IT 06-20
Tax Type: **Income Tax**
Issue: **Federal Change (Individual)**
Commerce Clause (U.S. Const.) Controversy

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, v. ***JOHN* & *JANE DOE***, Taxpayers	No. 00-IT-0000 SSN. 000-00-0000 Tax Years 1999 - 2002 John E. White, Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: *Smith Doe*, *Doe* & Taylor, appeared for *John* and *Jane Doe*; Rickey Walton, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

This matter arose after *John* and *Jane Doe* (taxpayers or the *Doe*s) protested a series of Notices of Deficiency (NODs) the Illinois Department of Revenue (Department) issued to them. The original NODs for tax years 1999 through 2001 proposed to assess Illinois income tax based on the Department's determination that taxpayers did not accurately report the amount of their adjusted gross income (AGI) on their Illinois returns for those years. The original NOD issued regarding 2002 proposed to assess Illinois income tax based on the Department's determination that taxpayers did not file an Illinois return for that year. Additionally, the Department issued amended NODs to taxpayers for the same years, in which it proposed to assess additional amounts of Illinois income tax.

The hearing was held at the Department's offices on Chicago, Illinois. *John Doe* testified at hearing, and the parties stipulated to the admissibility of scores of documents. After considering the evidence admitted at hearing, I am including in this recommendation findings of fact and conclusions of law. I recommend the original NODs be finalized as issued, and the amended NODs be cancelled.

Findings of Fact:

1. For the years at issue (and unless specifically noted, all of these findings refer to acts, transactions or occurrences undertaken regarding calendar years 1999 through 2002), taxpayers filed joint federal income tax returns. Stip. Exs. 26, 28, 65, 83 (copies of, respectively, taxpayers' 1999 through 2002 federal income tax returns).

2. On those federal returns, taxpayers reported the following amounts on the following lines:

Tax Year	Line 7, Wages	Line 21, Other income	Line 33, AGI
1999	209,195.12	737,034.84	207,141.30
2000	259,441.32	530,710.00	788,432.00
2001	250,501.18	47,450.00	295,351.00
2002	270,598.42	132,585.00	400,224.00

Stip. Exs. 26, 48, 65, 83 (page 1 of each return).

3. The entries made on line 21 of taxpayer's federal returns refer to amounts reported to the IRS via form W-2G. Stip. Exs. 26, 48, 65, 83 (line 21 of each return).

4. Taxpayers reported the following amounts as a miscellaneous itemized deduction, gambling losses, on line 27 of their Schedule A:

Tax Year	Schedule A, line 27, amount
1999	739,035
2000	528,635
2001	47,450
2002	132,585

Stip. Exs. 26, 48, 65, 83.

5. Taxpayers filed Illinois income tax returns for 1999 through 2001. Stip. Exs. 27, 49, 66 (copies of, respectively, taxpayers' 1999 through 2001 Illinois income tax returns). The Department determined that taxpayers did not file an Illinois return for 2002. Department Ex. 94 (copy of NOD for 2002 dated March 17, 2005).

6. On their 1999 through 2001 Illinois returns, taxpayers reported the following amounts for AGI:

Tax Year	IL-1040, line 1, AGI
1999	207,141.30
2000	259,797.00
2001	250,901.00

Stip. Exs. 27, 49, 66.

7. Pursuant to § 6103(d) of the Internal Revenue Code (IRC) (26 U.S.C. § 6103(d)), the Department obtained information from the Internal Revenue Service (IRS) of a change it made to the amount of AGI taxpayers reported for 1999. Department Ex. 87 (copy of NOD for 1999, dated September 3, 2002), p. 2.

8. The Department also obtained information from the IRS regarding the amounts of AGI taxpayers reported on their joint federal returns for years 2000 through 2002. Department Ex. 89 (copy of NOD for 2000, dated September 16, 2003), p. 2; Department Ex. 92 (copy of NOD for 2001, dated August 3, 2004), p. 2; Department Ex. 94 (copy of NOD for 2002, dated March 17, 2005), p. 2.

9. Based on the information it received from the IRS, the Department issued NODs to taxpayers, setting forth deficiencies in the following amounts, which deficiencies were calculated using, *inter alia*, the AGI taxpayers reported to or determined by the IRS:

Tax Year	Deficiency Amount
1999	26,232

2000	18,230
2001	1,644
2002	14,276

Department Exs. 87, 89, 92, 94.

10. In response to the Department's discovery requests, taxpayers produced documents that summarized their wagering activities at various casinos. *See* Stip. Exs. 1, 18, 19, 29, 32-34, 51, 56, 57, 78, 70, 71 & 84 (copies of documents taxpayers produced to the Department during discovery).

11. On May 17, 2005, and based on information included in the documents taxpayers produced during discovery, the Department issued amended NODs to taxpayers. Department Ex Nos. 88, 90, 93, 95 (respectively, May 17, 2005 amended NODs for 1999 through 2002). On May 26, 2006, after discovering that it made computational errors when calculating the amounts of tax proposed on the May 17, 2005 amended NODs for 2000 and 2002 (Department's Brief, pp. 4-5), the Department issued a second set of amended NODs for 2000 and 2002. Department Exs. 91, 96 (respectively, May 26, 2005 amended NODs for 2000 and 2002).

12. The deficiencies, with interest, set forth in the amended NODs are as follows:

Tax Year	**Original NOD Amount**	**May 17, 2005 Amended NOD Amount**	**May 26, 2005 Amended NOD Amount**
1999	26,232	159,902	
2000	18,230	68,625	159,517
2001	1,644	52,857	
2002	14,276	70,129	46,948

Department Exs. 87, 89, 91-92, 94-96.

