# tax notes℠

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# GROSS REVENUE FROM GAMBLING: SOME UNINTENDED CONSEQUENCES

by Sheldon D. Pollack

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In this article, Pollack describes one unintended consequence of provisions added to the Internal Revenue Code under the Omnibus Budget Reconciliation Act of 1990 (OBRA). The "phase-out" of personal and dependency exemptions, as well as the deduction for certain miscellaneous itemized deductions above thresholds of adjusted net income, has a curious and unintended effect on the tax returns of nonprofessional gamblers. It seems that under the right circumstances, the more you gamble — even if you merely break even — the greater your tax liability. Gambling activity per se can push the recreational gambler above the statutory thresholds of adjusted net income, and thereby result in the loss of the tax benefits. It is the *activity* of gambling, and not *winning*, that results in the greater income tax liability. This curious outcome suggests one more reason why Congress should avoid disingenuous tax increases such as those enacted under the OBRA phase-out provisions.

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*Render unto Caesars World that which belongs to Caesars World, and render unto the IRS that which belongs to the IRS — plus interest.*

— Sheldon D. Pollack, September 15, 1993

## The Tax Code Bites Back

As Edward Tenner reminds us in his delicious account of the unintended consequences (or "revenge effects") of our own ingenuity, things do not always turn out as planned.[1] Among those human innovations that "bite back" on a fairly regular basis must be included the noble enterprise of reforming the federal income tax. Former chairman of the House Ways and Means Committee Dan Rostenkowski once warned of the risk of legislative efforts to purify the tax code: "Fundamental reform almost always runs the risk of making things worse."[2] This is Murphy's Law applied to tax legislation: If you can possibly make the income tax worse, you probably will. Congress often does — usually unnecessarily and for the wrong reasons.

The tax code is a vast and impressive edifice, a testament to human ingenuity. Comprised of nearly 800 provisions (and thousands of pages of accompanying regulations), the income tax has been integrated into a finely tuned revenue-raising machine — or so we like to think. In fact, the more complicated the tax code becomes, the more difficult it is to fully anticipate how new legislation will impact on other seemingly unrelated tax provisions. This would not be such a problem if the income tax evolved solely through the "incremental" policy-making process that scholars typically

[1]Edward Tenner, *Why Things Bite Back: Technology and the Revenge of Unintended Consequences* (New York: Alfred A. Knopf, 1996).

[2]*See Tax Notes*, Aug. 22, 1994, p. 1081. Of course, the chairman liked the legislative process just the way it was — or at least the way it was before he got his hand caught in the cookie jar.

ascribe to it.[3] But for better or worse (in most cases, for worse), it has become commonplace since the 1970s for Congress to rewrite the tax code every few years through massive, omnibus revenue bills.[4] During such exercises in political hubris, legislators and their staff inevitably face short deadlines that make impossible thoughtful analysis of the legislation at hand. Charles McLure refers to this as policymaking "under the gun."[5] When proposed legislation includes so many provisions amending so many different sections of the tax code, no single individual — not even those in control of the legislative process, if there really are such persons — can possibly comprehend the enterprise as a whole. The results are not always pretty. Taking on so much all at once has contributed to an increase in tax legislation that is poorly thought out, poorly written, inconsistent with other sections of the tax code, and often internally incoherent. The increased need to enact technical corrections legislation points out one of the shortcomings of this approach. In 1986, this phenomenon reached new heights as the overwhelming burden of crafting a massive tax bill in such a short time resulted in an extraordinary number of flawed statutory provisions.[6] (The recently enacted Taxpayer Relief Act of 1997 has the potential for challenging the 1986 act for the dubious honor of that tax bill requiring the greatest number of technical corrections.)

While on the whole, the tax legislation passed in 1990 during the Bush administration was not of a scale comparable to that of the massive tax bills enacted in the 1980s, it did greatly suffer from the short time constraints imposed by the peculiar political circumstances in which it was born. Propelled by its inability to persuade a Democratic Congress to impose further spending cuts on federal expenditures, the Republican White House entered into budget negotiations with congressional leadership in May 1990 in an effort to achieve reconciliation over budget cuts coupled with increases in tax rates. The Bush administration was pushed into these negotiations by the looming presence of a worsening economy and the threat of a sequester of government spending mandated under Gramm-Rudman-Hollings.[7] Pressure on the president, as well as reluctant members of Congress, was increased by the threat of a sequester requiring the shutdown of the federal government. This pressure only intensified as the October 1 deadline for a new budget approached. When the deadline came and went without agreement on a congressional resolution authorizing the government to continue to spend money, operations were effectively shut down after October 5 for the Columbus Day holiday weekend. The president was forced to play "Let's Make a Deal."

***The Omnibus Budget Reconciliation Act of 1990 reflected few clear principles and little coherent ideology. For good reason, neither Democrats nor Republicans were anxious to claim credit for the bill.***

Much has been written of the political hay made by Democrats over the Bush administration's many strategic blunders in the 1990 budget negotiations.[8] There were few guiding principles behind the deal-making. The Republican administration re-interpreted the president's "no-new-taxes" pledge to apply only to *income* taxes, allowing agreement to be reached over increased user fees, an increase in the excise tax on liquor, and a 10-cent increase in the gasoline excise tax. Eventually the White House gave in anyway and accepted an increase in the top individual income tax rate from 28 to 31 percent, with the tax on long-term capital gains capped at the 28 percent rate as a political compromise and concession to Republicans. In an effort to camouflage this tax increase, budget negotiators conceived two rather nasty revenue-raisers: the "phase-out" of the tax benefit of personal and dependency exemptions and the reduction of certain miscellaneous deductions above thresholds of adjusted net income.

[3]The leading account of the development of the income tax is John F. Witte, *The Politics and Development of the Federal Income Tax* (Madison: University of Wisconsin Press, 1985). Professor Witte describes the policy-making process for the income tax as follows: "Legislative changes in tax policy usually begin as marginal adjustments to the existing tax structure. . . . The tax code offers a variety of easily grasped levers. In this sense, it is an incrementalist paradise, susceptible and seductive to political tinkerers. As a result, most changes in tax bills consist of simple adjustments in existing policy provisions." Witte, *Politics*, 244-45.

[4]For a discussion of the complexity and erratic pattern of tax policy in the post-War era, see Sheldon D. Pollack, *The Failure of U.S. Tax Policy: Revenue and Politics* (University Park: Penn State Press, 1996).

