procedure gives the Service determination of inclusion a very strong presumption of correctness. *See* TAX CT. R. 142 (stating that the burden of proof is on the petitioner, unless otherwise provided by statute or determined by the Court); United States v. Janis, 428 U.S. 433, 441–42 (1976) (stating that the determination of the Commissioner is presumed correct and the burden is on taxpayer to establish error); Welch v. Helvering, 290 U.S. 111, 115 (1933) (same). Until that presumption is overcome, courts will not examine the basis for the adjustments that have been made, the propriety of the Commissioner's motives, or the administrative policy or procedure used in determining a deficiency. *See* Zuhone v. Comm'r, 883 F.2d 1317, 1325 (7th Cir. 1989) (stating that courts have consistently held that they should refuse to examine "evidence used or the propriety of the commissioner's motives or administrative policy or procedure in making the determination"). For an excellent discussion, see Leandra Lederman, *'Civil'izing Tax Procedure: Applying General Federal Learning to Statutory Notices of Deficiency*, 30 U.C. DAVIS L. REV. 183 (1996).

139. 348 U.S. 426 (1955).

140. Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 301–07 (2011) [hereinafter Abreu & Greenstein, *Defining Income*] (explaining that the expansion of the positive definition of income culminated in *Glenshaw Glass*).

141. *See* Bryan Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 HASTINGS L.J. 1, 25 (2007) (explaining that "current tax doctrine . . . contains three operational limits, or exceptions, to what taxpayers must include as 'gross income'").

courts. Those limitations, I have maintained, are aimed at "preventing government over-reach when income is too difficult to measure, too difficult to pay, or would require intolerable government intrusion into individual lives."[142]

Other scholars have also recognized this connection.[143] Notably, Professors Alice Abreu and Richard Greenstein have expanded on that insight in two very comprehensive articles.[144] They argue that because the operation of the tax law departs from the economic theory of income, the legal meaning of income should be decided by a broad standard, composed of multiple indeterminate factors, rather than by a web of rules.[145]

I believe that the problem of redeemable game credits shows the weakness in this approach. The theoretical problem is perhaps best framed as a debate between accountants and economists over what should count as income, with accountants taking perhaps a too operational view, economists taking perhaps a too theoretical view, and lawyers borrowing from both groups to arrive at a legal definition of income that is a mix of both theory and practice. The key is to find the right mix and find a good rule or set of rules to express it.

A. Accountants vs. Economists

Two groups of non-legal thinkers—accountants and economists—have influenced the legal evolution of the term "income."[146] Accountants tend to use the term in a very practical way, to help their clients make decisions on how to

142. *Id.*

143. *See generally* Abreu & Greenstein, *Defining Income*, *supra* note 140.

144. *See generally id.*; Abreu & Greenstein, *It's Not a Rule, supra* note 6.

145. *See* Abreu & Greenstein, *Defining Income*, *supra* note 140, at 346 (proposing that "the definition of income be acknowledged to be a standard that should be interpreted in light of the values—including noneconomic values—that animate the field of income taxation").

146. *See, e.g.*, Seto, *supra* note 5, at 1045 (providing an accounting perspective of income taxation); EDWIN R. A. SELIGMAN, THE INCOME TAX: A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 19 (2d ed. 1921) (providing an economic perspective of income taxation); Willard J. Graham, *Some Observations on the Nature of Income, Generally Accepted Accounting Principles, and Financial Reporting*, 30 L. & CONTEMP. PROBS. 652, 653 (1965) (describing economic definitions of income as advanced by theorists such as Adam Smith and Alfred Marshall).

behave in a capitalist system. Economists tend to use the term in a more theoretical way, to help further their study of the human condition. One can see in the legal history of the term a tug-of-war between these two groups. Those who write the law, those who implement it, and those who interpret have looked to both groups to help define the *legal* meaning of the term "income." My thesis here is that the current legal meaning of gross income is best viewed as a compromise between accountants and economists.

Financial accountants have long thought about "income" as something distinct from "capital." I cannot explain this better than did Professor Seto:

> From an accounting perspective, governments can tax two kinds of things: stocks and flows. Stocks include but are not limited to the kinds of items that would appear on a balance sheet. Flows include but are not limited to the kinds of items that would appear on an income statement. For readers unfamiliar with accounting concepts, it may be useful to think of a "stock" as analogous to the amount of water in a storage tank at a specified point in time. A "flow" is then analogous to the amount of water added to or taken out of the tank over a specified period. More generally, stocks represent the state of the world at any given point; flows represent changes in that state over time. As a general matter, governments can structure taxes in either of two ways: they can tax the amount of water in the tank at a particular moment (a tax on stocks) or they can tax the amount added over a particular period (a tax on flows). Head taxes and property taxes are taxes on stocks; income taxes and sales taxes are generally taxes on flows.[147]

Some early tax economists agreed with this accounting view. Edwin Seligman, for example, a well-respected economist and staunch proponent of the income tax in the early 1900s, wrote that "income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired."[148]

147. Seto, *supra* note 5, at 1045.

148. SELIGMAN, *supra* note 146, at 19.

Other tax economists, however, rejected this accounting view. Another prominent economist, Henry Simons, was perhaps the most forceful. Simons made the point: "We do best, in general, to regard income not as something accruing or flowing with time—for such language is dangerously figurative—but merely as a result imputed to particular periods."[149] Simons preferred to think of income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[150] Call this the standard economic model.[151] Put in equation form, Simons' model formula looks like this where I = Income, C = market value of rights exercised in consumption, and ΔW = the change in wealth over time: $I = C + \Delta W$.[152]

Notice that, for Simons, "income" is the residual term. It is the result of figuring out the other two terms. Compare this with the traditional Form 1040.[153] Judged by the standard economic model, the Form 1040 is exactly backwards. The form first asks taxpayers for information about their income (usually their gross income, although some lines ask for income net of allowable deductions, such as the line which taxpayers calculate using the Schedule C, on which they report their business income and appropriate business deductions to arrive at a net gain or loss on the business), with the penultimate line being a catch-all for "other income." Once taxpayers report their gross income, they then take various

149. HENRY C. SIMONS, PERSONAL INCOME TAXATION 99 (1938).

150. *Id.* at 50.

151. For an illuminating study of Simons's more nuanced thinking, see Daniel Shaviro, *The Forgotten Henry Simons*, 41 FLA. ST. U. L. REV. 1 (2014). I call this the "standard" economic model because it has formed the basis for legal writing about the income tax.

152. Proponents of a cash-flow income tax do not seem to dispute the basic model so much as desire to change the focus of what is to be taxed from the Income variable to the Consumption variable, arguing that doing so leads to a simpler and fairer tax regime. *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1118–22 (1974).

153. The traditional 1040 was last used for the 2017 tax year. *See* Form 1040, INTERNAL REV. SERV., https://perma.cc/GBC8-5BMP (PDF). The IRS has departed from the traditional forms for tax years 2018 and 2019, but those forms still ask the gross receipts questions first.

deductions to eventually arrive at their "taxable income." If an economist designed the Form 1040, it would ask taxpayers to first report the market rights of their consumption during the time period and then report their change in wealth.

An accountant, however, will rearrange Simons' equation to this: $I - C = \Delta W$. Income is what gets measured first, then consumption is measured and subtracted from income. The residual is your change in wealth.

In sum, accountants generally view income as something directly measurable, that flows over time. In contrast, economists generally conceive of income as what *results* from changes in consumption and wealth over the reporting period; it is the residual.

B. The Triumph of the Economists

The accounting and economic concepts of income have both influenced the *legal* meaning of the term income. Early on, the Supreme Court appeared to adopt the accounting view in *Eisner v. Macomber*.[154] The taxpayer there had received a corporate dividend in the form of additional corporate stock. The Court decided that what the taxpayer had received was an increase in her capital—her stock—and hence could not be income, or flow.[155] Thus, to tax the stock dividend was to tax capital stock and not income.[156] While Congress could indeed tax it, such a tax did not come under the 16th Amendment apportionment exception to direct taxation because what was being taxed was not "income" (or "flow") but was, literally, the stock.[157]

That the Court here adopted the accounting view of income is evident in two aspects of its opinions: the source doctrine and the realization doctrine. As to the first, the Court held that mere accretion of wealth was not "income" within the

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154. 252 U.S. 189 (1920); *see also* Graham, *supra* note 146, at 654–55 (referring to *Eisner* as the authority on the legal meaning of income).

155. *Eisner*, 252 U.S. at 219.

156. *See id*. ("The stockholder's share in the accumulated profits of the company is capital, not income.").

157. *Id*.; *see also* Seto, *supra* note 5, at 1045 (stating that a "direct" tax was a tax on "stock").

meaning of the 16th Amendment and, hence, could not be "income" within the meaning of the language now in § 61.[158] Instead, the Court opined that income arose from either of two sources, capital or labor, calling that the understanding "used in common speech."[159] This formulation implied that the source of income mattered: increases in wealth not linked to capital or labor or to a concept of income "used in common speech" could not be income within the scope of the 16th Amendment.

Second, the Court looked to the idea of "realization," an accounting concept, to explain that mere increase in wealth did not become "income" unless and until it was severed from the capital.[160] Until then it was just more water in the tank, a "paper" gain that was still part of the "stock."[161] Thus, while a cash dividend was income, a true stock dividend was not because it left the taxpayer with no new assets and no change in position with respect to the other owners of the corporation. While the taxpayer had an increase in wealth, she did not realize any income from it until she cashed out.[162]

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158. *Eisner*, 252 U.S. at 219. The practical result of the case was to deny Congress the ability to tax the amount in question because there was no practical way for Congress to ensure the tax was imposed in proportion to the population of each state.

159. *See id*. ("After examining dictionaries in common use . . . we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909, 'Income may be defined as the gain derived from capital, from labor, or from both combined[.]'" (citations omitted)).

160. *See id*. at 207

> Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being *'derived'*—that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal—*that* is income derived from property. Nothing else answers the description.

(emphasis in original).

161. *See id*. at 213 ("[T]he stockholder has 'derived' nothing except paper certificates which, so far as they have any effect, deny him present participation in such earnings.").

162. *See id*. at 211

> A stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of

Eisner was the high water mark of the accounting concept's influence on the legal meaning of income. Over time, the Supreme Court has repudiated the source doctrine and has significantly weakened the realization doctrine. In so doing, the Court has aligned the legal concept of income more closely to the economic concept.

The source doctrine died in 1954 in *Glenshaw Glass*.[163] The taxpayer there had been a plaintiff in a prior lawsuit who did not report as income some $325,000 in punitive damages it had received.[164] The Third Circuit, relying on the "common usage" limitation implied by *Eisner*, accepted the taxpayer's argument that punitive damage award was not income because, being a windfall, it did not flow from either capital or labor and ordinary folks would not consider it to be income.[165] Refusing to be drawn in to a metaphysical argument about how income derived from capital or labor, the Supreme Court insisted that § 61 contained "no limitations as to the source of taxable receipts, or restrictive labels as to their nature."[166] Instead of relying on a formalist inquiry as to source, the Court inscribed into tax law and lore the famous formulation: the receipt of $325,000 was gross income because it was an "instance of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[167] This

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> the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

163. 348 U.S. 426, 429–30 (1955).

164. *Id.* at 428.