13. Taxpayers gamble at casinos for recreation, and not as a business. Stip. Exs. 26, 48, 65, 83; Tr. pp. 76-78.

14. Most often, taxpayers play slot machines. *E.g.*, Stip. Exs. 1 (Club Victoria visit statistics of taxpayers' slot play during 1999), 4 (83 separate 1999 W-2G forms from Grand Victoria Casino for taxpayers), 8 (1999 W-2G form from Rio Suite Casino in Las Vegas for taxpayer), 9 (W-2G summary report from Rio Suite Casino regarding taxpayers' gross wins), 10 (1999 W-2G form from Rio Suite Casino in Las Vegas for taxpayers).

15. Taxpayers earned considerable income from playing slot machines. Stip Exs. 4 (W-2G statements from Grand Victoria Casino for 1999), 9 (W-2G statements from Rio Suites for 1999), 12 (W-2G statements from Desert Inn for 1999), 30 (W-2G statements from Grand Victoria Casino for 2000), 34 (W-2G statements from Hollywood Casino for 2000), 42 (W-2G statements from Rio Suites for 2000), 47 (W-2G statements from Desert Inn for 2000), 52 (W-2G statements from Grand Victoria for 2001), 59 (W-2G statements from Hollywood Casino for 2001), 62 (W-2G statement from Hollywood Casino for 2001), 73 (W-2G statements from Hollywood Casino for 2002), 75 (W-2G statements from Hollywood Casino for 2002), 78 (W-2G statements from Grand Victoria Casino for 2002), 80 (W-2G statements from Harrah's for 2002).

16. Taxpayers also lost a considerable amount of money at slot machines. Stip. Exs. 1, 18-19, 29, 32-33, 51, 56-57, 70-71.

17. Taxpayers are part of clubs at two Illinois casinos, the Grand Victoria and Hollywood Casino, and those casinos keep and made available to taxpayers

records regarding their gambling activities from slot machines. Stip. Exs. 1 (Grand Victoria's year end visit statistics re: the *Does*' slot activity for 1/27/99 through 12/31/99), 18-19 (Hollywood Casino's Slot Summary Rating Reports for, respectively, *Jane* and *John Doe*, for the period from 3/99 through 12/99), 29 (Grand Victoria's year end visit statistics for 1/00 through 12/00), 32-33 (Hollywood Casino's Slot Summary Rating Reports for, respectively, *John* and *Jane Doe*, for the period from 1/00 through 12/00), 51 (Grand Victoria's year end visit statistics for 1/01 through 12/01), 56-57 (Hollywood Casino's Slot Summary Rating Reports for, respectively, *John* and *Jane Doe*, for the period from 1/01 through 12/01), 70 (Grand Victoria's year end visit statistics for 1/02 through 12/02), 71 (Hollywood Casino's Slot Summary Rating Reports for *John* and *Jane Doe*, for the period from 1/02 through 12/02).

18. The *Does* received visit statistics reports from the Grand Victoria Casino, which reports listed entries under the following headings:

Date	Denom	$In	$Out	$Net	$TWin	Jckpts	Pts	Time	W

Stip. Exs. 1 (Grand Victoria visit statistics report for taxpayers for 1999), 29 (2000 Grand Victoria visit statistics report), 51 (2001 Grand Victoria visit statistics report), 70 (2002 Grand Victoria visit statistics report).

19. Taxpayer also received letters from the Grand Victoria casino that were tendered to taxpayers with the visit statistics reports. Stip. Exs. 28, 50, 67, 69. None of those letters are signed. Stip. Exs. 28, 50, 67, 69.

20. One of the letters, dated March 25, 2002, includes the following paragraphs:

> Please note that this information denotes coin in, coin out and jackpots, the tracking of which is activated by insertion

> of your players' card into a slot machine. It does not necessarily denote winnings or losses. We suggest that you give this information to your tax advisor on the best way to use this information.
>
> The following key will assist in understanding this statement:
> $In = your total tracked coin in
> $Out = your total tracked coin out
> $Net = your tracked coin in — coin out — tracked jackpots paid. (Please note that if this is a negative number, then our records show this as a win for you.)

Stip. Ex. 50.

21. The other three letters from the Grand Victoria include the following statement:

> **Please note that these systems are used solely for Grand Victoria Casino's internal business use and do not constitute a definitive accounting of gaming activity nor do they denote actual winnings or losses.** This information should be used as a supplement to your own records and should be given to your tax advisor to determine the best way to use this information.

Stip. Exs. 28, 67, 69 (emphasis added).

22. The Grand Victoria visit statistics reports reflect taxpayers' slot wagering activity on a per-session basis, not on a per-wagering transaction basis. Stip. Exs. 28, 50, 67, 69. Some of the sessions lasted days. Stip. Ex. 1, entries for date identified as "1/20/99 – 1/31/99."

23. The *Does* received Slot Summary Rating Reports from the Hollywood Casino (Hollywood Report), which reports listed entries, for applicable months during each of the years at issue, under the following headings:

Denominations Played	Total Machines Played	Coin In	Coin Out	Win/ (Loss)	Jackpots	Net Win / (Loss)

Stip. Exs. 18 (1999 Hollywood Report for *Jane*), 19 (1999 Hollywood Report for *John*), 32 (2000 Hollywood Report for *John*), 33 (2000 Hollywood Report for *Jane*), 56 (2001 Hollywood Report for *John*), 57 (2001 Hollywood Report for *Jane*), 71 (2002 Hollywood Reports for *John* and *Jane*).

24. Taxpayer also received letters from the Hollywood Casino that were tendered to taxpayers with the Hollywood Reports. Stip. Exs. 20-22.