[5]Charles A. McLure Jr., "The Budget Process and Tax Simplification/Complication," 45 *Tax L. Rev.* 25, 79-81 (1989).

[6]One saving grace may be that such massive bills keep lobbyists and interest groups off guard, providing policymakers with some greater independence in a floor vote. For instance, many otherwise well-organized interest groups were simply unable to keep up with the fast pace or fully appreciate the import of many of the provisions on the tax-reform agenda in 1986.

[7]The so-called Gramm-Rudman-Hollings bill was formerly known as the Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99-171, 99 Stat. 1037, section 200 *et seq.*

[8]*See, e.g.*, Alan Murray and Jackie Calmes, "How the Democrats, With Rare Cunning, Won the Budget War," *Wall St. J.*, November 5, 1990, A1; Donald F. Kettl, *Deficit Politics: Public Budgeting in Its Institutional and Historical Context* (New York: Macmillan, 1992), 3-12. A perceptive assessment of the 1990 budget agreement is found in Aaron B. Wildavsky and Joseph White, *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s* (Berkeley and Los Angeles: University of California Press, 1989), 577-89; *see also* C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* (Washington, D.C.: Urban Institute Press, 1992), 173-84; Michael J. Graetz, *The Decline (and Fall?) of the Income Tax* (New York: W.W. Norton & Company, 1997), pp. 162-70.

This was little more than a sleight-of-hand attempt to disguise what were in fact increases in marginal tax rates.[9]

This game had been played before in 1986 with the so-called bubble, a 5 percent surtax imposed to phase out the 15 percent bracket and personal exemptions. Above the applicable income ranges, the surtax ended and the marginal rate dropped back down to 28 percent — within these income ranges, marginal rates rose to 33 percent.[10] The bubble fooled no one into believing that taxes hadn't been raised, although it did confuse many into believing that tax rates were lower for the wealthy (confusing effective or average tax rates with marginal tax rates).

In 1990, the House bill proposed a more honest and straightforward approach — repealing the bubble and raising the top marginal rate to 33 percent.[11] However, this welcome manifestation of integrity was spurned by the Conference Committee, which ostensibly preserved the top rate at 31 percent, and in lieu of an overt tax increase, introduced the idea for the phase-out of personal exemptions and miscellaneous itemized deductions.[12] The final bill, the Omnibus Budget Reconciliation Act of 1990 (OBRA),[13] reflected few clear principles and little coherent ideology. It did, however, add section 68 to the Internal Revenue Code implementing the aforementioned phase-out of itemized deductions and amended section 151 to include the phase-out of personal exemptions. For good reason, neither Democrats nor Republicans were anxious to claim credit for the bill, which in any event made only a modest contribution to closing the budget deficit.

The technical problems resulting from making tax policy through such an *ad hoc* process of political bargaining and log-rolling often take time to surface. This was the case with this disingenuous attempt to alter the structure of the income tax through a disguised tax increase. For reasons that are difficult to fathom, Congress adopted a rate increase in 1990 that imposed additional taxes on the upper middle class, rather than on the highest incomes at the margin.[14] Such ill-conceived statutes are prone to consequences that were neither intended nor anticipated by those who originally propose them. This was the case with the 1990 ruse.

***Gamblers have always been treated rather harshly under the tax laws.***

One curious example of an unintended consequence of the 1990 tax increase came to my attention recently during an afternoon round of golf with the unfortunate victim himself. The problem relates to the vice of recreational gambling — an activity even more suspect than squandering countless afternoons chasing after a little white ball on the golf course. It seems that the 1990 tax bill really stuck it to "recreational" gamblers. Since the committee reports do not express any deliberate plan to do so, I presume that this was done quite unintentionally. But happen it did. That afternoon, I listened to this gambler's sad tale. Being more the academic than the practitioner these days, and recognizing a losing case when I see one, I politely declined the representation and set down his story for all the world to hear.

## Recreational Gambling and the Tax Law

Gamblers have always been treated rather harshly under the tax laws. Those foolish enough to squander their hard-earned savings at the gambling tables in Las Vegas or Atlantic City (to say nothing of tossing dice in dark alleys), have faced a largely unsympathetic tax system. The basic premise of the taxing authorities is that gambling is a personal activity and the inevitable losses suffered by gamblers are nondeductible personal expenditures.[15] What you lose at the tables is the price of your entertainment. Some of us happen to spend thousands of dollars each year for the privilege of wasting our time playing golf. That is my own particular vice, and I accept with grace the commissioner's view that the expenses incurred to support my addiction are strictly personal and hence, nondeductible.[16]

[9]Once a taxpayer crosses the threshold for the "phase-out" of personal exemptions, which under the original bill began at $100,000 for a single taxpayer, as well as the threshold for the phased-in reduction in the enumerated deductions, which began at $150,000 for the same single taxpayer, the effective marginal tax rate was really 34 percent, and not the statutory 31 percent.

[10]Former section 1(g), repealed by Pub. L. No. 101-508, section 11101(b)(1). Beginning in tax year 1988, the Tax Reform Act of 1986 provided for a phase-out of the 15 percent bracket through a 5 percent surtax on income between $61,650 and $123,790 for joint returns and $43,150 to $89,560 for single filers. Personal exemptions were thereafter phased out on income above those income ranges. In these income ranges, the marginal rate was 33 percent.

[11]Legislative History of Ways and Means Democratic Alternative, H.R. WMCP No. 37, 101st Cong., 2d Sess. 2-3 (1990).

[12]H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1029-30 (1990).

[13]Pub. L. No. 101-508, 104 Stat. 1388.

[14]For a comprehensive and detailed analysis of how the phase-out of personal exemptions and itemized deductions impacts on marginal tax rates, see Elliott Manning and Laurence M. Andress, "The 1996 Marginal Federal Income Tax Rates: The Image and the Reality," *Tax Notes*, Dec. 30, 1996, p. 1585; *see also* Gene Steuerle, "The True Tax Rate Structure," *Tax Notes*, Oct. 16, 1995, p. 371 (benefit phase-outs as implicit tax rate hike); Gene Steuerle, "Bubbles, Bangles, and Beads: Fixing Up the Top Rate," *Tax Notes*, Apr. 19, 1993, p. 425; Kaye A. Thomas, "Phase Out the Phaseouts," *Tax Notes*, Dec. 25, 1995, p. 1689 (urging replacing the phase-outs with higher marginal tax brackets).