165. *See* Comm'r v. Glenshaw Glass Co., 211 F.2d 928, 933 (3d Cir. 1954) (stating punitive damages "do not fall within the definition of *Eisner v. Macomber*"). In effect, the Circuit Court punted the entire issue, noting that "[t]he Supreme Court has never expressly departed from the definition of income of *Eisner v. Macomber*" and that, in fact, "[t]here is as yet no decision which has adopted the contentions made by the Government here." *Id.* So, no matter how attractive the government's position might be, the Circuit concluded that "if such a result is to be achieved after nearly two decades it should be effected by the Supreme Court and not by this tribunal." *Id.* at 934.

166. *Glenshaw Glass*, 348 U.S. at 429–30.

167. *Id.* at 431. The Court's holding reflected the intent of the tax writers who revised the 1939 Tax Code into the 1954 Tax Code. The House Ways and Means Committee Report noted that "Section 61(a) provides that gross

focus on access to and control of wealth aligned the legal concept of income more closely with the economic concept of income as the exercise of rights in consumption and changes in wealth.[168] Scholars debate the extent to which the Court was embracing the general economic model.[169] Those who argue it was still concede that the Court's use of the word "realized" meant that the embrace was more of a side hug than a bear hug.[170]

The realization requirement took a blow in 1947 in *Helvering v. Bruun*[171] when the Court held that income could indeed include accrued economic value.[172] There, the taxpayer leased some land on which the tenant built a building. When the tenant defaulted on the lease, the taxpayer got back the property which now had a valuable building sitting on it. Relying on *Eisner* the taxpayer argued that since the termination of the lease did not (and indeed could not) formally sever the building from the land, all that had happened was

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income includes 'all income from whatever source derived.' This definition is based upon the 16th Amendment and the word 'income' is used in its constitutional sense." H. R. REP. NO. 1337, n. 10, at A18 (1952).

168. *See* Joseph M. Dodge, *The Story of* Glenshaw Glass*: Towards a Modern Concept of Gross Income*, *in* TAX STORIES 17, 23 (Paul L. Caron ed., 2d ed. 2009) (explaining that the *Macomber* definition of income considers it erroneous to view "income" as separate from "gains"). It is true that the Court made no reference to Simons's definition, nor does it appear that any of the parties before the Court argued for it. *See id.* at 22 (noting that the parties' briefs focused primarily on the *Macomber* definition of income). Nonetheless, by rejecting source as the touchstone for the legal definition, the *Glenshaw Glass* Court freed the legal meaning from the accounting shackles and aligned it more closely with the economic vision. Commentators generally believe that the "breadth of the *Glenshaw Glass* definition appears to be nearly co-extensive with the Haig-Simons definition of income, which is widely accepted as providing the theoretical foundation for the income tax. Accordingly, many tax professionals interpret the language in section 61 and *Glenshaw Glass* solely in light of the economic principles reflected in the Haig-Simons definition." Abreu & Greenstein, *Defining Income*, *supra* note 140, at 296–97. I agree with Professors Abreu and Greenstein on that.

169. Dodge, *supra* note 168, at 39 (stating that the *Glenshaw Glass* Court "did not explicitly commit to any single normative and comprehensive conception of personal income taxation").

170. Abreu & Greenstein, *Defining Income*, *supra* note 140, at 306–07.

171. 309 U.S. 461 (1940).

172. *See id.* at 469 ("Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction.").

that the underlying property had appreciated in value.[173] What the taxpayer had gotten back was just like a true stock dividend. The Court rejected that view and found that the appreciation in the property due to the building was indeed "income" within the meaning of the statute.[174] The Court said the taxpayer had to report the value of the building as income in the year the lease terminated and that the government did not need to wait until the taxpayer took some action to convert the now more valuable "stock" into cash "flow."[175]

The realization requirement was chopped down further in 1991 in *Cottage Savings Ass'n v. Commissioner*.[176] There the taxpayer bank had swapped a portfolio of mortgage loans with another bank's portfolio of loans. The taxpayer had a basis of $6.9 million in the portfolio but because interest rates had risen dramatically, the stream of income generated by that $6.9 million could now be generated by a mere $4.5 million in loans. Accordingly, the face value of the taxpayer's portfolio had dropped. The taxpayer figured that if it swapped its portfolio with another, more recent, set of loans worth $4.5 million, it could take a $2.4 million loss and still be in the same economic position as it was before relative to risk of default. So in an attempt to cash out the loss it did the swap. The Service argued the swap was not a realization event sufficient to trigger the § 1001 calculations because there was no change in economic position by the bank. It really had not cashed out of anything as evidenced by its strict compliance with the Federal Home Loan Bank Board's Memorandum R-49 which approved such deals only when the mortgage loan portfolios were

173. *See id.* at 468 (stating that the respondent argued "that gain derived from capital must be something of exchangeable value proceeding from property, severed from the capital, however invested or employed, and received by the recipient for his separate use, benefit, and disposal").

174. *See id.* at 469 ("[T]he realization of gain need not be in cash derived from the sale of an asset.").

175. *Id.* Congress statutorily overruled *Bruun* by writing a cash-out rule in § 109, which provides that "gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease." Section 1019 drops the other shoe: the amount excluded by § 109 cannot figure into basis and so will eventually be included in income when the lessor cashes out by selling or exchanging the property.

176. 499 U.S. 554 (1991).

"substantially identical" such that there was no transfer of risk.[177]

The Supreme Court held that the swap was a realization event.[178] The Court said the swap met the "administrative purposes underlying the realization requirement in § 1001(a)" because it resulted in the parties having "legal entitlements that are different in kind or extent."[179] The test was thus whether there was an ascertainable, reportable, and verifiable change in *legal* relations: "as long as the property entitlements are not identical, their exchange will allow both the Commissioner and the transacting taxpayer easily to fix the appreciated or depreciated values of the property relative to their tax bases."[180]

C. The Persistence of Accounting Memory

Like Monty Python's Black Knight, the accounting concept of income may have lost some limbs, but has never been completely out of the fight over the legal meaning of income.[181] That is because tax administrators are more like accountants than economists: income is not an abstraction to be debated, but a reality to be taxed. Tax administration requires rules that people can follow—both those subject to the law and those who must administer it. The need to administer the law to a population of over 150 million individual taxpayers ensures the legal concept of "gross income" will never reach as far as the economic concept.[182] Hence, discussion of tax

177. For a good summary of this story, see Scott Lenz, Note, *The Symmetry of the Realization Requirement and Its Application to the "Mortgage Swap" Cases*, 9 VA. TAX. REV. 359 (1989).

178. The Court rejected the government's contention that it had to evaluate "the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the [Federal Home Loan Bank Board]" to decide whether realization occurred. *Cottage Savings Ass'n*, 499 U.S. at 565.

179. *Id.*

180. *Id.*

181. *See Monty Python and the Holy Grail*, IMDB, https://perma.cc/HS5F-5K7L (last visited May 9, 2019) (on file with the Washington and Lee Law Review).

182. In Fiscal Year 2018, the Service received over 145 million individual tax returns. *See* INTERNAL REV. SERV., I.R.S. DATA BOOK 4 (2018), https://

policy—including any normative discussion—cannot be divorced from implementation.

The current legal meaning of income reflects a balance between the economic and accounting meanings. Two accounting concepts relevant to this Article persist in the law: the idea of an accounting period and the idea of imputed income. Each has an associated legal doctrine that articulates that persistence.

1. Accounting Periods and the Doctrine of Constructive Receipt

The most obvious accounting concept is found in the requirement for an annual accounting period. As the Supreme Court put it in *Burnet v. Sanford & Brooks Co.*,[183] "[i]t is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals."[184] The economist's view of income does not translate well into tax law because it ignores the practical requirement that income be something that can be reliably measured and reported. The Service cannot collect tax on items that cannot be measured and reported. Unlike an economist, the Service cannot assume payment.

Taxpayers generally use one of two methods to account for their income: cash or accrual. Taxpayers choosing the cash method report the income they actually receive during the year.[185] In contrast, accrual method taxpayers report income when all events have occurred to fix their right to an ascertainable amount, whether or not they have actually received that amount.[186]

For both methods, § 441(a) creates an annual accounting rule. Taxpayers make their annual accounting on the forms prescribed by the Service.[187] Section 451(a) tells cash method

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perma.cc/3ST7-H2QH (PDF). Since many were joint returns, the actual number of taxpayers is much higher. *Id.*

183. 282 U.S. 359 (1931).

184. *Id.* at 365.

185. § 451(a).

186. § 451(b)(1).

187. Section 6011 instructs taxpayers to use the "forms and regulations prescribed by" the Service and to report the "information required by such

taxpayers to include on their yearly tax return all the income they have *received* in that year. Taxpayers make only one return for each yearly accounting period.[188]

Any rule invites evasion and the annual accounting rule is no exception. Early in the modern era of income tax, cash method taxpayers attempted to push income items from one accounting year into the next. The courts and the Service quickly came up with the constructive receipt rule to combat those attempts to push income from one year into the next.

Tax regulations created the constructive receipt rule in 1916.[189] The contours of the rule have not much changed since then and are currently set out in Treas. Reg. § 1.451-2:

> 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.[190]

You can see the early development of the doctrine in *Appeal of Brander*.[191] Mr. Brander was a fifty percent shareholder of a corporation that paid him a salary of $115,166

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forms or regulations." § 6011(a). Given that the Service processed over 145 million individual income tax returns in Fiscal Year 2018, one quickly sees why Congress has delegated to the Service the power to regulate the reporting requirement. For discussion of a recent case in which the taxpayer unsuccessfully challenged the applicable forms and regulations, see Bryan Camp, *Lesson from the Tax Court: Taxpayer Cannot Cure Reporting Error During Audit*, TAXPROF BLOG (Mar. 2, 2020), https://perma.cc/MT56-272B (last visited Mar. 10, 2020) (on file with the Washington and Lee Law Review).

188. Badaracco v. Comm'r, 464 U.S. 386, 401 (1984). I explain the one return rule in Bryan Camp, *Lesson from the Tax Court: The One Return Rule*, TAXPROF BLOG (July 2, 2018), https://perma.cc/8C38-ZKCJ (last visited Dec. 23, 2019) (stating that a taxpayer may only file one return document for limitation period purposes and penalty purposes) (on file with the Washington and Lee Law Review).

189. *See In re* Republication of A.R.R. 4385, GCM 34788 (I.R.S. Feb. 28, 1972).

190. Treas. Reg. § 1.451-2(a) (1979).

191. 3 B.T.A. 231 (1925).

in 1915. He did not actually receive all of that. He received $112,662, with the remainder left on the corporation's books as accrued and owing, but unpaid. He reported income that year of the $112,662 he had actually received. On audit, the Bureau of Internal Revenue (BIR) said that he should have reported the entire $115,166. In the ensuing litigation, the Board of Tax Appeals held that Mr. Brander had constructively received the entire amount of salary he was entitled to in 1915 because of his control over the corporation:

> During the year he . . . could just as freely have permitted it to pay its salary debt to him. It was not that the corporation would not pay, but rather that he would not receive. This election to give the corporation the temporary use of the amount is an exercise by him of its enjoyment, and this is one of the primary attributes of income. The Commissioner therefore correctly determined that the taxpayer's income from salary and commission was $115,166.[192]

The constructive receipt doctrine is a timing doctrine. It tells a taxpayer the proper accounting period in which the taxpayer must report an item of income. The relevant accounting period is not a daily period, a monthly period, or a transactional period, starting and stopping with each transaction. It is a yearly period. The purpose of the constructive receipt doctrine is to force taxpayers to conform to the § 451(a) yearly accounting requirement and to deny them the ability to choose which year to receive income. As then-Judge Felix Frankfurter explained: "The doctrine of constructive receipt was, no doubt, conceived by the Treasury in order to prevent a taxpayer from choosing the year in which to return income merely by choosing the year in which to reduce it to possession."[193]

Put another way, the question answered by the constructive receipt doctrine is *when* does a taxpayer receive income, not *whether* a taxpayer receives income. It does not turn every refusal to accept something of value into income. An example is *Mott v. Commissioner*.[194] There, the taxpayer was

192. *Id.* at 236.