25. Two of those letters provide, in part:

> ***
>
> We are in receipt of your request for your gaming history at the Hollywood Casino — Aurora, Inc. ("Hollywood") for the calendar year 1999.
>
> To that end, this letter will constitute the requested report covering your gaming activity at the Hollywood that year. **In this regard, please note that these records are based on "rating information" and are not accounting records.** Stated differently, the Hollywood either employs raters, whose responsibility it is to traverse the Hollywood casino floor and record the amount placed into play by a patron as well as the time spent by such patron playing into a particular game, or uses electronically-computed rating entries. Such information is then input into the Hollywood's computer system which, by means of certain proprietary statistical analyses and account for by the type of game, amount wagered, time of play, and statistical advantage of the game played, generates these rating reports. Therefore, based on such analyses and in order to represent the same as records of gaming wins or losses, it must be assumed that (i) the rating information inputted into the Hollywood's computer system is accurate and (ii) except as otherwise noted, no other extraordinary winnings were held.
>
> Based on such analyses and assumptions, the Hollywood's computer-generated records reflect that, for the calendar year 1999, you [*Jane*] experienced an aggregate $31,132.00 gaming loss.
>
> ***

Stip. Ex. 21 (emphasis added). Stipulated Exhibit 22, which was addressed to *John* for 1999, provides, in part, "Based on such analyses and assumptions, the Hollywood's computer-generated records reflect that, for the calendar year 1999, you experienced an aggregate $48,703.00 gaming win." Stip. Ex. 22.

26. The Hollywood Reports reflect taxpayers' slot wagering activity on a per-month basis, not on a per-wagering transaction basis. Stip. Exs. 18-19, 32-33, 56-57, 71.

Conclusions of Law:

When the Department introduced the NODs into evidence under the certificate of the Director, it presented prima facie proof that the *Doe*s were liable for the tax proposed. 35 **ILCS** 5/904; PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 33, 765 N.E.2d 34, 48 (1st Dist. 2002); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296-97, 421 N.E.2d 236, 239 (1st Dist. 1981). The Department's prima facie case is a rebuttable presumption. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's assessment, or merely by denying knowledge of a tax deficiency. Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239. Instead, a taxpayer has the burden to present evidence that is consistent, probable and closely identified with its books and records, to show that the proposed assessment is not correct. PPG Industries, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48 (a taxpayer has the burden of overcoming the Department's *prima facie* case using documentary evidence, meaning books and records, and not mere testimony).

Taxpayers argue that the Department's assessments violate its due process rights under the Illinois and United States Constitution. Taxpayers' Brief, pp. 3-4. Taxpayers also argue that the assessments violate the equal protection clause of the United States Constitution, and the Uniformity Clause of the Illinois Constitution. *Id.*, pp. 3-4. Specifically, taxpayers argue,

> *** Because the IITA utilizes the federal adjusted gross income in defining Illinois Base Income without allowing deductions for gambling losses consistent with the federal system, Illinois taxpayers are required to declare gambling winnings and pay up the 3% income tax without regard to gambling losses for the taxable year. The taxpayers are challenging the constitutionality of the Illinois taxation scheme whereby the Illinois Department of Revenue seeks to asses them for over 5 million dollars in alleged unreported income based on the Department's characterization of every dollar paid out of various slot machines as constituting taxable income.

Taxpayers' Brief, p. 2.

Before directly addressing taxpayers' arguments, I will briefly review how income from gambling is treated under the IRC. Next, I will review the Illinois statutory provisions that detail how an individual resident taxpayer's Illinois income tax liability is measured.

Under federal law, income derived from gambling winnings is includable in gross income under § 61 of the IRC, and must be reported on a taxpayer's federal return. 26 U.S.C. § 61; McClanahan v. United States, 292 F.2d 630, 631 (5th Cir. 1965). Because federal law has long treated differently, for income tax purposes, income that persons derive from a trade or business, and income derived from activities that do not constitute a trade or business, taxpayers who gamble as a trade or business report income from gambling winnings differently than taxpayers who, like the *Doe*s, do not gamble as a trade or business. Commissioner v. Groetzinger, 480 U.S. 23, 107 S.Ct. 980, 94 L.Ed.2d 25 (1987); Winkler v. United States, 230 F.2d 766, 774 (1st Cir. 1956).

During the years at issue, individual recreational gamblers were required to report income from gambling winnings on line 21 of their federal return, and such income was taken into account when determining AGI. IRS Publication 17 (1999), Your Federal Income Tax For Individuals, p. 88 (available for viewing at http://www.irs.gov/pub/irs-prior/p17--1999.pdf). That is how the *Doe*s reported their W-2G income on their federal returns. Stip. Exs. 26, 48, 65, 83 (page 1, line 21 of each exhibit). Individuals who gambled as a trade or business were required to report income from gambling winnings as business income, on line 12 of their federal return, after completing Schedule C. 1999 Instructions for Schedule C, Profit or Loss from Business (available for viewing at http://www.irs.gov/pub/irs-prior/i1040sc--1999.pdf); 33A Am. Jur. 2d *Federal Taxation* ¶ 13260 (2006).

For purposes of this matter, the critical aspect of Congress' purposefully distinct tax treatment for professional versus recreational gamblers involves how the different classes of taxpayers take into account the statutory deduction Congress authorized for gambling losses. That deduction is codified at IRC § 165(d), and provides, in pertinent part, "Wagering Losses. — Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions. ***" 26 U.S.C. § 165(d). Professional gamblers take the deduction for gambling losses as a deduction from gross income from gambling when they calculate business income using Schedule C. <u>Baxter v. United States</u>, 633 F.Supp. 912 (U.S.D. Nev. 1986). Thus, such losses are deducted from gross income *before* AGI is determined. *Id*. Recreational gamblers, on the other hand, take the deduction as an itemized deduction, *after* AGI is determined. <u>Lyszkowski v. Commissioner</u>, T.C. Memo. 1995-235 (May 31, 1995).