[15]Section 262 ("[n]o deduction shall be allowed for personal, living, or family expenses").

[16]The Revenue Reconciliation Act of 1993 enacted new section 274(a)(3), which flatly disallows any deduction for country club dues, even that portion allocable to "business" use of the club. Daily greens fees are still deductible, but only to the extent such expenses are "directly related" to the taxpayer's "active conduct" of a trade or business. Section 274(a)(1) and (2).

(This is simple enough — except perhaps to those who like to deceive themselves into believing that they are really discussing "business" on the course during a purportedly tax-deductible round of golf with a client.) Despite the obvious nondeductible nature of both greens fees and blackjack, gamblers are forever trying to deduct their expenses — and even worse, their losses.[17] This has led to some rather harsh rules crafted to govern gambling activity. These rules in turn have led to some of the most bizarre cases in the history of the income tax.

***To understand that there is something inherently peculiar about gambling losses, one need look no further than the recent case of Zarin v. Commissioner.***

To understand that there is something inherently peculiar about gambling losses, one need look no further than the recent case of *Zarin v. Commissioner*.[18] David Zarin was, at one time, a rather wealthy professional engineer who made the fatal mistake of moving to Atlantic City. There he succumbed to the allure of casino gambling, and proceeded to throw away his fortune at the casino in Resorts International Hotel. Resorts was kind enough to fund Zarin's highly unsuccessful gambling activity by extending to him a generous line of credit. Zarin also was allowed to sign counter checks ("markers") for chips, which practice allowed him to exceed the limit on his line of credit. The counter checks were later exchanged for Zarin's personal checks. Through this means, Zarin proceeded to lose the rest of his life savings. After suffering a $2.5 million loss in 1979, Zarin came back for more. (They always come back for more.) In 1980, Zarin ran up a debt to Resorts for $3.4 million of chips "purchased" on credit and subsequently lost in gambling at the casino. A good deal of this debt related to credit extended to Zarin in apparent violation of certain rules and orders issued by the New Jersey Casino Control Commission. When Zarin failed to pay this debt, Resorts was no longer quite so chummy. Soon after, the casino brought suit to recover this sum. In his defense, Zarin raised questions as to the enforceability of the debt based on these alleged violations of New Jersey law. In 1981, Zarin settled his $3.4 million debt to the casino for a mere $500,000. Then the fun began.

On audit, the IRS claimed that in tax year 1981 Zarin recognized some $2.9 million of income from the discharge of indebtedness for less than its face amount. The Tax Court agreed. Under the theory advanced by the IRS and upheld by the Tax Court, "Zarin was properly taxable on nearly $3 million of cancellation of indebtedness income due to his windfall opportunity to engage in almost $3.5 million of gambling for only $500,000."[19] As Judge Theodore Tannenwald Jr. wryly noted in his dissent, the Tax Court's holding "produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth."[20] Under this standard, Mr. Zarin was indeed a very wealthy man. Unfortunately, he also was broke! And so David Zarin was taken to the cleaners twice — the first time by Resorts, the second by the commissioner. His Philadelphia lawyers also made a few bucks off this impecunious high-roller.

On appeal, the Third Circuit subsequently recognized the "incongruity" of taxing Zarin on his losses and reversed the IRS and Tax Court.[21] This spared Zarin from paying tax to the Treasury on the phantom income attributable to the benefit of gambling at a reduced rate. (Of course, Resorts still took Zarin for nearly $3 million. Needless to say, the casino kept the cash.) But the metaphysical issues raised by the case leave even the most hardened of tax lawyers puzzled and perplexed. As Professor Daniel Shaviro has put it: "Considered as a story, *Zarin* mixes personal tragedy with the sledgehammer irony of a 'Twilight Zone' episode."[22] Of course, what created the tax nightmare for Zarin in the first place was the mismatching of his gambling loss and the income recognized from the discharge of his debt to the casino. The mismatch was produced by the application of section 165(d), which states that: "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." Losses from gambling transactions that exceed annual gains from gambling transactions may not be deducted against income from other sources and do not carry over to succeeding taxable years. For this reason, the $3.4 million gambling loss suffered by Zarin in 1980 went unused — as did the $2.5 million gambling loss suffered in 1979. Under the Tax Court's holding, in 1981 Zarin recognized $2.9 million of income from the discharge of his gambling debt (arguably, income from a "gambling transaction"), but in that year he had no gambling loss to shelter such income. Heads, the casino wins; tails, the IRS wins. It seems that the only way Mr. Zarin could have won was by investing his $3.9 million in stock of Resorts.

Given the statutory limitation on deducting gambling losses, gamblers are greatly tempted to claim that their gambling activity amounts to a "trade or busi-

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[17]In the world of golf, deducting expenses (and losses) is generally left to professional golfers — those in the "trade or business" of being golfers.

[18]*Zarin v. Commissioner*, 92 T.C. 1084 (1989). The most enlightening discussion of this bizarre and perplexing case is Daniel Shaviro, "The Man Who Lost Too Much: *Zarin v. Commissioner* and the Measurement of Taxable Consumption," 54 *Tax L. Rev.* 215 (1990). The discussion that follows draws heavily on Professor Shaviro's account.

[19]Shaviro, *supra* note 18, at 235.

[20]*Zarin v. Commissioner, supra* note 18, at 1101 (Tannenwald, dissenting).

[21]*Zarin v. Commissioner*, 916 F.2d 110, *90 TNT 213-10* (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989).