193. Ross v. Comm'r, 169 F.2d 483, 491 (1st Cir. 1948).

194. 30 B.T.A. 1040 (1934), *aff'd in part, rev'd in part sub nom.* Comm'r v. Mott, 85 F.2d 315 (6th Cir. 1936).

trustee of three trusts he had created for each of his three children. The trust instruments entitled the trustee to compensation of three percent of the trust income. He had total control on whether to pay himself the compensation he was entitled to receive. The taxpayer never paid himself the compensation. On audit, the BIR determined that the three percent compensation was constructively received. Both the Board of Tax Appeals and the Sixth Circuit rejected the application of the constructive receipt timing doctrine to an outright refusal to accept compensation—as opposed to a deferral. Wrote the Board:

> To say that petitioner received these amounts as compensation is to indulge in a deliberate legal fiction. Petitioner had the right to render his services free if he wished, and we know of no rule of law which requires a person to accept compensation or income. The fiction of constructive receipt of income is resorted to usually to fix the time of receipt, where it is ultimately actually received and accepted.[195]

2. Realization and the Bargain Purchase

To an economist like Simons, income comes from appreciation in a property's value as much as from cash inflows. Both are part of the ΔW term.[196] The need for an accounting period, however, creates a measurement problem because not all economic income flows neatly within the bounds of the tax accounting period, particularly when the income arises from ownership of property. Marking one's

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195. 30 B.T.A. at 1044 (emphasis added); *see also* Giannini v. Comm'r, 42 B.T.A. 546, 556–57 (1940), *aff'd sub nom.* Comm'r v. Giannini, 129 F.2d 638 (9th Cir. 1942) (stating that bank president did not constructively receive salary when he waived receipt, nor did his suggestion that the money be used for charity constitute assignment of income); Estate of Kiser v. Comm'r, 12 T.C. 178, 182 (1949) (stating that executor of estate did not constructively receive fees when he waived receipt); Wood v. Comm'r, 22 B.T.A. 535, 537 (1931) (same); Rev. Rul. 66-167, 1966-1 C.B. 20 (stating that statutory fees or commissions are not included in the gross income of the executor of an estate when the executor effectively waives his right to receive such fees or commissions).

196. As Professor Shaviro points out: "[T]he Haig-Simons income definition gives realization absolutely no place. Changes in the market value of one's assets are economic income, as the definition makes clear, whether one sells the assets or not." Shaviro, *supra* note 151, at 30.

property to market values at the start and end of each accounting period would be one solution.

The idea of realization is the accountant's solution. The concept of realization allows taxpayers to track the income represented by appreciation in property by waiting until they have done something to unlock that appreciated value.[197] The focus is on finding a suitably identifiable event by which the taxpayer actualizes the economic abstraction of appreciation.[198]

Economists dislike the realization concept because it ignores the economic truth that appreciated property makes a person wealthier before (and sometimes long before) any realization event. Simons, for example, called the realization concept a "professional conspiracy against truth."[199] Anyone with a home equity mortgage is probably part of that conspiracy. Still, even Simons apparently accepted that the practical benefits of a realization rule outweighed the theoretical tidiness of a mark-to-market rule, and so realization is the rule.[200]

The realization requirement is another accounting rule that boils down to timing.[201] Before an accession to wealth is reportable as gross income, there must be some event by which the taxpayer realizes that accession in a way as to be legally

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197. *See* Marjorie E. Kornhauser, *The Story of* Macomber*: The Continuing Legacy of Realization*, *in* TAX STORIES 53, 54 (Paul L. Caron ed., 2003) (noting that realization "provides many opportunities for taxpayers to manipulate their tax status to achieve desirable tax consequences").

198. Or, as Professor Kornhauser puts it, "some transaction, usually a market transaction, must occur which changes the taxpayer's relationship to the asset." *Id.* at 55.

199. *Id.* (quoting Simons).

200. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). I was certainly surprised to learn about Simons's views from Professor Shaviro, *supra* note 151, at 38 ("[H]e considered realization 'relatively unobjectionable in principle where it results only in postponement of assessment' rather than its permanent elimination.").

201. *See* Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 388 (2004) ("Taxpayers can magnify the advantage of the timing option by strategically timing sales, taking losses when the tax rate is high and deferring gains until the rate is low.").

taxable.[202] There is a continuum of choices.[203] Lots of events might occur, and which ones constitute a "realization event" is a practical inquiry, which has turned out to be significantly path-dependent.[204]

202. *See id.* at 357–58 ("A realization event does not create income but merely serves to denominate the point in time at which the taxpayer reports the accrued income.").

203. *See id.* at 396 (stating that "[s]ince neither an accrual tax or a pure realization rule is tolerable, the task for policymakers is to determine where along the continuum to draw the line").

204. The American legal system depends on a concept of judicial precedent where the outcome of one case determines the range of potential outcomes in later cases. This is true even for highly codified areas of law like tax. An outcome in an earlier case may well block one or more paths to alternative outcomes in future cases. Actions by other legal institutions, such as Congress and the Service, also affect the range of potential outcomes. One valuable service traditionally provided by the academy has been to expand the range of available choices by discovering new analytical paths for courts to use when addressing recurring issues. A good example of this dynamic between Congress, courts, commentators, and the Service is found in *Commissioner v. Tufts*, where the Court wrestled with how to treat relief from a non-recourse debt. 461 U.S. 300 (1983). Professor Wayne G. Barnett of Stanford had marked out the best approach to the problem, but the Court would not adopt it. *See id.* at 317 (O'Connor, J., concurring) ("I would take a quite different approach—that urged upon us by Professor Barnett as *amicus*."). The majority agreed that the Service approach, adopted by the Court in *Crane v. Commissioner*, 331 U.S. 1 (1947), had significant problems, including that it "laid the foundation stone of most tax shelters." *Tufts*, 461 U.S. at 309. But while "a different approach might have been taken," the Court would "express no view as to whether such an approach would be consistent with the statutory structure." *Id.* at 308. It was just too late in the day because the government pressed its case on the ground already well-trod. The Court would not deviate from the path previously chosen by the Service and blessed by the Court. Justice O'Connor's concurring opinion explained why the Court accepted a "second best" resolution of the issue. *See Tufts*, 461 U.S. at 318–20

> Persuaded though I am by the logical coherence and internal consistency of [Prof. Barnett's] approach, I agree with the Court's decision not to adopt it judicially. We do not write on a slate marked only by *Crane*. The Commissioner's longstanding position is now reflected in the regulations. In the light of the numerous cases in the lower courts including the amount of the unrepaid proceeds of the mortgage in the proceeds on sale or disposition, it is difficult to conclude that the Commissioner's interpretation of the statute exceeds the bounds of his discretion. As the Court's opinion demonstrates, his interpretation is defensible. One can reasonably read § 1001(b)'s reference to "the amount realized from the sale or other disposition of property" . . . to permit the Commissioner to collapse the two aspects of the transaction. As

Early in the modern era of tax the question came up as to whether a bargain purchase was a realization event.[205] That is, was the act of *purchasing* property a realization event when the price paid was far less than the property's fair market value.[206] If so, the taxpayer would need to report the difference between the cost and the fair market value as gross income.[207] As early as 1926 the Board of Tax Appeals held that an arms-length bargain purchase was not a realization event.[208] The reason was *ipse dixit*:

> [I]t is not at all unusual that the purchaser of property may through his ability and shrewdness as a buyer, or by reason of other influences or forces, be able to purchase property at a price substantially lower than the price at which it may be immediately sold, but it does not follow that gain is presently realized through such a purchase.[209]

The Supreme Court gave an actual rationale in *Palmer v. Commissioner*.[210] A bargain purchase was not a realization event because of an inference from what is now codified in § 1001.[211] The Court noted that since that statute provided that realization happened upon a "sale or other disposition,"

> long as his view is a reasonable reading of § 1001(b), we should defer to the regulations promulgated by the agency charged with interpretation of the statute. Accordingly, I concur.

205. *See* McMichael v. Comm'r, 4 B.T.A. 266, 267 (1926) ("This appeal raises the question of the taxpayers' gain . . . ." from a bargain purchase and subsequent sale of stock).

206. *See id.* (explaining that taxpayer contended that the stock was worth at least as much in 1913 as it was sold for in 1917, and that no income arose out of the transaction, while commissioner contended that the basis for determining gain is the cost of the stock to the taxpayer).

207. *See id.* at 269 ("The Commissioner determined the taxable gain on the installment basis in proportion as the selling price for the stock was paid, and this method of computation is not in question in this appeal.").

208. *See* Geeseman v. Commissioner, 38 B.T.A. 258, 263 (1938) ("[T]he purchase of property does not result in the realization of taxable gain . . . upon sale the general rule is that no taxable gain is realized until the seller has recovered his cost or capital.").

209. *Id.* at 264.

210. 302 U.S. 63 (1937).

211. *See id.* at 69 ("But the bare fact that a transaction, on its face a sale, has resulted in a distribution of some of the corporate assets to stockholders, gives rise to no inference that the distribution is a dividend . . . .").

that meant that an arms-length bargain *purchase* did not result in income to the taxpayer:

> Profit, if any, accrues to [the taxpayer] only upon sale or disposition, and the taxable income is the difference between the amount thus realized and its cost, less allowed deductions. It follows that one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it.[212]

An important component to the Supreme Court's reasoning in *Palmer* was the arms-length nature of the transaction.[213] Employees of corporations who received and exercised stock options to buy corporate stock at below-market values tried to shoehorn themselves into the bargain purchase rule.[214] But the Supreme Court later disallowed those efforts and distinguished *Palmer* in *Commissioner v. LoBue*,[215] writing:

> It is true that our taxing system has ordinarily treated an arm's length purchase of property even at a bargain price as giving rise to no taxable gain in the year of purchase. [*See Palmer*.] But that is not to say that when a transfer which is in reality compensation is given the form of a purchase the Government cannot tax the gain under [§ 61(a)]. The transaction here was unlike a mere purchase. It was not an arm's length transaction between strangers. Instead it was an arrangement by which an employer transferred valuable property to his employees in recognition of their services. We hold that LoBue realized taxable gain when he purchased the stock.[216]

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212. *Id.* In contrast, purchase of discounted property as part of a scheme of compensation does count as gross income. *Id.* at 67–68 ("[P]rofits derived from the purchase of property, as distinguished from exchanges of property, are ascertained and taxed as of the date of its sale or other disposition by the purchaser.").

213. *See* Comm'r v. LoBue, 351 U.S. 243, 248 (1956) ("It is true that our taxing system has ordinarily treated an arm's length purchase of property even at a bargain price as giving rise to no taxable gain in the year of purchase." (citing *Palmer*, 302 U.S. at 69)).