Congress' distinct treatment for differently situated taxpayers was explained by the United States Tax Court in the recent summary opinion of Clemons v. Commissioner, T.C. Summ. Op. 2005-109, 2005 WL 1799248, ** 2-3 (U.S. Tax Ct.) (August 1, 2005). The taxpayer in Clemons argued, as taxpayers do here, that he should be entitled to deduct his gambling losses against gambling winnings when calculating AGI. The tax court rejected that argument, using the following analysis:

> Petitioner [taxpayer] contends that his $44,833 gambling winnings need not be included in his gross income because he had gambling losses to offset these winnings. Respondent [i.e., the IRS], however, contends that petitioner must include his gambling winnings in his gross income and is then entitled to a Schedule A miscellaneous itemized deduction for his gambling losses.
>
> The present problem seems to be that petitioner steadfastly rejects or ignores certain basic principles of the Federal income tax laws. Petitioner wishes to net his winnings and losses and, on his tax return, report in gross income only the amount of any net gambling winnings. Petitioner considers as "actual income" only his capital gain proceeds and any net gambling winnings. Petitioner is in error.
>
> Section 61(a) defines gross income as "all income from whatever source derived," including gambling, unless otherwise provided. *McClanahan v. United States,* 292 F.2d 630, 631-632 (5th Cir.1961). The Supreme Court has consistently given this definition of gross income a liberal construction "in recognition of the intention of Congress to tax all gains except those specifically exempted." *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 430 (1955); see also *Roemer v. Commissioner,* 716 F.2d 693, 696 (9th Cir.1983) (all realized accessions to wealth are presumed taxable income, unless the taxpayer can demonstrate that an acquisition is specifically exempted from taxation), revg. 79 T.C. 398 (1982).
>
> Section 62 defines adjusted gross income and allows expenses of a trade or business and certain employee business expenses to be deducted from gross income. These deductions are sometimes referred to as deductions "above the line," meaning simply that they are deducted from gross income to arrive at "adjusted gross

> income." Gamblers who are engaged in a trade or business of gambling may be able to deduct their gambling losses above the line; indeed, courts have based their decisions in some cases on the proposition that such a professional gambler may net losses against winnings for purposes of determining what is includable in gross income. See *Winkler v. United States*, 230 F.2d 766 (1st Cir.1956); *Green v. Commissioner*, 66 T.C. 538 (1976). This is not the present case.
>
> In the case of a taxpayer not engaged in the trade or business of gambling, gambling losses are allowable as a miscellaneous itemized deduction, but only to the extent of gains from such transactions. See sec. 165(d); *McClanahan v. United States, supra; Winkler v. United States, supra; Gajewski v. Commissioner*, 84 T.C. 980 (1985); *Lutz v. Commissioner,* T.C. Memo. 2002-89; see also *Stein v. Commissioner,* T.C. Memo. 1984-403; *Umstead v. Commissioner,* T.C. Memo. 1982-573.

Clemons v. Commissioner, T.C. Summ. Op. 2005-109, 2005 WL 1799248, ** 2-3 (U.S. Tax Ct.) (August 1, 2005). When I cite to and quote Clemons, I acknowledge that tax court summary opinions are not precedential, and I do not cite it as precedent here. *Id*.; 26 U.S.C. § 7463(b). I cite to Clemons merely because it sets forth a well-written, and concise description of how individual recreational gamblers are to report income from gambling winnings on their federal returns. I further acknowledge that, while Clemons itself has no precedential value, that it not true for the cases the tax court cited within that decision.

Since the *Doe*s are recreational gamblers and not professional gamblers, they are, in essence, engaged in a very expensive hobby. Groetzinger, 480 U.S. at 35, 107 S.Ct. at 987 ("Of course, not every income-producing and profit-making endeavor constitutes a trade or business. … A sporadic activity, a hobby, or an amusement diversion does not qualify."). The money they spend on losing wagering transactions constitutes part of the expenses they choose to make when engaging in their chosen hobby. Some of the other expenses associated with their hobby might be, for example, travel and hotel expenses when they go to Las Vegas to gamble. They incur such expenses for recreation; for fun. The *Doe*s pay the expenses associated with their hobby using income *John Doe* earns in the form of wages, as well as the gain that both *Doe*s earn when they have winnings from their hobby. When either of them makes a winning wagering transaction, however, they earn taxable income. 26 U.S.C. § 61; McClanahan, 292 F.2d at 631.

There are different kinds of expensive hobbies, and the scope of extravagance can vary from, for example, yachting, to, more modestly, golf. Hobbyists, moreover, can choose to spend a considerable part of their income to pursue their interests. Ordinarily, the costs of such hobbies are not allowable as a deduction against an individual hobbyist's taxable gross income. In this way, the *Doe*s are luckier than other hobbyists, at least for federal tax purposes. Congress has graced recreational gamblers (in fact, *all* gamblers) with a deduction for some of the expenses (gambling losses) associated with their hobby. 26 U.S.C. § 165(d). But again, that deduction represents a grant of legislative grace that Congress is permitted, but not constitutionally required, to extend. Winkler, 230 F.2d at 774.

This brings me to a description of the IITA's provisions affecting an individual's Illinois income tax liability. Section 201(a) of the IITA imposes a "tax measured by net income on every individual, corporation, trust and estate … on the privilege of earning or receiving income in or as a resident of this State." 35 **ILCS** 5/201(a). Section 202 defines net income as "that portion of his base income for such year which is allocable to this State under the provisions of Article 3, less the standard exemption allowed by Section 204 and the deduction allowed by Section 207." 35 **ILCS** 5/202. Section 301 is the section within Article 3 that applies to Illinois residents, and it provides that all of a resident's base income is allocable to Illinois. 35 **ILCS** 5/301(a).