[22]Shaviro, *supra* note 18, at 215.

ness" for income tax purposes. Achieving the cherished trade or business status for gambling activity would mean not only that a gambler's "inevitable annual net gambling loss" (or "IANGL") would be deductible against income from other sources, but also that all the costs associated with conducting the trade or business of gambling (e.g., airfare to Las Vegas, hotel rooms, tickets to Wayne Newton concerts, etc.) also would be deductible on the gambler's Schedule C. For decades, gamblers made little headway with their arguments that gambling activity can rise to the level of a trade or business. Mr. Zarin seems not to have even raised this argument — for good reason. The IRS flatly rejected the premise.[23] Then in an unexpected roll of the dice, the tables were turned on the Service as the U.S. Supreme Court found in favor of one rather pathetic "professional" gambler, Robert Groetzinger.[24]

Groetzinger was a casual gambler of quite limited skills. After being terminated from his long-time position as a sales and market researcher, rather than find some new equally dreary job, Groetzinger decided to pursue his life-long dream: devoting all his time and energy to the vocation of gambling. Unfortunately, after a year of "full-time" gambling, dedicating 60 to 80 hours a week to his calling, Groetzinger's skills did not improve very much. In 1978, the tax year at issue, he managed to generate $70,000 of gross winnings from parimutuel wagering of $72,032, leaving him a net gambling loss of $2,032 for the year. (For those unfamiliar with big-time gambling, this was *not* a good result.) Groetzinger was sneaky and did not actually claim this loss on his tax return. Instead, he netted out the income with the loss and called it a "wash" unworthy of even reporting.[25] On audit, the Service dug a little deeper and uncovered the $72,032 of gambling activity. The Service then declared that part of the gambling loss was an item of tax preference under then current law and therefore, that Groetzinger was subject to minimum tax under old section 56(a) of the Internal Revenue Code of 1954. Thereafter, in a triumph of good lawyering over logic and reason, Groetzinger managed to convince the Tax Court and the Supreme Court that his gambling activity was not a mere "sport" (as Justice Byron R. White disparagingly depicted it in his dissent), but rather a trade or business — notwithstanding that it was a losing business venture.[26] The Supreme Court fell hook, line, and sinker for the claim that Groetzinger was a "professional" gambler. His $2,032 gambling loss was held to be incurred in a trade or business, and hence, no part of the loss was an item of tax preference under the alternative minimum tax.

***In a triumph of good lawyering over logic and reason, Groetzinger managed to convince the Tax Court and the Supreme Court that his gambling activity was not a mere 'sport' but rather a trade or business.***

The Supreme Court's holding had important ramifications for gamblers, offering heaven on earth: big action, high-roller treatment by the casinos, and respect from the Highest Court in the Land. Of course, the commissioner is not so easily fooled. Even conceding the theoretical premise that gambling can be a trade or business, the IRS still imposes a very strict standard on any particular gambler seeking to claim trade or business status. Remember that Groetzinger had no job or significant source of income during the year. All he did was gamble, albeit with limited skills and unfavorable results. Few gamblers can make similar claims of devotion to their calling. As a result, all the working stiffs who gamble merely for "sport" face the much less favorable classification as a nonprofessional, recreational gambler. For the recreational gambler (like poor Mr. Zarin), no deduction is allowable for the expenses associated with their personal entertainment and hence, their IANGL will surely go unused. This much tax law every gambler knows. However, few realize that as a result of those changes made to the tax code in 1990, the tax treatment of recreational gambling got a whole lot worse. Here's why. (Yes, at last, the story comes together!)

### The Unintended Consequences

Under the treatment carved out by the courts and IRS for recreational gamblers, all winnings from "wagering transactions" must be included in gross income and all losses from "wagering transactions" must

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[23]Well, actually when it suited its purposes, the IRS could accept the notion that a gambler was in the trade or business of gambling. *See, e.g., Gentile v. Commissioner*, 65 T.C. 1 (1975). In general, the federal courts, including the Tax Court, were more even-handedly accepting of the argument. *See, e.g., Ditunno v. Commissioner*, 80 T.C. 362 (1983).

[24]*Commissioner v. Groetzinger*, 480 U.S. 23; 107 S. Ct. 980, *87 TNT 37-7* (1987), *aff'g* 771 F.2d 269 (1985) (7th Cir.), *aff'g* 82 T.C. 793 (1984).

[25]For the year, Groetzinger had $6,498 of income from other sources (dividends, interest, capital gains, and salary earned prior to his termination). He did not report any gambling winnings or losses, and he did not itemize his deductions.

[26]According to the Court, for a taxpayer to be in a trade or business, the taxpayer "must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify." Under this test, Groetzinger's gambling activity was held to be a trade or business. In a dissenting opinion in which Chief Justice Rehnquist and Justice Scalia joined, Justice White read some of the 1982 amendments to the alternative minimum tax (in which gambling losses were expressly classified as an item of tax preference) to indicate Congress's view that gambling activity cannot be a trade or business (if it could be, then gambling losses would not be an item of tax preference). According to White, gambling is just a "sport." Some sport; some trade or business.

be treated as itemized deductions, rather than as adjustments to gross income. This much is settled law. For instance, in *Stein v. Commissioner* (1984), the Tax Court flatly rejected a recreational gambler's attempt to directly reduce his adjusted gross income by his deduction for gambling losses.[27] The court conceded that if a taxpayer is engaged in the trade or business of gambling, gambling losses are deductible from gross income in computing adjusted gross income. However, for the nonprofessional gambler, losses are deductible only to the extent of gains — and only as itemized deductions. Accordingly, gambling winnings must be included in income and gambling losses (in an amount no greater than the gambler's total annual winnings from gambling transactions) must be claimed as itemized deductions.[28] Of course, including total gambling winnings in gross income and claiming an equal amount of losses as an itemized deduction is a meaningless procedure having no net impact on the gambler's tax liability — at least, that was the case prior to 1990. Then the OBRA phase-out provisions were added to the complex equation for computing taxable income. Herein lies the predicament for the recreational gambler.

> ***The disguised tax increase enacted under OBRA collides head-on with the tax treatment fashioned by the Service and the courts for recreational gamblers.***

Who would have guessed it in 1990? The disguised tax increase enacted under OBRA collides head-on with the tax treatment fashioned by the Service and the courts for recreational gamblers. The inclusion of gambling winnings in gross income, with gambling losses treated as itemized deductions, creates unfortunate and discrepant results for the nonprofessional gambler — these on top of the otherwise tough treatment imposed under the tax code.

The problem arises where the recreational gambler is just on the edge of the threshold of adjusted gross income (AGI) at which point the OBRA phase-out provisions kick in. For taxable year 1996, the OBRA phase-out of personal and dependency exemptions begins at AGI of $176,950 for married taxpayers filing a joint return; phase-out is complete when AGI reaches $299,451.[29] The phase-out of miscellaneous itemized deductions (which applies to such deductions as taxes paid, home mortgage interest, interest "points," and charitable contributions, but *not* gambling losses) is triggered when AGI reaches $117,950 (again, for married taxpayers filing a joint return).[30] What is important is that these phase-outs are based on the taxpayer's AGI, rather than net taxable income.[31] For the recreational gambler, gambling losses do not reduce AGI, while gambling winnings increase AGI. As a consequence, as illustrated below, a recreational gambler can sustain an increased tax liability while having no net gambling winnings — or even while suffering a net loss for the year.