214. *See generally* William P. Wiggins, *When Does a Bargain Purchase Become a Taxable Bargain Purchase?* 86 TAX MAG. 45, 57–59 (2008) (discussing various cases in which those receiving compensation in the form of stock options argued it was a bargain purchase, not income).

215. 351 U.S. 243 (1956).

216. *Id.* at 248.

Other means of acquiring property may also constitute realization events. For example, acquisition of treasure trove does produce gross income in the amount of the property's fair market value.[217] Thus, a taxpayer who picks up an 1899 Morgan Silver Dollar minted in Philadelphia on the street must report income of its fair market value of about $70 but a taxpayer who buys the same coin at an estate sale for $20 does not have to report $50 of income.[218]

Generally, however, the realization rules key off when an event can be a "disposition" within the meaning of § 1001.[219] Only when a taxpayer makes a "sale or other disposition" of property must the taxpayer identify an amount realized and report the excess of that amount over basis as gross income.[220]

What constitutes a "disposition" is determined in large part by case law and is driven by practical inquiry on what is administrable.[221] The current realization rule is one that looks to legal relationships rather than economic relationships. The rule looks at whether there was an administratively convenient event between the taxpayer and another that meets the "administrative purposes underlying the realization requirement in § 1001(a)" by creating "legal entitlements that are different in kind or extent" between the parties.[222]

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217. Treas. Reg. § 1.61-14(a) (1960) ("Treasure trove, to the extent of its value in United State currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.").

218. *See 1899 Morgan Silver Dollar Value*, COIN STUDY (Jan. 6, 2020), https://perma.cc/Q3PQ-QMBC (last visited Jan. 9, 2020) (providing insight on current coin values) (on file with the Washington and Lee Law Review).

219. *See* Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) ("The realization requirement is implicit in § 1001(a) of the Code . . . which defines 'the gain [or loss] from the sale or other disposition of property' as the difference between 'the amount realized' from the sale or disposition of the property and its 'adjusted basis.'").

220. *See id.* ("[T]o realize a gain or loss in the value of property, the taxpayer must engage in a 'sale or other disposition of [the] property.'").

221. *See supra* notes 176–180 and accompanying text (discussing *Cottage Savings Ass'n*).

222. *Cottage Savings*, 499 U.S. at 565.

D. The Theoretical Problem with Current Electronic Gaming Tax Rules

Both current doctrinal approaches to taxing electronic gaming improperly favor the economic concept of income and disfavor the accounting concept. First, both approaches rely on a distorted application of the constructive receipt doctrine. This reliance comes from the practical ease of tracking electronic gaming activity. This distorted application elides the concept of an annual accounting. As a result, both approaches end up taxing consumption rather than income. Second, both approaches negate the realization rule. They ignore the underlying legal relationship, created by gaming account agreements, between gamers and gaming providers. They instead treat as real the distracting labels used in those accounts associated with redeemable gaming credits. As a result, both approaches impose taxation on economic income that has not been realized under the current concept of realization. I discuss each problem in turn.

1. Current Rules Distort the Constructive Receipt Doctrine

As early as 1925 the Board of Tax Appeals warned: "Constructive receipt is an artificial concept which must be sparingly applied, lest it become a means for taxing something other than income and thus violating the Constitution itself."[223] The Board was likely reflecting the then-common view that constitutionally taxable income was solely flows and did not cover appreciation in stocks.[224] Still, the warning is apropos. Both the per-transaction rule and the per-session rule distort the constructive receipt doctrine to tax something other than income. That something is consumption. They tax the churn. While Congress could do that by imposing an excise tax, the income tax does not reach so far.

A per-transaction rule treats each game or play of a slot machine as a reportable transaction that produces either a gain or loss. Professor Seto's reasoning is that since the taxpayer could (in theory) cash out the redeemable game

223. Brander v. Comm'r, 3 B.T.A. 231, 235 (1925).

224. *See supra* notes 154–156 and accompanying text.

credits won after each successful wager, the taxpayer should be deemed to have done so.[225]

Failing to redeem a redeemable game credit during a year when the game credit gets used, however, does not push income from one year into the next. That is true whether the failure happens after each game or after each "session."[226] The taxpayer has instead simply augmented their "stock" of play in much the same way taxpayers do when they are using slot machine tokens or using clay chips when betting on roulette or other table games in casinos.[227] Like tokens and chips, redeemable game credits are an accounting mechanism to track what the casino or website operator will owe the taxpayer if and when the taxpayer decides to redeem them. The constructive receipt rule should not operate to force a taxpayer to report income for each transaction or for each deemed daily session. Doing so simply taxes consumption.

Consider again our two intrepid players Alice and Myra. We will use the same numbers but now assume both are playing on Worldwinner or that both are playing slots in a casino. Each spends $20 in a day enjoying their gaming activity and consuming the gaming services provided by the website owner or by the casino.

Imagine now that Alice is twice as skillful as Myra. Thus, while Myra interstitially wins P$132 in redeemable game credits, Alice wins P$264 before exhausting her account. Both have still spent $20 to play games. The only difference now is that Alice got more play for her $20 cost. She got more consumption for her money. Saying that Alice has double the

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225. *See* Seto, *supra* note 5, at 1043 ("[I]f in practice there is a high probability that players who earn redeemable or convertible in-world currency or credits can cash out at will, the earning of such credits constitutes theoretic 'income.'").

226. *See* Park v. Comm'r, 722 F.3d 384, 386 (D.C. Cir. 2013) ("U.S. citizens do *not* treat every play or wager as a taxable event. The result is that U.S. citizens can measure their gambling winnings and losses on a per-*session* basis." (citation omitted, emphasis in original)).

227. *See* Seto, *supra* note 5, at 1035 ("Even if she does not log on again for a year, the software excludes all others from her property in the interim. When she returns, she continues to be able to use, exclude, and assign that same property.").

gross income of Myra simply taxes her for her ability to make her initial $20 last longer. It taxes her consumption of gaming.

Courts and the Service have rejected the per-transaction rule in this scenario.[228] Courts have found persuasive that the operative legal language in § 165(d) is written in the plural.[229] The Service hangs its legal analysis on the fact that § 165(b) speaks of transactions, in the plural. The CCA 2008-11 finds that the use of the plural implies a permitted netting:

> The better view is that a casual gambler, such as the taxpayer who plays the slot machines, recognizes a wagering gain or loss at the time she redeems her tokens. We think that the fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens and can definitively calculate the amount above or below basis (the wager) realized.[230]

Notice that the CCA is discussing the use of tokens. The same logic, however, applies to electronic redeemable game credits. Tokens are just tangible redeemable game credits.

Similarly Judge Kavanagh in the *Park* case believed the word "gains" was the key.[231] Recall that case involved nonresident aliens. Section 871 taxes a nonresident alien who is not in the business of gambling on all "gains." That includes, say the courts, gains from wagering transactions.[232] Worse, nonresident aliens cannot deduct losses from wagering transactions.[233] Thus, the proper netting rule becomes all the more important for them.

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228. *See Park*, 722 F.3d at 387 (stating that there would be practical "difficulties . . . if slots players had to track the wins from every pull of the slot machine lever").

229. *See id* at 386 ("We begin our independent analysis by noting that the key term in interpreting Section 871—'gains'—also appears in Section 165(d) . . . .").

230. CCA 2008-11 at 4.

231. *Park*, 722 F.3d at 386.

232. Barba v. United States, 2 Cl. Ct. 674, 675–78 (1983).

233. *See id.* (stating that the Revenue Act of 1936 changed the way non-resident aliens are taxed to be different from U.S. citizens). Additionally, § 871(a)(1) taxes nonresident aliens for all "interest . . . dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income" received from sources in the United States. Section 183 forbids § 165(d) deductions. *See id.*

Judge Kavanaugh believed the proper netting came in the process of determining "gains" in the first place, both as the word was used in § 871 and in § 165(d). He relied on the CCA 2008-11 analysis that rejected the per-transaction approach applied equally well to nonresident aliens, writing "the logic and analysis of the Service's per-session approach to U.S. taxpayers in Section 165(d) has no less force when applied to non-resident aliens in Section 871."[234] He then made the important point that the issue was not which wagering losses were to be netted against which wagering "gains."[235] The issue was the very meaning of "gains."

> The IRS's only real response is that . . . once wins and losses are calculated—whether on a per-bet or per-session basis—non-resident aliens may not deduct losses from wins when doing their annual income taxes. The IRS therefore concludes that non-resident aliens should be required to pay taxes on each winning pull of the slot machine lever.
>
> The IRS's reasoning is a non sequitur. What the IRS says about deductions for non-resident aliens . . . has nothing to do with the issue in this case. The fact that non-resident aliens may not deduct gambling losses from gambling winnings does not tell us how to measure those losses and winnings in the first place.[236]

Recall the economic concept of income is the sum, over the accounting period, of a taxpayer's exercise of rights in consumption added to the taxpayer's change in wealth.[237] Thus, any definition of income will necessarily implicate consumption. The current legal definition of income, however, holds onto the accounting concept of periodicity with the relevant period being one year.[238] The constructive receipt doctrine, properly applied, is a timing doctrine that polices the one-year accounting period, blocking taxpayers from moving income from one year into the next. To use the constructive receipt doctrine to decide *whether* a taxpayer has income at

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234. *Park*, 722 F.3d at 386.

235. *Id.* at 387.

236. *Id.*

237. *See supra* note 86 and accompanying text.

238. *See supra* note 137 and accompanying text for further discussion on the definition of income.

any other discrete point in time within the annual accounting period blows a hole in the annual accounting period rule for determining income.

The per-session method is just as flawed in this regard as the per-transaction method. The per-session rule explicitly recognizes that "fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens."[239] That's a step in the right direction. But then both the CCA and the implementing regulations (on the information reporting side) ignore that step when they arbitrarily limit a session to one twenty-four hour period and apply a constructive receipt rule to whatever redeemable game credits the taxpayer has in the account at the end of that twenty-four hour period.[240] The rationale given in Preambles of both the proposed and final reporting regulations is that the twenty-four hour period for reporting was "intended to facilitate reporting by payees on their individual income tax returns under the proposed safe harbor in Notice 2015-21, 2105-12 I.R.B. 765."[241] However, there is no rationale given in Notice 2015-21 for the concept of a "session." Instead, the Notice simply assumes the existence of a session because it is addressing a scenario where the taxpayer is using physical tokens. That assumption does not hold for electronic gaming accounts.

The per-session rule is again a distortion of the constructive receipt rule's purpose. Imagine that our player Myra is able to use her $20 initial deposit to play slots for a time period that crosses the twenty-four hour session. Until she loses all her money, she has "fluctuating wins and losses left in play." Assume that at the very end of the first twenty-four hour period—say it ends at 3:59 a.m.—her

239. CCA 2008-11 at 5.

240. Treas. Reg. § 1.6041-10(b)(2) (2016). This reporting regulation gives casinos the choice of using a calendar day or a "gaming day" which is defined as "a 24-hour period other than a calendar day . . . selected by the payor" with the exception that the regulations put a hard cut-off for midnight on December 31st of each year.