Section 203 of the IITA defines base income, which, for individuals, means:

> (1) *** an amount equal to the taxpayer's adjusted gross income for the taxable year as modified by paragraph (2).
> (2) Modifications. The adjusted gross income referred to in paragraph (1) shall be modified by adding thereto the sum of the following amounts:
>
> ***
>
> and by deducting from the total so obtained the sum of the following amounts:
>
> ***

35 **ILCS** 5/203(a). Thus, the first part of § 203(a)(2) includes modifications that add amounts to an individual's AGI, and the second part includes modifications that subtract other amounts from the sum of the individual's AGI plus the addition modifications. 35 **ILCS** 5/203(a)(2). Other than the modifications expressly detailed within IITA § 203, § 203(h) prohibits any attempt to limit or modify items of income, loss or deduction that are taken into account when determining an individual's AGI, or any attempt to limit or modify such items when calculating the person's Illinois base or net income. 35 **ILCS** 5/203(h). Section 203(a) does not include a deduction for gambling losses, like the deduction allowed by IRC § 165(d). 35 **ILCS** 5/203(a)(2).

Next, § 403 requires taxpayers to report items of income, deduction and exclusion on his Illinois income tax return "in the same manner and amounts as reflected in [his] federal income tax return for the same taxable year." 35 **ILCS** 5/403(a). The only exception to what might be referred to as § 403(a)'s "consistent reporting rule" would be if reporting consistently would be "inconsistent with the provisions of this Act or forms or regulations prescribed by the Department …." 35 **ILCS** 5/403(a).

Finally, § 506 of the IITA requires persons with an Illinois reporting obligation, who file a federal return for a given tax year, to provide the Department with a copy of a federal return that may pertain to any deficiency proposed, or refund claimed, under the IITA. 35 **ILCS** 5/506(a). It also requires a taxpayer to notify the Department of changes to items reported on the person's federal return, where such changes would affect its Illinois income tax liability. 35 **ILCS** 5/506(b).

I now analyze taxpayers' arguments, first focusing on the original, and then the amended, NODs.

The Original NODs

In the original NODs for 1999 through 2001, the Department proposed to assess Illinois income tax and interest after it corrected taxpayers' Illinois returns. Department Exs. 87, 89, 92; 35 **ILCS** 5/904(a). In the NOD for 2002, after determining that taxpayers did not file a return regarding that year, the Department proposed to assess Illinois income tax and interest using the best available information. Department Ex. 94; 35 **ILCS** 5/904(b). The Department calculated the tax, penalties and interest proposed in the original NODs using information the Department obtained from the IRS regarding entries taxpayers made, or entries that the IRS determined to be the correct amounts to be reported, on taxpayers' joint federal returns filed for 1999 through 2002. Stip. Exs. 26, 48, 65, 83; Department Exs. 87, 89, 92 94. Taxpayers do not contend that the amounts that they reported on line 21 of their federal returns were not correct. Taxpayers' Brief, *passim*. Nor do they assert that the tax proposed in the original NODs was calculated in a manner that is other than the manner set forth within Articles II and III of the IITA. *Id*.

I begin by acknowledging that statutes are presumed constitutional. Geja's Cafe v.

Metropolitan Pier & Exposition Authority, 153 Ill. 2d 239, 248, 606 N.E.2d 1212, 1216 (1992). Second, the Department, as a state agency, is not empowered to declare a legislative act unconstitutional (*see* 20 **ILCS** 2505/39b (Powers of the Department)), as is a court, pursuant to Article VI of the Illinois Constitution. *See* Ill. Const., art. VI, § 1. Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill. 2d 262, 278, 695 N.E.2d 481, 489 (1998). Even if I had that power, however, the evidence in this matter does not reflect any violation of taxpayers' due process, equal protection, or uniformity rights.

Taxpayers' initial argument, that the IITA constitutes a facial violation of their due process and equal protection rights, must be rejected. That is because the plain text of § 203(a)(2) provides individuals a statutory subtraction modification for:

> ***
> An amount equal to all amounts included in such total which are exempt from taxation by this State either by reason of its statutes or Constitution or by reason of the Constitution, treaties or statutes of the United States; provided that, in the case of any statute of this State that exempts income derived from bonds or other obligations from the tax imposed under this Act, the amount exempted shall be the interest net of bond premium amortization;
> ***

35 **ILCS** 5/203(a)(2)(N). In other words, the text of the IITA expressly provides that if the federal constitution or statutes, treaties, etc., require that an individual taxpayer be allowed a deduction not expressed within § 203, such a deduction shall be allowed.

Further, taxpayers fail to show why the Illinois General Assembly's decision not to include a deduction for gambling losses within § 203(a)(2) must be considered an "as applied" violation of their constitutional rights in this case. Taxpayers' due process argument is that that there is no rational basis for a tax scheme, like Illinois', that taxes all of the gain from wagering transactions, without allowing the bettor to deduct his losses from his gambling winnings. Taxpayers' Brief, pp. 11-12, 14. This argument is a substantive due process argument, since it is, in effect, an argument that recreational gamblers have a constitutional right to shield from Illinois taxation the amount of money they choose to risk on losing wagering transactions.

Under substantive due process, if a statute does not affect a fundamental constitutional right, the rational basis test applies to determine whether the statute comports with due process. Schultz v. Lakewood Electric Corp., 362 Ill. App. 3d 716, 720, 841 N.E.2d 37, 42 (1st Dist. 2005). The rational basis test is satisfied where the challenged statute bears a rational relationship to the purpose the legislature intended to achieve in enacting the statute. *Id*., at 720, 841 N.E.2d at 43. Under the rational basis test, Illinois courts give great deference to the judgments made by the legislature. *Id*.