## The New Hidden Cost of Recreational Gambling

The best way to visualize how the OBRA phase-out provisions impact on recreational gambling is to consider some specific examples. The following examples involve one hypothetical recreational gambler, Landrau "Dice" Pay. Dice is an insurance executive with a wife, Roulette, five dependent children, and an on-again-off-again addiction to gambling. In 1996, Dice earns an annual salary of $150,000, and Roulette has no taxable income for the year. Together, they file a joint tax return and claim $25,000 of itemized deductions subject to the section 68 phase-out (i.e., taxes, mortgage interest, and charitable contributions). With $150,000 of AGI and $25,000 of itemized deductions, Dice and his wife would have a tax liability of $25,395 (see Table 1) — if only Dice could stay away from the casinos. Unfortunately, he cannot. During the year, Dice succumbs to temptation and drives down to Atlantic City. All of Dice's gambling activity for the year

[27] *Stein v. Commissioner*, 48 T.C.M. 724 (1984); *see also Hochman v. Commissioner*, 51 T.C.M. 311 (1986); *but cf. Frey, Jr. v. Commissioner*, 1 B.T.A. 338 (1925), *acq.* VI-1 C.B. 2 (1925).

[28] Rev. Rul. 54-339, 1954-2 C.B. 89. Mechanically this rule is implemented as follows: The taxpayer determines all gross losses, and then determines the allowable amount by reference to gross income from gambling transactions. The gross winnings are includable in income on line 21 ("Other Income") on Form 1040 for 1996, and the allowable portion of the gambling loss is deductible as an itemized deduction on Schedule A.

[29] The phase-out of personal and dependency exemptions is such that 2 percent of the exemptions is phased out for every $2,500 of AGI above the threshold. For married taxpayers filing jointly, the threshold for tax year 1996 is $176,950. The calculation is as follows:

(1) Subtract threshold ($176,950) from AGI to find excess AGI, if any;

(2) Divide by $2,500, round to next whole increment;

(3) Multiply by 2 percent, this yields the phase-out percentage;

(4) Multiply phase-out percentage by total personal and dependency exemptions;

(5) Subtract (4) from total exemptions to get net exemptions.

[30] The phase-out of itemized deductions is calculated by taking the lesser of: AGI in excess of $117,950 multiplied by 3 percent, or 80 percent of itemized deductions subject to phase-out.

[31] Obviously, it would have been difficult to peg the phase-out provisions to net taxable income, since it is necessary to know the amount of allowable itemized deductions and personal and dependency exemptions to determine net taxable income. A concept such as "tentative net taxable income" would need be introduced to the computation to determine whether the phase-out provisions are triggered. Of course, this would just impose even greater complexity to solve an unnecessary problem carelessly and inadvertently introduced into the tax law in an effort to deceive voters.

takes place on this one day, in one casino (Shlump's World), on a line of credit extended by the casino.

First, consider the method for determining Dice's net loss/gain for the day (which also just so happens to be his net loss/gain for the taxable year). There are many possibilities, but one thing is certain. Dice is *not* allowed to net his total winnings against his total losses — neither on an annual basis, a daily basis, nor by netting out his activity on a "table by table" basis. More than a few recreational gamblers who frequent the casinos do just this; they net their gains against their losses and report the difference — maybe. Since most gamblers lose at the casinos, most forget the whole thing and disregard the nondeductible net loss.[32] (Whether recreational gamblers report their rare annual net gains is another story — one I would rather not go into here.) However, netting winnings against losses is an impermissible method of reporting gambling activity.[33]

***There is only one 'right' way to compute gambling winnings and losses — the IRS's way.***

There is only one "right" way to compute gambling winnings and losses — the IRS's way. Hard as it is for most gamblers to believe, the Service's position is that the cost of every single losing bet during the year must be totaled to determine a gambler's annual loss.[34] Conversely, every single gain (the pay-off, less the "cost" of that particular wager) from every single "wagering transaction" (every bet, roll of the dice, spin of the roulette wheel, dash of the dogs, run of the horses, etc.) must be totaled for the year to determine the gambler's annual winnings from gambling activity. In other words, regardless of how many days or nights the gambler gambles, regardless of how many tables he frequents, and regardless of how many bets he places, all individual losing bets for the year must be totaled in calculating a gambler's gross loss for the year, and all pay-offs must be totaled to calculate his gross winnings for the year. Then the net gain or loss is computed. The former is taxable while the latter is disallowed.

[32]This is what Groetzinger did on his original return, apparently not believing himself the claim later advanced by his lawyer that he was engaged in a trade or business.

[33]*See, e.g.*, Rev. Rul. 54-339, 1954-2 C.B. 89.

[34]*See, e.g.*, Rev. Proc. 77-29, 1977-2 C.B. 538, wherein the IRS sets forth the taxpayer's responsibilities for "maintaining adequate records in support of winnings and losses." According to the IRS, "[a]n accurate diary or similar record regularly maintained by the taxpayer, supplemented by verifiable documentation will usually be acceptable evidence for substantiation of wagering winnings and losses." The diary should include "the date and type of specific wager or wagering activity." The diary also should contain: the name of the gambling establishment; the location of gambling establishment; the names of other persons, if any, present with the taxpayer; and the amounts won or lost. Leave it to the IRS to take all the fun out of gambling!

According to the Service, separate bets on the same hand, team, or animal in a single contest may be lumped together as a single "wagering transaction." However, bets on different hands, teams, or animals, even in the same contest or race, are separate wagers that must be accounted for separately: "If the wagers are not identical, then there is more than one wagering transaction."[35] As far as the Service is concerned, the term "winnings" as it applies to "wagering transactions" entered into at table games such as blackjack, roulette, baccarat, or craps, means the pay-off from each bet at each table, less the cost of each winning wager.[36] The same theory applies to parimutuel betting. The total of each winning gambling transaction for the year is what is includable in gross income. And this is the problem: The extra revenue jacks up the recreational gambler's AGI and nails him to the wall.