241. 81 Fed. Reg. 96,374 (December 30, 2016) (codified at 26 C.F.R. pt. 1, 7, 15). The regulations give casinos the flexibility to designate any 24-hour period as a gaming session, with the exception that midnight on December 31 is a hard cutoff. Judging by the examples given in the regulations, most casinos will likely start their 24-hour reporting period in early evening or early morning.

"fluctuating wins and losses left in play" net out to an account balance of $30 because at that moment in time she has had more interstitial wins than losses. Myra continues to play until her account balance is reduced to zero. To say that she has constructively received $10 at that magic moment of 3:59 a.m. is taxing her consumption of gaming and not any accretions to wealth. Her winnings are still "left in play" in the electronic account, to use the CCA language. Thus, by taxing the unredeemed units of play at the end of each session, the per-session method also taxes consumption and not income.[242]

The one point in time where it would be proper to use the constructive receipt doctrine is at the end of the tax year; the reporting regulations impose a hard cutoff of midnight on December 31 for casinos to report any winnings held in an electronic account.[243] But even then the constructive receipt doctrine would not apply unless the taxpayer actually redeems those gaming credits in the next tax year. The constructive receipt doctrine is about timing. It forces a taxpayer to pull back into a prior tax year income the taxpayer actually realizes in a future tax year. If a taxpayer has no income in either year, the doctrine has nothing to operate on.

Thus, the strong argument is that the constructive receipt doctrine should not ever apply to Alice and Myra, not even if they have a redeemable balance on December 31, because they completely use up their $20. Whether they do so in one session or two, or whether they do so in one year or two does not matter. Either way there are never "undeniable accessions to

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242. Some would call this consumption "in-kind consumption" because the taxpayer receives something (play) that can be, and is in fact, consumed. Professor Dodge believes that in-kind consumption should normally be counted as gross income. *See* Joseph Dodge, *Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the 'Claim of Right Doctrine' to Found Objects, Including Record-Setting Baseballs*, 4 FLA. TAX. REV. 685, 701 n.62 (2000) ("Generally, in-kind consumption should be included in gross income where it is judged to be the equivalent of the receipt of cash followed by a free, or lightly constrained, spending choice."). To the extent one views winning redeemable game credits as in-kind consumption, the value should be imputed to the taxpayer's own efforts and would not count as gross income under the doctrine of imputed income. See Camp, *supra* note 141, at 37–44 for a more in-depth discussion of imputed income.

243. Treas. Reg. § 1.6401-10(b)(3).

wealth, clearly realized."[244] It is this realization requirement that is the second theoretical problem with both the per-transaction and per-session approaches to the problem of taxing redeemable game credits. To that problem I now turn.

2. Current Rules Ignore Realization

Even in the unlikely event that a taxpayer is reporting on the accrual method, the current rules violate a second strong and persistent accounting rule: realization. A player account, whether with an online company like Worldwinner or a brick-and-mortar casino, is easily conceptualized as property, a chose in action: the right to play.[245] Section 61 speaks of "income," § 74 speaks of "prizes," the reporting statute § 6041 speaks of "payments" and the implementing regulation to § 6041 speaks in terms of "winnings" but when discussing property values, all of these terms mean nothing until there has been a realization event, an event that changes the legal relationships between the player and gaming operator (whether a casino or website operator like Worldwinner).[246]

Fluctuations in a taxpayer's electronic gaming account balance represent no change in the legal relationships between the player and the gaming operator. What Alice and Myra win in their games, whether denominated "prize," "payout," "winnings," or "banana," is nothing more than the right to keep playing. All that changes is the amount of play the casino or operator is obliged to give.[247]

Just as my efforts in Defender were rewarded with more units of play in the form of new ships with which to fight the

244. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

245. *See* Camp, *supra* note 141, at 54–60 for a more in-depth treatment of this idea.

246. *See* Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991).

247. This is different than virtual items accumulated in a virtual world. The accumulation of those items, whether labeled "Sword of 1000 Truths" or "Gold" changes the property rights each taxpayer has with the virtual world operator, as I explain in some detail in *The Play's the Thing*. *See* Camp, *supra* note 141. Even in that article, I acknowledged that the realization argument was a close one. I rejected it, however, in favor of an imputed income argument because the virtual items, in my view, did change the set of legal relationships between the players and the virtual world operators. Here, in the case of skill games, that imputed income argument is also a good one, but it does not work so well for gambling games.

aliens, so are Alice and Myra's efforts rewarded with more units of play, however denominated. The fact that better or luckier players get more play for their money puts them in the same position as a bargain purchaser: their right to play will vary depending on "ability and shrewdness . . . or by reason of other influences or forces."[248] Not until Alice or Myra actually cash out do they realize any appreciation in their property. Critically, the appreciation in their property—their right to play—does not meet even the *Cottage Savings* relaxed concept of realization.[249] There is simply no change in legal relationships between the player and the gaming operator (whether a casino or Worldwinner) simply because the player accumulates more units of play in the account. The odds remain the same, and never in their favor.

Thus, the two current approaches to taxing electronic gaming are contrary to the doctrine of realization because both seek to include unrealized gain as gross income. One might raise two objections to this way of conceiving the problem of redeemable game credits: (1) the cash equivalency doctrine; and (2) the economic benefit doctrine.

First, if redeemable game credits were cash or the equivalent of cash, then income would be realized when they are credited to a player's account, just like the interest a bank credits to a deposit account, or the dividends earned in a mutual fund account that are automatically reinvested into more stock. In both of those situations, what is being credited to the taxpayer by the bank or the mutual fund is cash or the equivalent of cash.

What makes an item equivalent to cash is the ability of the taxpayer to use it to purchase a wide variety of goods or services.[250] Thus, a paper check is the equivalent of cash.[251]

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248. Geeseman v. Comm'r, 38 B.T.A. 258, 264 (1938).

249. *See Cottage Savings*, 499 U.S. at 565 (defining a realization event as an event that changes the legal relationships between the player and gaming operator).

250. For a good discussion of current doctrine, see Fred B. Brown, *Proposing a Single, Simpler Test for Cash Equivalency*, 71 TAX LAW. 591 (2018). He proposes to define a cash equivalent as any obligation that is readily tradable in an established securities market.

251. Kahler v. Comm'r, 18 T.C. 31, 35 (1962) (holding that the receipt of a check is the realization of income).

Promissory notes can sometimes be the equivalent of cash, if they are "unconditional and assignable, not subject to set-offs, and . . . of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money . . . ."[252] Otherwise, they are simply evidence of a debt.[253] Finally, even the crediting of an account with redeemable service credits can be the equivalent of cash.[254]

What all these cash equivalent situations have in common is that the taxpayer receives something that not only has ascertainable economic value, it is something the taxpayer can *use like cash*. It is something that is always "reflected in a negotiable note, bond, or other evidence of indebtedness which, like money, commonly and readily changes hands in commerce."[255] That means the taxpayer must be able to use what is received to purchase a wide variety of goods and services.[256]

Redeemable game credits are neither cash nor the equivalent of cash. What is confusing are the labels. Worldwinner and casinos label redeemable game credits using dollar signs. In fact, as the illustration on page nine above shows, Worldwinner likes to label redeemable game credits as "real money." But redeemable game credits are not like real money because they are not something that is "like money, commonly and readily [used] in commerce."[257] They are simply the receipt of more units of play, an increase in the contractual rights governing the player's account, which is a species of

252. Cowden v. Comm'r, 289 F.2d 20, 24 (5th Cir. 1961).

253. *See* Reed v. Comm'r, 723 F.2d 138, 141 (5th Cir. 1983) ("[A] cash basis taxpayer's contractual right to future payment must be reflected in a negotiable note, bond, or other evidence of indebtedness which, like money, commonly and readily changes hands in commerce."); Williams v. Comm'r, 28 T.C. 1000, 1002 (1957).

254. *See* Rev. Rul. 80-52, 1980-1 CB 100 (stating that cash method members of barter clubs realize income when amounts credited to their accounts can be used to purchase goods or services or be transferred for value to other members). I discuss the history of barter club taxation in *The Play's the Thing*. *See* Camp, *supra* note 141, at 30–33.

255. *Reed*, 723 F.2d at 147.

256. I develop this idea more fully in *The Play's the Thing*. *See* Camp, *supra* note 141, at 60–71.

257. *Reed*, 723 F.2d at 147.

property. True, they can become cash if the player makes the choice to actually redeem them. But it is only at that point in time any income is potentially realized.

The second objection rests on the economic conception of income. There is a common law set of tax rules, closely related to the constructive receipt doctrine, that together make up what is called the economic benefit doctrine.[258] As typically applied, it requires an individual to report as gross income any economic benefit conferred upon him, to the extent that the benefit has an ascertainable fair market value.[259] It is elementary that gross income can come in any form, whether cash, property or services.[260] When a taxpayer receives property or services, they can be income in the amount of their fair market value.[261] Since the redeemable game credits arguably have a fair market value, their receipt is arguably realized income to the extent of their fair market value.

The second objection is not well taken. The economic benefit doctrine arises from and deals with employee deferred compensation schemes.[262] The key context for application of the economic benefit doctrine is that the taxpayer is providing services *in exchange* for what is received. Treas. Reg. 1.161-2 is even titled "Compensation for services, including fees, commissions, and similar items."

Neither Alice nor Myra are providing services to the game site operators or the casinos. It is the game site operators and casinos who are providing the gaming services. Alice and Myra

258. *See* Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1116 (2005); Patricia Ann Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525, 550 (1974).

259. *See* Polsky & Hellwig, *supra* note 258, at 1151 ("[T]he seller realizes compensation income to the extent of the fair market value of property received as consideration in the sale.").

260. Treas. Reg. § 1.61-1, 1.61-2(d); *see also* Rev. Rul. 80-52, 1980-1 CB 100.

261. *Id.*

262. According to Metzer, the first Supreme Court case that articulated the doctrine was *Commissioner v. Smith*, 324 U.S. 177 (1945), which dealt with employee compensation. There the Court held that the legal meaning of gross income was "broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." *Smith*, 324 U.S. at 181.

are consumers. The redeemable game credits are more like shopping coupons in that the credits represent a discount given by the game site operators and casinos for the gaming services. The discounts create nothing more than bargain purchases. When used, they represent a reduction in cost of one particular exercise of market rights in consumption and, hence, are not income.[263]

VI. Finding the Right Rule

> *"In theory, there is no difference between theory and practice. But, in practice, there is."*[264]

Tax law is messy. It is, as Jack Manhire so nicely says, a wicked system.[265] The messiness exists partly because tax law shadows life and life is messy.[266] It exists partly because tax

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263. *See* Westpac Pacific Food v. Comm'r, 451 F.3d 970, 971 (9th Cir. 2006) ("Harry Homeowner goes to the furniture store, spots just the right dining room chairs for $500 each, and says 'I'll take four, if you give me a discount.' Negotiating a 25% discount, he pays only $1,500 for the chairs. He has not made $500, he has spent $1,500."). What is true for purchase of property can also be true for purchase of services. Rev. Rul. 91-36, 1991-2 C.B. 17 (explaining that credits granted to customers of an electric utility company represented a reduction in the purchase price of electricity rather than income).

264. Attributed to Yogi Berra, among others. *See Yogi Berra*, WIKIQUOTE, https://perma.cc/S5JD-B6SQ (last updated Jan. 20, 2020) (last visited Apr. 4, 2020) (on file with the Washington and Lee Law Review).