Before addressing taxpayers' constitutional arguments, I must first note that they are based on a fundamentally flawed premise — that gambling winnings are properly measured only on a per-gaming-session basis, instead of on a per-bet basis. Taxpayers specifically provide the following argument and example:

> Notwithstanding the fact that the taxpayers in this case have presented unchallenged evidence demonstrating that for the relevant tax years they sustained gambling losses which exceeded their gains by more than $200,000.00, the Department has assessed the taxpayers taxes, penalties and interest for tax years 1999-2002 in excess of $400,000.00 by classifying as base income every coin paid to a slot machine player during each tax year **without any regard for the fact that the slot player is putting coins into the machine to earn the occasional payout.** For example, under the Department's theory, a slot player goes to the local casino and spends three hours playing a dollar slot machine. He methodically puts 4,999 dollar coins into the slot machine without any success and never receives a single payout. When he puts in the 5,000th and final dollar coin in and pulls the handle, he wins back a

> thousand dollar coins. **He began the session with $5,000, leaves the machine and the casino after three hours with only a thousand dollars for a sustained loss of $4,000,** but owes the State of Illinois 3% of the $1,000 he earned back from the machine or $30 in income taxes. Assume that the slot player compulsively returns to the casino on 300 days in a given tax year with identical results. Each of the 300 days he goes he takes $5,000 to the casino with him and loses $4,000 because on the 5000th spin of the reel, he earns back $1,000. At the end of the tax year, he has lost 300 multiplied by $4,000, or $1.2 million dollars. Because the machine paid him back $1,000 each of the 300 days, under the Department's theory, he owes income taxes on $300,000 at the rate of 3%, or a total of $90,000, even though he lost $1.2 million dollars, or $4,000 each of the 300 sessions. It is this practice that the taxpayers challenge as being violative of the Illinois and United States Constitutions, under numerous theories.

Taxpayers' Brief, pp. 2-3 (emphasis added).

Taxpayers' example appears to suggest that the bettor had to wager $4,999 to win the $1,000 jackpot. That is not the case — under federal tax law, or logically. Each of the separate 4,999 unsuccessful one-dollar bets that taxpayers describe constitutes a separate, one-dollar wagering loss. On this point, the tax court's reasoning in <u>Hochman v. Commissioner</u> applies:

> To the extent that the cost of his winning ticket is included in the payoff which petitioner receives at the cashier's window on a winning race, therefore, petitioner has only recovered his capital, and is entitled to exclude the amount of that winning ticket from his gross receipts in order to arrive at gross income within the meaning of section 61. **Such recovery of capital, however, would clearly not include the cost of tickets which did not win. The latter items were separate wagers, made without reference to the winning wager, and are allowable only as permitted by section 165(d).** [footnote omitted]

<u>Hochman v. Commissioner</u>, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986) (emphasis added). Simply put, a wager transaction, as referred to in IRC § 165(d), is a

single bet, or, for purposes of a slot machine, a single pull of the reel. *Id*.; 33A Am. Jur. 2d *Federal Taxation* ¶ 13260 (2006).[1]

In taxpayers' example, none of the bettor's initial 4,999 wagers produced any income. For federal tax purposes, those losing wagering transactions may be deducted from a recreational gambler's AGI as an itemized deduction, and only to the extent of his gambling winnings. 26 U.S.C. § 165(d); Lyszkowski, T.C. Memo. 1995-235 (May 31, 1995). But before any federal deduction might apply to taxpayers' bettor example, there can be no doubt that his 5,000th one-dollar wager produced gross winnings of $1,000, or a taxable gain of $999. McClanahan, 292 F.2d at 631; Hochman, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986). Section 61 of the IRC requires that that $999 gain be reported as gross income on the bettor's federal return. McClanahan, 292 F.2d at 631. The Department is correct when it argues that federal law requires that gambling income be determined on a per-wagering transaction basis. *See* Department's Brief, pp. 12-15; Hochman, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986).

As to taxpayers' claim that there is no rational basis for Illinois' failure to provide a subtraction modification for gambling losses similar to the one provided by IRC §

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1 In an applicable entry in American Jurisprudence, the encyclopedia provides, in pertinent part:

> *** In computing the amount of income from (a nonprofessional gambler's) winnings, the cost of losing tickets (or other forms of wager) isn't netted against the winnings. [citing Hochman v. Commissioner].
>
> **Illustration:**
>
> C plays a slot machine that takes $5 tokens. He makes ten "pulls." He loses nine times, but on the tenth pull, he wins $100. The amount of his winnings income is $95 — the $100 win, less the cost of the $5 winning token. The $45 C spent on losing tokens is a gambling loss.
>
> ***

33A Am. Jur. 2d *Federal Taxation* ¶ 13260 (2006).

165(d), there is nothing irrational about being able to distinguish between winning wagering transactions and losing wagering transactions. Winning wagering transactions produce taxable income (McClanahan, 292 F.2d at 631; Lyszkowski, T.C. Memo. 1995-235 (May 31, 1995)), and losing wagering transactions — by definition — are not related to a winning wagering transaction. Hochman, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986).

Further, taxpayers fail to cite to any case holding that the United States or Illinois Constitutions have granted to recreational gamblers the right to shield from taxation the amounts they choose to spend on gambling. This is not surprising, since it would be hard to imagine that a constitutional right exists to guarantee to persons the ability to shield from state taxation certain of the amounts they choose to spend on hobbies. Thus, there seems nothing irrational about the Illinois General Assembly's policy decision to not grant an express deduction for some hobbyists (recreational gamblers) for certain hobby expenses (amounts spent on gambling losses).