Example 1 below illustrates the result from following the IRS's procedure for calculating a recreational gambler's annual net loss/gain. In this example, Dice walks into the casino at Shlump's World without a penny in his pocket. He "buys" $10,000 of chips on credit, sits down at one table, and plays craps for 24 hours straight in one marathon session. For his trouble (dare I say entertainment?), he has $200,000 of gambling winnings and $200,000 of gambling loses. He then cashes in the remaining $10,000 of chips and goes home. He thinks that he "broke even" for the day. Think again, Dice!

**Example 1: Effect on Tax Liability From Using IRS Procedure**

Dice reports his 1996 gambling activity consistent with the method mandated by the IRS. He reports $200,000 of gross winnings from wagering transactions and $200,000 of gross losses from wagering transactions for the year. Under this method, Dice and his wife will have AGI of $350,000, comprised of Dice's $150,000 in wages and the $200,000 in gross gambling winnings. The gross gambling losses of $200,000 are deductible, but only as an itemized deduction on Schedule A. With AGI of $350,000, the couple's personal and dependency exemptions will be fully phased out (since full phase-out is reached when AGI reaches $299,451). This results in lost exemptions of $17,850 (or $2,550 x 7). The section 68 phase-out of itemized deductions will be the lesser of:

[35]LTR 8123015.

[36]LTR 8710006. The issue here was whether the withholding requirement under section 1441 as it applies to gambling "winnings" of nonresident aliens should be imposed on the gross winnings or net winnings from table games. The Service's position is that withholding is due on gross winnings: "[E]ach win by a nonresident alien at a table game must necessarily be subject to withholding since offsetting losses against wins following one hour of play, for example, would automatically result in withholding with regard to net amounts of winnings. Withholding on net amounts of winning is clearly prohibited by section 1441- 2(a)." So nonresident recreational gamblers have it even worse than the domestic variety.

($350,000-$117,950) x 0.03, or $25,000 x 0.80. Accordingly, the phase-out amount is $6,962. The total amount of lost tax benefits is $23,912 (or $17,850 + $6,962). At the 31 percent marginal tax rate, the tax liability of Dice and his wife on their joint tax return increases by $7,393 solely on account of Dice's gambling activity.

And so, another gambler wakes up in the Twilight Zone. Even though Dice had no net gain for the year attributable to his gambling activities, his tax bill goes up $7,393. Breaking even at the craps tables (a pretty big accomplishment in itself given the distinctly unfavorable odds loaded in favor of the casino) turns out to cost this recreational gambler an extra $7,393 in tax. This means that Dice's break-even gambling activity produces a 29 percent increase in his tax liability for the year. Ouch! While the magnitude of this liability is minor in comparison with that proposed by the IRS for Mr. Zarin, the outcome is equally absurd.

It is doubtful that very many recreational gamblers actually keep records of every single bet placed on table games during the year, as the Service requires them to do to substantiate their losses.[37] It is mighty tempting to use some form of an impermissible netting procedure for calculating net losses (or gains) incurred during the year. Just for the fun of it — purely as an academic exercise — let us consider the tax consequences of using an impermissible netting procedure for purposes of calculating Dice's net loss for the year. Example 2 illustrates how different, more favorable tax results follow from using such a netting procedure.

**Example 2: Effect on Tax Liability From Impermissible Netting Procedure**

As before, all of Dice's gambling activity in 1996 takes place on one day, in one casino, at one table, and on a line of credit extended by the casino. Dice has $200,000 of gross winnings and $200,000 of gross losses on this single day of gambling. Dice uses the impermissible netting method to calculate his net gain/loss. For his one day of gambling activity, Dice nets out his $200,000 of gains against his $200,000 of losses. Of course, at the end of the day of gambling, Dice is exactly where he was before he started. Since his gambling activity was a "wash" for the day (and taxable year), he just forgets the whole thing when preparing his tax return. As a result, his AGI remains $150,000, and hence, there is no impact on his $25,000 of itemized deductions resulting from his gambling activities. Using this improper method of reporting gambling activity, Dice and his wife have a tax liability of $25,395 — the same as if Dice had stayed home and watched TV that fateful day, instead of hitting the casino.

This netting procedure is intuitive and commonly followed, but it is also quite improper — whether applied on a daily or annual basis. For obvious reasons, recreational gamblers such as Dice prefer to report their gambling activities on a net annual basis (forgetting the whole thing if there is a net loss). Unfortunately, the IRS discovers Dice's gambling activity in an audit of his tax return (or more likely, on account of information reporting by the casino), and following proper procedure, issues a notice of deficiency. This only seems right — or is it?

> ***It is not winning or losing that creates this additional tax liability; it is the activity of gambling that is being taxed. And the greater the volume of activity, the greater the tax liability.***

First, it must be remembered that section 165(d) merely states that losses from wagering transactions shall be allowable "only to the extent of the gains from such transactions." The statute does *not* say that gambling *activity* is subject to tax.[38] And remember, Dice really only broke even for the day (and taxable year); there was no net change in his economic position for the year attributable to his gambling. So why should his vice affect his tax liability? Dice left the casino no better and worse off than when he sauntered in, yet his activities resulted in an additional tax liability of $7,393. In fact, even if Dice had lost more than his $200,000 of winnings, he still would have suffered the exact same tax result. In such a case, the net tax loss would have been disallowed under section 165(d). So it is not winning or losing that creates this additional tax liability; it is the *activity* of gambling that is being taxed. And the greater the *volume* of such activity, the greater the tax liability.

To better grasp how the volume of gambling activity impacts on Dice's tax liability, let us consider three cases illustrating the effect of various levels of gambling activity. Assume four levels of annual gambling activity: $10,000, $100,000, $200,000, and $500,000. In

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[37]Rev. Proc. 77-29, *supra* note 34, provides recordkeeping guidelines to substantiate wagering gains and losses. As noted above, a diary regularly maintained and supported by verifiable documentation will ordinarily constitute acceptable proof. Verifiable documentation includes withholding statements, wagering tickets, canceled checks, credit records, etc. Of course, the IRS can still accept the taxpayer's records as to winnings but ignore those same records as to losses if the records are deemed "inadequate." *See, e.g., Plisco v. U.S.*, 306 F.2d 784 (D.C. Cir. 1962), *cert. denied* 371 U.S. 948 (1963) (court accepts as "not arbitrary" the IRS's determination of adequacy of taxpayer's records of daily profits but rejection of taxpayer's records of losses); *Zielonka v. Commissioner*, T.C.M. 1997-81, *Doc 97-4851 (8 pages)* (February 18, 1997) (professional gambler not allowed deduction for gambling losses because of failure to maintain accurate and contemporaneous records of gambling activity).