265. J.T. Manhire, *Tax Compliance as a Wicked System*, 18 FLA. TAX REV. 235, 242 (2016)

> [S]ocietal systems . . . are a type of system where complexity and complicatedness interact and yield a different and emergent quality. This new quality, called "wickedness," does not lend itself well to traditional complexity science analysis, structural systems approaches, mathematical models, or any combination thereof. Wickedness is something more than complexity and complicatedness alone, and as Nobel laureate Philip Anderson famously put it, "more is different."

Professor Manhire is discussing in that article only the administrative aspect of tax law. Tax compliance, however, overlays a base of tax rules which are themselves both complex and complicated.

266. That is, tax rules do not regulate the primary behavior of taxpayers but instead reflect the tax consequences of behavior. That is the central reason why tax administration and rulemaking seems "exceptional" to conventional administrative law thinkers and why tax regulations have traditionally been viewed as "interpretative" and not "legislative" under

rules emanate from three sources—Congress, Treasury, and courts—in what I like to think of as a slow-moving conversation. Those sources create complex and sometimes conflicting rules and systems of rules and do so over time, meaning tax law is not just messy at any moment in time but is messy over time. Finally, the messiness comes from an inherent and ongoing tension between economic theory and administrative necessity, with the latter represented in this Article by the persistence of accounting memory.

This Article's very existence illustrates the messiness. An existing regulation tells casinos how to satisfy their § 6041 reporting obligations. That's a tax rule. This Article argues the rule is wrong. At some point a taxpayer may disagree with how the casino has reported its payments and decline to follow that rule when reporting income. If the Service audits and the matter goes to court, a court might create a different rule than what is in the information reporting regulation. If so, a later court might uphold the current rule. Or the Service will refuse to change the current rule. Or Congress might step in and enact a different rule. Or the Service might change the reporting rule. In short, the messiness comes not just from theory but also from the practical workings of tax administration.

Professors Abreu and Greenstein offer a way out of this messiness in two articles they published in 2011 and 2012.[267] They observe that "no single rule can determine the existence of income across the great run of human activity."[268] From that they argue that the legal meaning of income should be conceptualized as a standard and not a rule. They argue that an income-as-standard approach "illuminates the treatment of the vast majority of exchanges that occur in human interaction. Those exchanges create wealth but implicate important non-economic values too vast and varied for any rule to capture."[269]

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conventional administrative law doctrines. Wading into that debate, however, is beyond the scope of this Article.

267. Abreu & Greenstein, *Defining Income*, *supra* note 140, at 301–07; Abreu & Greenstein, *It's Not a Rule*, *supra* note 6, at 126.

268. Abreu & Greenstein, *It's Not a Rule*, *supra* note 6, at 126.

269. *Id.* at 130.

By "standard" they mean "an all-things-considered analysis informed by the relevant tax values."[270] They recognize that their "first order of business is to identify those values: the things we care about when deciding whether an accession to wealth should be [legally] treated as income." That makes sense. If one is going to propose a legal standard, one needs to identify the various factors that are relevant to the standard. They then identify various "things we care about" including: (1) administrability; (2) taxpayer privacy; (3) disincentives to private improvement of living standards; (4) incentives for social cooperation; (5) horizontal equity; (6) other things that may come up in particular fact patterns.

The idea of conceiving the § 61 tautology as a standard rather than a rule is initially appealing. Upon closer examination, however, I submit that the idea is not workable in practice. And even in theory it presents a very real danger of equating what *can* be taxed to what *should* be taxed. The better approach is to recognize § 61 is a rule, but one subject to complex and sometimes conflicting sub-rules.

A. Why Tax Law Should Prefer Rules over Standards

Rules can be frustrating in their rigidity with enforcement being over-inclusive or under-inclusive, or both.[271] I like the hoary example of the speed limits, and I offer a couple of twists. A rules approach to preventing speeding would be a sign that says "Speed Limit 35." Driving above that limit is speeding and subjects one to a ticket.[272] Driving below the limit is not speeding.

Sometimes, however, a driver should really drive below that limit, such as when hazardous road conditions make driving 35 mph dangerous. Or if the road runs by an elementary school, driving 35 mph may be too fast at the start and end of school when little irrational legs dart about the landscape. Other times, drivers might justifiably drive faster

270. *Id.* at 107.

271. Many commentators have explained this. I like the discussion in Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

272. *See id.* at 559–60 ("A rule may entail an advance determination of what conduct is permissible, leaving only factual issues for the adjudicator.").

than 35 mph, such as when taking a badly injured person to the hospital.

One twist to this common example is that a rules-based system can add sub-rules to mitigate the inclusiveness problem.[273] For example, the authorities who are tasked with administering the law might post a second speed limit sign that says "20 mph when flashing."[274] The sign is then programmed to flash during the start and end times of school. This sub-rule creates an exception to the otherwise applicable general rule imposing a 35 mph speed limit. The downside of sub-rules is complexity.[275] Drivers in congested urban areas experience this daily when confronted with myriad such rules and sub-rules, signs that instruct them when a lane is one-directional, or when right turn or left turns are permitted, or when commuter lane rules are in effect.[276]

Another often overlooked twist is that the actual administration of rules and sub-rules creates additional complexity.[277] In the speed limit example, the authorities who enforce speeding laws must rely on programmers to correctly program the second sign. If the programmers fail to program the correct times, or fail to account for holidays and summer, then the 20-mph-when-flashing sub-rule adds complexity but no value. Such failures are a byproduct of the bureaucratic process that produces rules. My hypothetical programming error could result from any number of communication errors in the process of creating the sub-rule.

273. *See* Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953, 962 (1995) ("Rules may be *simple* or *complex*.").

274. *See id.* ("A law could say, for example, that no one under eighteen may drive. . . . Or it could be quite complex, creating a *formula* for deciding who may drive.").

275. *See id.* at 992 ("The first problem with rules is that it can be very hard to design good ones. . . . If strictly followed, the rule will often produce arbitrariness and errors in particular cases. . . . [A]ny rule that people can generate will produce too much inaccuracy.").

276. *See, e.g.*, *Frequently Asked HOV Questions*, U.S. DEPT. OF TRANSP. FED. HIGHWAY ADMIN., https://perma.cc/F2YD-HRMU (last updated Feb. 1, 2017) (last visited Jan. 2, 2020) (describing the complexities and variations in HOV lanes among states) (on file with the Washington and Lee Law Review).

277. For example, I see no mention of this in Kaplow's otherwise excellent discussion.

In contrast to a rules approach, authorities tasked with administering the law forbidding speeding could use a standards approach. A standards approach would be a sign that says "Drive a Reasonable Speed."[278] The standard then needs no further ex-ante modification because it is inherently flexible, depending on a host of factors, including factors outside the vehicle (such as what is happening around the road, the state of the road, the weather) and factors inside the vehicle (such as the nature of the driver's errand, the driver's ability, how the driver's ability is affected by age, disease, or intoxication, what cargo or other persons are in the vehicle).[279] Those factors would be applied on a case-by-case basis by the enforcement authorities.

Traffic authorities prefer rules to standards. One sees this in the plentitude of speed limit and other traffic signs.[280] One reason is practical: rules lend themselves to low-cost enforcement, especially when administrators are faced with high-volume enforcement needs such as regulating traffic speed.[281] A single police officer can enforce the applicable speed limit by using a radar gun to identify and pull over speeders. Pulling over one motorist has a cascading deterrence effect on drivers, who see the rule actually enforced. That is because they know the rule—don't exceed 35 mph—and seeing it enforced helps discipline them.[282] Or a speed camera can automatically take a picture of a speeding car's license plate and then generate a fine letter. While there are well-known

278. *See* Kaplow, *supra* note 271, at 560 ("A standard may entail leaving both specification of what conduct is permissible and factual issues for the adjudicator.").

279. *See id.* ("A standard might prohibit 'driving at an excessive speed on expressways.'").

280. For example, the Federal Highway Administration maintains an 800+ page manual on providing and marking traffic rules and signs. U.S. DEPT. TRANSP., FED. HIGHWAY ADMIN., MANUAL ON UNIFORM TRAFFIC CONTROL DEVICES FOR STREETS AND HIGHWAYS (2009), https://perma.cc/YK9J-4Q53 (PDF).

281. Kaplow highlights this practical consideration of rules being preferable to standards. *See* Kaplow, *supra* note 271, at 563 ("[T]he frequency of individual behavior and of adjudication is of central importance.").

282. Or at least they know the common law enforcement norm of allowing a grace level of five MPH above the posted limit.

downsides to both modes of enforcement, they do enable the authorities to enforce the rule efficiently. Thus, even a non-working speed camera or an empty parked police car can enforce the law, when the law is a rule.

In contrast, standards require far more resources because they must be applied on a case-by-case basis. Even a camera equipped with artificial intelligence would be able only to ascertain and account for factors external to the vehicle. A police officer would need to stop any motorist suspected of violating the standard of reasonable speed to inquire about the relevant factors relating to inside the vehicle. Other motorists would not be affected by stopped speeder because surely while *that* person was unreasonable, *they* are not. Finally, enforcing a standard might work for a lightly traveled road—perhaps one in Montana—but enforcement of speeding law in highly congested urban or suburban environments would entail huge personnel costs.

Standards, moreover, have theoretical as well as practical problems. Standards can also be antithetical to the rule of law. It ain't called the "rule" of law for nothing.[283] Law—whether expressed as rule or standards—ultimately requires physical force to ensure that the law is obeyed. Robert Cover makes that point in his classic "Violence and the Word."[284] The violence part is that administration of the law imposes tangible, physical consequences on people.[285] But that iron fist of violence is clothed in the velvet glove of words. It is the combination of violence and words that creates the discipline in a citizenry to obey the law.[286] When the words are too fuzzy, when they become standards, discipline drops.[287]

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283. *See* Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1179 (1989) ("Even in simpler times uncertainty has been regarded as incompatible with the Rule of Law.").

284. Robert M. Cover, *Violence and the Word*, 95 YALE L.J. 1601 (1986).

285. *See id*. at 1601 ("Legal interpretive acts signal and occasion the imposition of violence upon others: A judge articulates her understanding of a text, and as a result, somebody loses his freedom, his property, his children, even his life.").

286. *See* MICHEL FOUCAULT, DISCIPLINE AND PUNISH: THE BIRTH OF THE PRISON 200 (Alan Sheridan trans., Vintage Books 2d ed. 1995) (discussing the link between systems of punishment and internalized individual discipline). I apply this idea more broadly to tax administration in Bryan

Speed limits are a real-world example of the dangers that standards can pose to the rule of law. For a brief time, the State of Montana eschewed hard speed limits and attempted to impose a standard of "Reasonable and Prudent Speed."[288] The Montana Supreme Court struck down the state's attempt, writing:

> It is evident from the testimony in this case and the arguments to the Court that the average motorist in Montana would have no idea of the speed at which he or she could operate his or her motor vehicle on this State's highways without violating Montana's "basic rule" based simply on the speed at which he or she is traveling. Furthermore, the basic rule not only permits, but requires the kind of arbitrary and discriminatory enforcement that the due process clause in general, and the void-for-vagueness doctrine in particular, are designed to prevent. It impermissibly delegates the basic public policy of how fast is too fast on Montana's highways to policemen, judges, and juries for resolution on an ad hoc and subjective basis.[289]

Tax law is currently implemented by a range of legal tools: from rules to standards to principles to guidelines to forms to

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Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1 (2004).