Moreover, taxpayers are simply wrong to argue that, under the IITA: "[w]hat is taxed … is not income, but rather, gambling activities without regard to whether there is any accretion to wealth resulting from gambling." Taxpayers' Brief, p. 14. The Department does not propose to tax, nor does the IITA impose a tax on, gambling activity. Rather, what the Department proposed in the original NODs, and what the IITA requires, is that taxpayers use their federal AGI as the starting point when calculating Illinois base and net income. 35 **ILCS** 5/202, 203(a). Every gain from a winning gambling transaction constitutes an accretion of wealth that is includable within the definition of gross income and, for recreational gamblers, such amounts are also included within their AGI. McClanahan, 292 F.2d at 631; Lyszkowski, T.C. Memo. 1995-235 (May 31, 1995).

Illinois law is also clear that just because an item of deduction is allowed under federal law does not mean that a corresponding Illinois deduction exits. Bodine Electric Co. v. Allphin, 81 Ill. 2d 502, 512, 410 N.E.2d 828, 833 (1980). Nor has any federal court ever held that United States Constitution required Congress to create a deduction within the IRC for gambling losses of recreational gamblers. Winkler, 230 F.2d at 774-76; Hartsock v. Commissioner, T.C. Memo. 2006-205 (September 25, 2006). Instead, the tax court and other federal courts have consistently recognized the gambling loss deduction as a deduction that Congress was permitted, but not required, to make. Winkler, 230 F.2d at 774-76; Hartsock, T.C. Memo. 2006-205 (September 25, 2006). Illinois law is similarly clear that deductions are a matter of legislative grace. Bodine Electric Co., 81 Ill. 2d at 512, 410 N.E.2d at 833.

While the United States Constitution did not require Congress to create a deduction for gambling losses, the tax court has consistently held that the United States Constitution limits the measure of gambling winnings that is properly includable as gross income pursuant to IRC § 61. The measure of gross income that is properly taxable is described in various tax court cases, and the tax court's decision in Hochman again provides a good example:

> Our findings of fact reflect petitioner's 'winnings' and 'losses,' exactly as stipulated by the parties. It appears clear from that stipulation, however, that petitioner's 'winnings' were stated in gross, i.e., the gross 'payoff' to petitioner, including the price of the winning tickets. The price of such winning tickets was further included among the price of the losing tickets under the column for 'losses.' Even in the case of a casual gambler such as this petitioner,

> who had no ‘cost of goods sold,‘ or trade or business deductions — because he was not engaged in a trade or business — a distinction of principle must be made. Although the power of Congress to tax income is very broad, and although section 61 is intended to reach and tax all income, from whatever source derived, Glenshaw Glass Company v. Commissioner, 348 U.S. 426 (1955), and although deductions are a matter of legislative grace, to be bestowed or withheld by Congress, New Colonial Ice Company v. Helvering, 292 U.S. 435 (1934), gross income still does not include the return of capital. The latter is an exclusion from gross receipts, and its allowance is not a matter of legislative grace, but rather a matter of determining the true gross income which constitutionally may be taxed. Eisner v. Macomber, 252 U.S. 189 (1920); Doyle v. Mitchell Brothers Company, 247 U.S. 179 (1918); Sullenger v. Commissioner, 11 T.C. 1076 (1948); see 1 Mertens, Law of Federal Income Taxation, sections 5.06, 5.10 (1985).

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Hochman, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986). The Department concurs that the amount of the wager risked in a winning wagering transaction is properly excludable from the amount subject to tax under IRC § 61. Department Brief, p. 12.

Within the original NODs, the Department proposed to assess Illinois income tax that was calculated using, as the starting point, taxpayers’ AGI as reported to or determined by the IRS. Department Exs. 87, 89, 92, 94. That AGI includes the amount of gambling winnings that casinos reported as having paid taxpayers throughout the years at issue. Stip Exs. 26, 48, 65, 83; Stip Exs. 4, 9, 12, 30, 34, 42, 47, 52, 59, 62, 73, 75, 78, 80. To the extent the total amount of W-2G income reported to the IRS properly should have been reduced by the amount of wagers actually placed to obtain such winnings, taxpayers had the opportunity to establish their entitlement to such exclusions, by correctly reporting such amounts on their federal returns, or by amending their federal returns. *See* 35 **ILCS** 5/506(a).

It is axiomatic that due process rights can be waived. Section 403 requires a taxpayer to report items of income, such as AGI, in the same manner as it was reported on his federal return. 35 **ILCS** 5/403. On their federal returns, taxpayers did not seek to exclude the amount of their winning wagers from the amount of the income reported to the IRS via forms W-2G. *See* Stip. Exs. 26, 48, 65, 83; Tr. pp. 162-63. Nor is there any evidence that they amended their federal returns to do so. Instead, the record clearly shows that, for purposes of their federal returns, taxpayers merely deducted their gambling losses as an itemized deduction against AGI. Stip. Exs. 26, 48, 65, 83 (Schedule A, line 27, of each return).

The IITA's structure clearly requires taxpayers that want to claim an Illinois tax benefit that can be achieved only by changing an item of income, loss, or deduction taken into account when determining federal gross income, taxable income or AGI, to first amend their federal return so as to actually report that proposed change to the IRS. 35 **ILCS** 5/403(a), 506(a)-(b). Taxpayers who forego the opportunity to have the IRS properly determine exclusions from gross winnings reported on W-2G forms are prohibited, by § 203(h), from attempting to reduce the amount of an item of income, loss or deduction that was taken into account when determining AGI. 35 **ILCS** 5/203(h).