[38]Obviously, "winnings" from gambling transactions are includable in income under section 61(a). But what constitutes "winnings" from a gambling transaction is the threshold question. Arguably, it is not *gross* winnings that is includable in income, but *net* winnings — with any net loss disallowed under section 165(d).

all four cases, Dice breaks even from his gambling; gross winnings exactly equal gross losses for the year. Gambling activity is properly reported using the IRS's prescribed method; gross winnings are included in gross income and gross losses are deducted as an itemized deduction. Recall that Dice's tax liability would be $25,395 if he refrained entirely from gambling during the year. The results of gambling at these four levels are compared on Table 2. When Dice engages in just $10,000 of gambling activity during the year, there is only a slight increase in his tax liability. He must pay an additional $93 of income tax — a mere 0.37 percent increase in his overall tax liability. When gambling activity rises to $100,000, the increase in tax liability becomes more pronounced. At this level of gambling, Dice's total tax liability increases by $4,139 — a 16.3 percent increase. As illustrated in Example 1 above, when Dice's gambling activity is $200,000, the increase in tax is $7,393. Finally, when gambling activity reaches $500,000, Dice's tax liability increases by $10,183 — which works out to a hefty 40.1 percent increase in his tax liability for the year.[39]

Again, these increases in tax liability are *not* attributable to having any net gambling winnings, but rather result from including the gross gambling winnings in AGI while claiming the same amount of gambling losses as an itemized deduction. On account of the increase to the gambler's AGI, which now includes his gross gambling winnings, the phase-outs of personal and dependency exemptions and itemized deductions kick in. In the above example where gambling activity is $500,000, the extra income pushes the gambler's AGI above the phase-out thresholds of $176,950 and $117,950, respectively, resulting in the total increased tax liability of $10,183. This additional $10,183 tax liability is attributable to what amounts to requiring Dice to recognize $32,850 of fictitious ordinary "income" (the $500,000 of gross income attributable to gambling activity, less the $500,000 deduction for his gambling loss, with a $15,000 reduction in his other itemized deductions subject to the section 68 phase-out and the loss of his seven exemptions, worth $2,550 each).

Of course, in all these cases Dice realized no actual economic gain from his gambling activities. Given the odds, he really did not have such a bad day at the casino. He just collided head-on with the Internal Revenue Code, as amended in 1990.

Actually, Dice and his wife could have suffered an even worse tax nightmare than that described above. If the couple had medical expenses in excess of 7.5 percent of their AGI for the taxable year, they would have been entitled to claim the excess as an itemized deduction. Likewise, certain other expenses (such as unreimbursed employee expenses) in excess of 2 percent of their AGI would have been deductible as well.[40] The allowable portion of these expenses are claimed as itemized deduction on Schedule A. However, to the extent that the couple's AGI increases by virtue of including Dice's gambling winnings in gross revenue (which again, he must do even if he breaks even or has a net loss for the taxable year), these itemized deductions could be lost as the thresholds are raised. While few taxpayers are able to claim these deductions on account of the 7.5 percent and 2 percent thresholds, recreational gamblers with jacked-up AGI will suffer an even worse fate.

> ***Heaven forbid that Dice or his wife should have a 'hobby activity' that generates gross income! If so, the couple will leave the Twilight Zone and enter the Outer Limits.***

And heaven forbid that Dice or his wife, Roulette, should have a "hobby activity" that generates gross income! If so, the couple will leave the Twilight Zone and enter the Outer Limits. Suppose Roulette has a hobby activity (such as growing orchids) that is subject to the limits imposed under section 183. The gross income from such a hobby must also be included in gross income, with the expenses attributable to producing such income allowable as a miscellaneous itemized deduction (in an amount not to exceed the income from such activity). The deduction is claimed on Schedule A. However, expenses incurred in such a hobby activity are subject to the 2 percent floor. As a result, when the income produced from the hobby activity is included in AGI, not only can the tax benefit for personal exemptions be lost and the deduction for itemized deductions be phased-out, but the deduction for the expenses incurred in producing the hobby income itself may be lost if the 2 percent threshold is raised by that very activity. So the more Roulette tends her orchids, the greater the couple's tax liability.

In the end, it is just too complicated to figure out how much Dice's gambling and Roulette's gardening could potentially cost the couple. If only they knew, surely they would restrict their leisure activities to watching TV. Under current law, that would appear *not* to impact on their tax liability. But who knows what "reforms" the next revenue bill will bring?

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[39]When gambling activity reaches such a level as $500,000, it becomes mighty tempting to argue that Dice is really in the trade or business of gambling, and that his activity as an executive (which generates a mere $150,000 of income) is his "hobby" activity. While the IRS agent rejected this argument in the real "Dice" case, it established a favorable opening position from which to negotiate.

[40]In 1986, Congress added section 67 to the Internal Revenue Code limiting the deduction for certain "miscellaneous itemized deduction" to the amount by which the total of such expenses exceeds 2 percent of the taxpayer's AGI. At the same time, the threshold for the deduction for unreimbursed medical expenses was raised to 7.5 percent (from 5 percent) of the taxpayer's AGI.

## Conclusion

What is the moral of this tale? To paraphrase Judge Tannenwald's wonderful description of David Zarin (by all measures, the most unfortunate recreational gambler in the history of the income tax): The more the recreational gambler wagers (regardless of whether he wins or loses), the more tax he owes. Talk about a "sin" tax!

Mind you, none of this was intended. (Only film director Oliver Stone actually believes that congressmen can plan and implement such nefarious schemes; mostly, they just stumble into this sort of thing by accident.) Nevertheless, in an era of "revenue-neutrality," a technical correction for this mess will require a matching revenue-raiser. One possibility: overturn the Supreme Court's decision in *Groetzinger.* Net losses from gambling would *not* be deductible — period. If "professional" gamblers cannot at least break even for the year, they won't be around for long anyway. (It is doubtful that Mr. Groetzinger continued his "career" as a professional gambler.) The tax law might as well encourage such gamblers to find gainful employment elsewhere, rather than tempting them through the allure of NOLs to linger a bit longer at the tables.