287. *See* Nicholas Georgakopoulos, *The Vagueness of Limits and the Desired Distribution of Conducts*, 32 CONN. L. REV. 451 (2000) (reviewing the standard literature).

288. State v. Stanko, 974 P.2d 1132 (Mont. 1998). The operative statute at that time provided that motorists had to drive "in a careful and prudent manner" and that was reflected on posted signs as "reasonable and prudent." Mont. Code Ann. § 61-8-303 (1996). One can still see a picture on this website, which lists what the author believes are the most ridiculous speed limit signs in the U.S.: Travis Okulski, *The Most Ridiculous Speed Limits*, JALOPNIK (Nov. 11, 2012, 11:00 AM), https://perma.cc/58H4-V58W (last visited Jan. 2, 2020) (on file with the Washington and Lee Law Review).

289. *Stanko*, 974 P.2d at 1137 (internal quotation marks and citation omitted).

computer coding.[290] It is, however, mostly a set of rules. Tax administrators prefer rules.[291]

For example, Section 469 is a mix of standards and rules. It prohibits a taxpayer from deducting losses arising from "passive activities."[292] A passive activity is any trade or business in which the taxpayer does not "materially participate."[293] Section 469(h)(1) then says: "A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is—(A) regular, (B) continuous, and (C) substantial."

Here, Congress created a standard, giving an undefined set of relevant considerations. This standard is a particularly "soft" standard, to use Lawrence Solum's typology.[294] It gives taxpayers more hope than guidance and must be entirely enforced ex post.

Tax administrators reacted to the statutory standard by issuing a regulation that imposes a set of hard rules and sub-rules. Treasury Regulation 1.469-5T(a) says that a taxpayer is deemed to materially participate if the taxpayer meets any one of seven conditions.[295] The first six are rules, such as the first one that says a taxpayer materially

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290. For a nuanced typology, see Sunstein, *supra* note 273. I explore how forms function as legal rules in: Bryan T. Camp, *The Function of Forms*, 110 TAX NOTES 531 (2006); Bryan T. Camp, *The Never-Ending Battle*, 111 TAX NOTES 373 (2006); and Bryan T. Camp, *The Function of Forms in the Substitute-for-Return Process*, 111 TAX NOTES 1511 (2006).

291. *See* ASS'N OF INT'L CERTIFIED PROF. ACCOUNTANTS, GUIDING PRINCIPLES OF GOOD TAX POLICY: A FRAMEWORK FOR EVALUATING TAX PROPOSALS 7 (2017) ("Certainty is important to a tax system . . . [and] generally comes from clear statutes as well as timely and understandable administrative guidance.").

292. § 469(a).

293. § 469(c)(1).

294. *Legal Theory Lexicon 026: Rules, Standards, Principles, Catalogs, and Discretion*, LEGAL THEORY LEXICON, https://perma.cc/TZ6H-UMFM (last updated Sept. 29, 2019) (last visited Jan. 3, 2020) ("Some standards give the decision maker substantial guidance, by specifying relatively specific and concrete factors the decision maker should consider and the relative weight or importance of those factors. Other standards are much more open ended, requiring consideration of factors that are general and abstract.") (on file with the Washington and Lee Law Review).

295. Treas. Reg. § 1.469–5T (1996).

participates if they spend more than 500 hours in the activity during the year. Even if a taxpayer spends less time than that, the regulations provide that the taxpayer will be deemed to materially participate if the taxpayer has spent more than 100 hours in the activity during the year and no one else has spent more time. The seventh condition just repeats the statutory standard and is the catch-all.[296] However, because the first six rules (and attendant sub-rules) are so complete, it is difficult to imagine any set of facts that will fit the standard when a taxpayer cannot meet any of the first six rules. In this way, the tax administrators have cabined the standard with rules.[297]

Section 61 states a definition of "gross income" as income from any source, but does not define "income." *Glenshaw Glass* provides that, as a general rule, the legal meaning of the word "income" in Section 61 is "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[298]

Professors Abreu and Greenstein propose to reconceive the legal meaning of income as standard-based and not rule-based.[299] In an important sense their proposal is shadowboxing. That is, they observe that "no single rule can determine the existence of income across the great run of

296. § 1.469–5T(a)(7) ("[A]n individual shall be treated . . . as materially participating in an activity for the taxable year if . . . [b]ased on all of the facts and circumstances . . . the individual participates in the activity on a regular, continuous, and substantial basis.").

297. I believe the regulations that define the term "material participation" as used in Section 469 support Professor Nicholas Georgakopoulos's thesis in *The Vagueness of Limits and the Desired Distribution of Conducts*, *supra* note 287. There, Professor Georgakopoulos posits that while most scholars believe that "the choice of vagueness [is] a determinant of the distribution of conducts," *id.* at 454, in fact "[t]he actual concentrating effect of precision depends on the distribution of preferences in the population as well as on the location of the limit," *id.* at 461. The choices of 500 and 100 hours illustrate at least the tax administrators' judgment of the desired distribution. I am unaware, however, of any empirical work on the effectiveness of that choice. A fuller explanation of this is beyond the scope of this Article.

298. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

299. *See* Abreu & Greenstein, *Defining Income*, *supra* note 140, at 339 ("The *Glenshaw Glass* definition of income has the appearance of a rule but is actually a standard.").

human activity."[300] I know of no one who would dispute that statement.

The legal meaning of income, however, is not a single rule. The *Glenshaw Glass* formulation is itself a synthesis of many smaller, well-defined, instances of income: wages, gains from sale of property, interest, rents, royalties, dividends, pensions, cancellation of debt, etc., all of which are listed as items of income in Section 61. And those instances of income are themselves general rules, subject to myriad exceptions. The legal meaning of income is not simply the single rule given in *Glenshaw Glass*, but is instead a system of rules and sub-rules—rules created by Congress, the Service, and the courts—that together do indeed reflect "the existence of income across the great run of human activity."[301] Professors Abreu and Greenstein's project would be better served if they explained how their proposal integrates with this system of rules.

On the merits, if we take their proposal seriously, it has multiple downsides. First is deciding what guidance to give taxpayers, who must report their income each year. Treating income as governed by a general rule enables taxpayers to generally know what to report and enables administrators to give them useful guidance. For example, the Form 1040 Instructions tell taxpayers what to report on each line of the form, tracking the general list of items enumerated in Section 61.[302] Thus, it tells taxpayers to report "the total of your wages, salaries, tips, etc." on line 1, and then gives additional rules on what that means.[303] For many of the lines, the Instructions tell the taxpayer to report to the IRS the same amounts that are reported to them on various forms, such as Form 1099-INT for interest payments reported on line 2, Form 1099-DIV for dividends received, reported on line 3, etc.[304]

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300. Abreu & Greenstein, *It's Not a Rule, supra* note 6, at 126.

301. *Id.*

302. INTERNAL REV. SERV., *IRS 1040 Instructions 2018 Tax Year* (2019) https://perma.cc/RQ76-S52G (PDF).

303. *Id.* at 26.

304. *See id.* at 14 (instructing filers to report tax-exempt interest from box 8 of Form 1099-INT on line 2a of Form 1040); *id.* at 13 (instructing filers to report items from box 1a of Form 1099-DIV on line 3b of Form 1040).

The current Instructions are able to give accurate guidance only because the legal meaning of income is a general rule, modified by a googolplex of sub-rules. If the legal meaning of income was instead a standard it would, by definition, be determined with reference only to "the things we care about." The instructions would be much simpler, just as a traffic sign that says "Reasonable and Prudent" is simpler than multiple signs giving rules and sub-rules. The simplified instructions might tell the taxpayer to "report as income those amounts you believe should be reported as income considering the various factors of administrability (which to a taxpayer means audit lottery), your privacy, the disincentives to private improvement that reporting the item as income would give you, the incentives for social cooperation that not reporting the item would give you, your belief that others like you are reporting similar items, and any other factor you think is relevant to deciding whether to report the amounts as income." Equally importantly, the Service would need to tell payors to report only those payments the payors reasonably believed needed to be reported.

To the extent that one believes the Instructions could stay the same under an income-as-standard approach, then one is not really taking Professors Abreu and Greenstein's proposal seriously. Their proposal becomes simply the identification of policy reasons that would support exceptions to the general rule that income is any realized accretion of wealth. That is nothing new. It is how the law already works. There is no statutory definition of "income." There are statutory definitions of "gross income" and "adjusted gross income" and "taxable income."[305] But the definition of "income" is a set of common law rules, created by court decisions such as *Glenshaw Glass*, that interpret the statutory term. And, as I discussed above as well as in a prior article, the common law rules do reflect consideration of all the "things we care about."[306]

The second downside is an irony. Treating the legal meaning of income as a standard actually untethers taxation from the very things "we" care about. Professors Abreu and Greenstein claim "[t]he definition of income is most aptly

305. § 61, § 62, § 63.

306. *See* Camp, *supra* note 141.

analyzed not as a rule but as a standard."[307] But analyzed by whom? The use of passive voice hides the legal actor. The first legal actors to define income in our system of taxation are taxpayers who make their annual return.[308] Taxpayers likely value their privacy more than they value contributing to the common fisc or making tax administration efficient. Administrators likely value efficiency over incentives for social cooperation or privacy.

In other words, the values embodied in Professor Abreu and Greenstein's indeterminate list of factors will inevitably collide. They freely acknowledge this but write "[c]olliding values require choosing which values will prevail in any given case, and . . . that is something that can only be accomplished by deploying a standard."[309] Again, note the passive voice. One gets to the things "we" care about only in an ex post procedure where a neutral party weighs the factors. Until then, the legal actor defining income is either the taxpayer or the Service and will make the definition favoring the things that either the taxpayer or the tax administrator cares about.

In short, bringing theoretical cohesion to treating income as a standard requires a different system of administering taxes. The system requires a neutral decision-maker to put the multiple colliding factors together. That would require 150 million trials per year. The Tax Court currently carries a docket of about 20,000.[310] Had it words enough, and time, income-as-a-standard would be no crime.

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307. Abreu & Greenstein, *It's Not a Rule*, *supra* note 6, at 126.

308. Many, including judges, politicians, and commentators, erroneously describe the U.S. tax system as one of "self-assessment." *See, e.g.*, J.T. Manhire, *What Does Voluntary Tax Compliance Mean?: A Government Perspective*, 164 UNIV. PENN. L. REV. ONLINE 11, 11 (2015) ("In most congressional reports, the IRS emphasizes voluntary taxpayer compliance as a foundational principle of the U.S. tax system."). What is accurate is to say that the U.S. tax system is one of self-reporting. *See id.* at 15 ("[The IRS] relies on individual taxpayers to accurately assess their own tax liability on annual returns and timely pay the correct amount due."). I explain the significant error inherent in the "self-assessment" conception in Bryan Camp, *"Loving" Tax Return Preparer Regulation*, 140 TAX NOTES 457 (2013).

309. Abreu & Greenstein, *It's Not a Rule*, *supra* note 6, at 109.

310. The most recent data is still from HAROLD DUBROFF & BRANT J. HELLWIG, THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS 909 (2d ed. 2014), https://perma.cc/B55M-FD3U (PDF) (listing Tax Court caseload

Even assuming a system design where the standards approach requires only the same number of trials as yearly field audits—some 250,000 in 2018[311]—the proposal to treat income as a standard through the use of multiple conflicting indeterminate factors is a dubious proposition. Certainly the tax law contains many areas where courts and regulations have created indeterminate multi-factor tests.[312] An example in the regulations is the test for determining whether a taxpayer's activity is really for profit or just for fun.[313] Professors Abreu and Greenstein discuss another: the common law test for when receipt of a payment in a business context can be excluded from income as a gift.[314]

Just because multi-factor tests exist does not make them desirable. Perhaps the most famous take-down is Judge Posner's in *Exacto Spring Corp. v. Commissioner*.[315] That case involved the multi-factor common law test the Tax Court used (and still uses) to determine the amount a corporation could deduct as reasonable compensation to its officers.[316] While

deficiency in 2013 as 30,046). The table covers the years between 1990 and 2013 and breaks down the Tax Court workload into the following categories: Deficiency; Collection Due Process; Innocent Spouse Stand-Alone; Partnership Actions; and Other. *Id.*

311. INTERNAL REV. SERV., IRS DATA BOOK TABLE 9A, https://perma.cc/TVU2-V4PM (PDF) (listing a total of 249,768 Field Examinations of tax returns in Fiscal Year 2018).

312. *Compare* RESTATEMENT (SECOND) OF AGENCY § 220(2) (1958) (listing ten factors for determining whether a person is an employee), *with* Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 751–52 (1989) (listing thirteen factors), *and* Rev. Rul. 87-41, 1987-1 C.B. 296 (offering a list of twenty factors).

313. *See* Treas. Reg. § 1.183-2(b) (1972) (creating a nine-factor test).

314. *See* Abreu & Greenstein, *Defining Income*, *supra* note 140, at 111–13 ("The Lawyer retains the Doctor's services, but, after the Doctor performs the surgery, he tells the Lawyer that he won't charge her because of their friendship. . . . The Lawyer would not have income because the Doctor has made the Lawyer a gift and section 102 excludes gifts from income.").

315. 196 F.3d 833 (7th Cir. 1999).

316. *See id.* at 834–35 ("It is apparent that this test, though it or its variants (one of which has the astonishing total of 21 factors . . .), are encountered in many cases, . . . leaves much to be desired—being, like many other multi-factor tests, 'redundant, incomplete, and unclear.'" (citations omitted)).

Posner was excoriating that particular test, scholars have generalized his critique.[317]

One of the inherent risks of a multi-factor test is its indeterminacy. As Posner notes: "since the test cannot itself determine the outcome of a dispute because of its nondirective character, it invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb."[318] Applying that critique here, the chief problem with the multi-factor test proposed by Professors Abreu and Greenstein is that it risks being dominated by one factor as a rule of thumb: administrability.

Consider how administrability affects the taxation of cash gaming. If Alice and Myra are playing each game with cash, then the per-transaction rule is the theoretically correct rule under an income-as-rule approach. For example, if Myra puts $2.50 in the slot machine, pulls the handle and out drops $6.00 in quarters, Myra has realized income of $3.50. Myra can use that $3.50 to do anything that $3.50 can do: buy a Starbucks coffee, buy a burger, buy a beer, buy a kitchen utensil, buy most anything at Dollar Tree. So in theory it is income. But odds are that Myra will scoop up that $3.50 and drop it all back in the machines. And she will do so before anyone notices, so it remains a private decision.

The Service has traditionally declined to tax each $3.50. Both it and the courts have long recognized the administrative difficulties of tracking the basis of each wager individually in a session of like play.[319] Under Professor Abreu and Greenstein's approach, one would weigh and balance the factors of privacy and administrability and whatever else are "things we care about" to decide that the $3.50 is simply not income. Then one would need to go through the same exercise with every other gambler. I warrant the balance comes out in favor of saying the $3.50 is not income.

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317. *See, e.g.*, Yair Listokin, *Posner on Tax: The Independent Investor Test*, 86 U. CHI. L. REV. 1157, 1157 (2019) ("In this Essay, I endorse Posner's devastating rejection of a tax law multifactor test in *Exacto Spring Corp.*").

318. *Exacto Corp.*, 196 F.3d at 835.

319. *See, e.g.*, Szkircsak v. Comm'r, 40 T.C.M. (CCH) 208 (1980) ("[I]t is impractical to record each separate roll of the dice or spin of the wheel.").

The Service, however, takes pains to create a rule of law by interpreting the text that Congress wrote in Section 165(d) to allow the $3.50 to be netted against all other similar gaming activity in a single session.[320] The Service approaches the problem by looking at the words in a statute and deciding the better of two legal meanings.[321] So while administrability drives the legal meaning, the result is a rule that applies to all taxpayers. The wheel has been invented. Individual privacy preferences are irrelevant.

When Myra opens an electronic gaming account, the Service's rule is unchanged, because the statute remains unchanged. However, I submit that now both the privacy and administrability factors cut the other way. Now every win of $3.50 can be individually tracked, and Myra knows that the casino knows. The per-transaction approach is now eminently feasible to administer. Ironically, however, it is now theoretically wrong, for the reasons I give above. And the Service's per-session rule also becomes theoretically wrong for those same reasons.

Truly, Abreu and Greenstein are spot-on in recognizing the messiness of tax law. The better approach to that messiness, however, is not to abandon rules but to create better sub-rules. Thus this Article: we must find a better rule for taxation of electronic gaming, locate that rule within the legal meaning of income, and tie that rule to the statutory language created by Congress, the language in which is contained the full force of the state.

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320. INTERNAL REV. SERV., GLAM 208-011 (Dec. 12, 2008)

> [U]nder that reading [of the statute], a taxpayer would have to calculate the gain or loss on every transaction separately and treat every play or wager as a taxable event. The gambler would also have to trace and recompute the basis through all transactions to calculate the result of each play or wager. Courts considering that reading have found it unduly burdensome and unreasonable. Moreover, the statute uses the plural term "transactions" implying that gain or loss may be calculated over a series of separate plays or wagers.

321. *See id.* ("Some would contend that transaction means every single play in a game of change or every wager made. . . . The better view is that a casual gambler, such as the taxpayer who plays the slot machine, recognizes gain or loss at the time she redeems her tokens.").

B. The Right Rule: No Gross Income Until Cash-Out

Alice and Myra have a third option for how to report income from their gaming activities: report only those amounts that they have actually withdrawn from their player account during the year that exceed the amounts they have put into their player account. Thus, Myra would have no "gains from wagering transactions" when a winning slot machine pull is reflected only in her player's account with the casino. Nor would Alice have any income simply because she wins an online game and receives redeemable game credits in her account. Only when Alice or Myra cashes out during the year more than what they have put in the account would they have reportable gains. The rule would not require income to be reported until either Alice or Myra receives cash or cash equivalent from the casino or casual game site operator in such form as can be spent outside the casino or the casual game website. Because losses would already be reflected in the account's balance at the time of redemption, there would be no need for players to keep track of the myriad individual game results. Players would need only to track deposits and withdrawals from the account, information that casinos and website operators could easily provide.

1. Cash-Out Solves the Practical and Theoretical Problems

A cash-out rule solves the practical problem. By defining "income" as only that which a player redeems for cash or cash-equivalent, it reduces the pressure on taxpayers to pretend to be in a business. What counts as wagering gains or losses now includes the netting process inherent in the player's account. The practical ability of Worldwinner or a casino to track a player's deposits and withdrawals from an account makes it easy to determine which withdrawals are a return of capital and which represent income for the annual accounting period.

A cash-out rule also solves the theoretical problem. It respects the persistence of accounting memory and the role of accounting concepts in shaping the legal definition of income. The value of Alice and Myra's property—their right to play—increases only by dint of their own efforts and not by any market transactions where they provide goods or services to another in exchange for something of value. Put another way, their success in either the casino or the website results simply in more units of play, unless and until they cash out. True, their units of play are represented by "play" currency and not Defender ships. But like Defender ships, the play currency cannot be used to buy a market basket of goods and services until it is cashed out. It can only be used to consume more games. Thus, the units of play are neither cash nor realized income until such time as they are actually converted into something that can be used as cash.

2. Cash-Out Rule Is Better than an Above the Line Deduction

Congress could fix the problem of electronic gaming by allowing deductions of wagering losses and hobby expenses above the line. Moving loss deductions above the line would take the pressure off taxpayers to pretend they are in the "business" of gambling when, in reality, they do it for fun or because they are addicted. That is a good result.

A cash-out rule is superior to moving the deduction for two reasons. First, moving the deduction still requires taxpayers to report as income redeemable tax credits either per-transaction or per-session, and thus continues to do violence to the accounting concepts of taxable year and realization. While moving the deduction solves a good bit of the practical problems, the continued use of the per-transaction or per-session rules would continue the theoretical error of counting unrealized gain in property as income.

Second, a cash-out rule can be implemented administratively. The odds of Congress making any fix are less than hitting a million-dollar jackpot on a single pull. In contrast, the Service can change its interpretation of the relevant statutes governing the reporting requirements of casinos and website operators and Section 165(d).

It can easily create a new Notice or CCA to explain how the cash-out rule is consistent with the statutory language in Section 165(b) for the same reasons as the per-session rule: the statutory use of the plural "transactions."[322] CCA 2008-11 focuses on the statutory use of the plural to conclude that the

322. *See* § 165(d) ("Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.").

set of wagering "transactions" within a session can be netted.[323] Nothing in the statutory language, however, limits the impact of the plural to a twenty-four hour session. With electronic gaming "transactions" may occur over a longer time period than one day, one month, or one year. The concept of a "session" comes from the underlying fact pattern in the CCA involving the use of physical tokens.[324] But the CCA's bottom line can just as easily be framed in terms of redeemable game credits. It just needs to say that "fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her [game credits] and can definitively calculate the amount above or below basis realized."

VII. Conclusion

Casinos and website operators want their customers to feel good about spending money. By eliminating the use of cash, casinos make it easy for gamblers to forget how much they are spending. The only way to get winnings is to visit the cage or cashier, places that are deliberately designed to make it difficult to cash out. As one website puts it: "Casinos make it easy for you to play, but not easy for you to walk away."[325] Websites such as Worldwinner accomplish the same result by labeling redeemable game credits as "real money." That makes players feel good even as they continue to play until their "real money" runs out and they top up with a credit card.

This Article's thesis has been that these illusions of real money propagated by casinos and websites are not income within the legal meaning of that term. They are nothing more than units of play, just like the extra ships I won in Defender. The fact that these game credits are redeemable does not affect

323. *See* CCA 2008-011 (Dec. 12, 2008) ("We think that the fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens and can definitively calculate the amount above or below the basis (the wager) realized.").

324. *See* INTERNAL REV. SERV., GLAM 208-011 (Dec. 12, 2008) ("On each visit to the casino, the taxpayer exchanged $100 of cash for $100 in slot machine tokens and used the tokens to gamble.").

325. *The Top 12 Casino Psychology Tricks Used on Players*, VEGAS MASTER, https://perma.cc/884Q-MZ7D (last visited Jan. 4, 2020) (on file with the Washington and Lee Law Review).

the analysis because of the two accounting concepts that persist in the legal meaning of income: the annual accounting period, and the realization requirement. The law should not be distracted by these illusions into making website operators report the credits as payments or prizes or make taxpayers report them as gross income.