***Apparently unaware of the different treatment afforded professional and recreational gamblers, Reed proposes taxing gross winnings by disallowing any tax benefit for gambling losses.***

Legislation was introduced this summer to do just this — or so the sponsor thinks. On June 26, 1997, Sen. Jack Reed, D-R.I., introduced a bill (S. 972, cosponsored by his Republican colleague from Rhode Island, John H. Chafee, a member of the Senate Finance Committee) that would amend section 165(d) to read: "No deduction shall be allowed for losses from wagering transactions." According to Reed, the tax laws subsidize "professional gamblers by allowing tax deductions for gambling losses to the extent of gambling winnings." This so-called subsidy (i.e., allowing gambling losses to the extent of winnings) primarily benefits "professional gamblers and wealthy individuals who spend large sums on gambling." Apparently unaware of the different treatment afforded professional and recreational gamblers, Reed proposes taxing *gross* winnings by disallowing any tax benefit for gambling losses. To say the least, this treatment would be a whole lot worse for the likes of Messrs. Groetzinger and Zarin — to say nothing of the devastating impact on the hypothetical Landrau "Dice" Pay.

Under Reed's absurd proposal, Dice would not only have the aforementioned problem with phantom AGI increasing his tax liability under the phase-outs of personal and dependency exemptions and itemized deductions. Dice would actually be *taxed* on his gross winnings, while denied a deduction for his offsetting losses. So a day at the casino when Dice has $100,000 of winnings and $100,000 of losses (i.e., a break-even day of gambling) could cost him as much as $39,600 of additional federal income tax — depending on his tax bracket. Speaking of bizarre results! Breaking even at the gambling tables would actually produce a worse economic (i.e., after-tax) result for Dice than if he had simply lost $38,000 on the first roll of the dice and went home with no winnings at all.[41] Wow! Reed is really onto something. Rather than being just a modest contribution toward balancing the budget, as the senator would have us believe, his proposal offers a way to both pay off the entire $5 trillion national debt and close down the casinos at once! Why didn't the IRS think of this first?

Perhaps a fairer approach would be to provide recreational gamblers with a new tax form — Schedule G. (Get it? "G" for gambling!) This form would be used to report gross gambling revenue *and* gross losses. Net revenue would flow through to Form 1040 on some new line titled "Net Gambling Income." A net loss would be suspended on Schedule G, with only net income (or zero) picked up on Form 1040. Under this procedure, a deduction for gambling losses would be allowed as an adjustment to gross income, such deduction not to exceed the gross revenue includable in income. The recreational gambler's AGI would be unaffected by his vice. Basically, this would just put gamblers back in the same position they were in before the 1990 tax increase.

But in all events, however Congress chooses to address this great inequity suffered by recreational gamblers, golfers must be left alone! We already pay our "fair share" of taxes and *never* (well, almost never) deduct the expenses of our "sport." And we *always* (well, almost always) include in gross income the winnings from our friendly "wagering transactions" on the golf course (the typical $5 Nassau) and properly deduct the gross losses from such wagers on Schedule A.

[41]In the first case (winning $100,000 and losing $100,000), Dice would owe the casino nothing, but owe the IRS $39,600. In the latter case, he would lose *only* $38,000 — to the casino, with no tax owed to the IRS. So under Reed's proposal, it could actually be better to lose than to win.

**Table 1**

| | No Gambling Activity | Example 1: IRS Procedure | Example 2: Impermissible Netting Procedure |
|---|---|---|---|
| AGI | 150,000 | 350,000 | 150,000 |
| Gross Personal Exemptions | 17,850 | 17,850 | 17,850 |
| Less: Exemption Phase-Out | 0 | (17,850) | 0 |
| Net Exemptions | 17,850 | 0 | 17,850 |
| Gross Itemized Deductions | 25,000 | 225,000 | 25,000 |
| Less: ID Phase-Out | (962) | (6,962) | (962) |
| Net Itemized Deductions | 24,038 | 218,038 | 24,038 |
| Taxable Income | 108,112 | 131,962 | 108,112 |
| Tax Liability | **25,395** | **32,788** | 25,395 |

**Table 2**

| | Activity Level | | | | | |
|---|---|---|---|---|---|---|
| | **$0** | **$10,000** | **$100,000** | **$200,000** | **$500,000** | **$634,617*** |
| AGI | 150,000 | 160,000 | 250,000 | 350,000 | 650,000 | 784,617 |
| Gross Personal Exemptions | 17,850 | 17,850 | 17,850 | 17,850 | 17,850 | 17,850 |
| Less: Exemption Phase-Out | 0 | 0 | (10,353) | (17,850) | (17,850) | (17,850) |
| Net Exemptions | 17,850 | 17,850 | 7,497 | 0 | 0 | 0 |
| Gross Itemized Deductions | 25,000 | 35,000 | 125,000 | 225,000 | 525,000 | 659,617 |
| Less: ID Phase-Out | (962) | (1,262) | (3,962) | (6,962) | (15,962) | (20,000) |
| Net Itemized Deductions | 24,038 | 33,738 | 121,038 | 218,038 | 509,038 | 639,617 |
| Taxable Income | 108,112 | 108,412 | 121,465 | 131,962 | 140,962 | 145,000 |
| Tax Liability | 25,395 | 25,488 | 29,534 | 32,788 | 35,578 | 36,830 |
| Tax attributable to gambling activity | 0 | **93** | **4,139** | **7,393** | **10,183** | **11,435** |

* *Note:* In this taxpayer's situation, this amount of gambling activity represents the point where any further gambling activity will not affect his tax liability. This point can be found by solving the following equation:

$$AGI = (ID \times 0.80)/0.03 + 117{,}950$$

Remember that the itemized deduction phase-out is the lesser of:

$$(AGI - 117{,}950) \times (0.03) \text{ or } (ID \text{ subject to phase-out }) \times (0.80)$$

The above equation finds the point where these two equations are equivalent, thus, the point where any further AGI will not increase the ID phase-out. In this case, with $25,000 of itemized deductions subject to phase-out, the maximum phase-out occurs at AGI of $784,617. Subtracting the AGI from wages of $150,000, the gambling activity level of $634,617 results.