But if I am wrong, and § 203(a)(2)(N) might be understood to permit a taxpayer in the *Does*' shoes to overcome §§ 203(h), 403 and 506, and attempt to show that their W-2G income should be reduced so as to exclude the amounts of the winning wagers that are included in those reports, I would still conclude that taxpayers waived that right here. That is because they failed to introduce evidence to show the actual amounts of the wagers that they risked to win the income that was reported to the IRS, and to them, on forms W-2G. *See* Stip Exs. 4, 9, 12, 30, 34, 42, 47, 52, 59, 62, 73, 75, 78, 80. Indeed, they failed to even make the argument. Taxpayers' Brief, *passim*; Taxpayers' Reply, *passim*. For federal tax purposes, taxpayers have the burden to show what amounts must be excluded from gross income from gambling winnings, because such amounts constitute the amounts of the winnings wagers. Lutz v. Commissioner, T.C. Memo. 2002-89, 83 T.C.M. (CCH) 1446 (April 4, 2002); Hochman, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986). Taxpayers bear the same burden under Illinois law. PPG Industries, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48. Thus, taxpayers have waived the very due process remedy that is available to them under the United States Constitution, the IRC, and pursuant to IITA § 203(a)(2)(N).

Taxpayers also argue that Illinois' tax scheme violates their equal protection rights under the United States and Illinois Constitutions. Specifically, taxpayers argue that "[t]he taxation scheme proposed by the Department in this case, as well as the IITA, create unreasonable classifications between slot play gambling and other forms of gambling like blackjack, craps, roulette and poker, as well as unreasonable and unjustifiable classifications between slot play gambling or gambling in general, and other forms of financial endeavors combining elements of both skill and luck, such a playing the stock *Smith* or day trading in stocks or other publicly traded investments, where losses are always deductible from gains in calculating income and the tax [paid] thereon." Taxpayers' Brief, p. 12.

Taxpayers, however, ignore that it is not the IITA that created the classifications they claim are unreasonable. Congress created a class of deductions that may be taken against gross income received by an individual that conducts a trade or business and another, separate, class of deductions that an individual can claim against his AGI. *See* 1999 Instructions for Schedule A, Itemized Deductions (available for viewing at http://www.irs.gov/pub/irs-prior/i1040sa--1999.pdf); 1999 Instructions for Schedule C, Profit or Loss From Business (available for viewing at http://www.irs.gov/pub/irs-prior/i1040sc--1999.pdf). The United States Supreme Court has consistently upheld Congress' power to create such classifications. Groetzinger, 480 U.S. 23, 107 S.Ct. 980, 94 L.Ed.2d 25; Commissioner v. Sullivan, 356 U.S. 27, 78 S.Ct. 512, 2 L.Ed.2d 559 (1958). Taxpayers have almost exclusive control over whether to engage in a trade or business, and, thus, the better ability to affect the legal consequences of income earned therefrom.

Similarly, it was the United States Department of Treasury that created the laws governing when, and for what types of games, casinos are required to report the amounts paid as winnings from different wagering transactions. 26 C.F.R. § 7.6041-1. Specifically, Temporary Treasury Regulation § 7.6041-1 provides, in pertinent part:

> § 7.6041-1 Return of information as to payments of winnings from bingo, keno, and slot machines.
> (a) In general. On or after May 1, 1977, every person engaged in a trade or business and making a payment in the course of such trade or business of winnings (including winnings which are exempt from withholding under section 3402(q)(5)) of $1,200 or more from a bingo game or slot machine play or of $1,500 or more from a keno game shall make an information return with respect to such payment.
> (b) Special rules. For purposes of paragraph (a) of this section, in determining whether such winnings equal or exceed the $1,200 or $1,500 amount--
> (1) In the case of a bingo game or slot machine play, the amount of winnings shall not be reduced by the amount wagered;

> (2) In the case of a keno game, the amount of winnings from one game shall be reduced by the amount wagered in that one game;
> (3) Winnings shall include the fair *Smith*et value of a payment in any medium other than cash;
> (4) All winnings by the winner from one bingo or keno game shall be aggregated; and
> (5) Winnings and losses from any other wagering transaction by the winner shall not be taken into account.
>
> ***

26 C.F.R. § 7.6041-1. Taxpayers fail to explain why the Treasury Department's decision to create different reporting requirements for different games of chance must be considered a violation of taxpayers' equal protection rights by the Department, or as a result of the IITA.

For the same reason, I must reject taxpayers' argument that the IITA's failure to offer recreational gamblers a tax deduction like the one authorized by IRC § 165(d) violates the uniformity clause of the Illinois Constitution. The uniformity clause states that, "[i]n any law classifying the subjects or objects of non-property taxes or fees, the classes shall be reasonable and the subjects and objects within each class shall be taxed uniformly. Exemptions, deductions, credits, refunds and other allowances shall be reasonable." Ill. Const.1970, art. IX, § 2; Geja's Cafe, 153 Ill. 2d at 247, 606 N.E.2d at 1215. The Illinois supreme court has acknowledged that since "[s]tatutes are presumed constitutional, and broad latitude is afforded to legislative classifications for taxing purposes[,]" its scope of inquiry when reviewing such challenges is relatively narrow. Geja's Cafe, 153 Ill. 2d at 248, 606 N.E.2d at 1216. A person challenging such a classification has the burden of showing that it is arbitrary or unreasonable, but if a state of facts can be reasonably conceived that would sustain it, the classification must be upheld. *Id*.

Taxpayers concede that the Illinois General Assembly did not include a deduction for gambling losses within § 203(a)(2) like the one set forth in IRC § 165(d). Taxpayers' Brief, p. 2. Taxpayers, therefore, must also recognize that the Illinois General Assembly has not created a deduction for gambling losses for one class of individual taxpayers, but not for another. There is no deduction for gambling losses within the IITA at all, for any class of taxpayer. 35 **ILCS** 5/203(a)(2).

Further, Congress' distinct treatment of income earned pursuant to a trade or business, and income not so earned, is not a classification created by the IITA. In Thorpe v. Mahin, 43 Ill. 2d 36, 250 N.E.2d 633 (1969), the Illinois supreme court was directly confronted by the argument that " '[t]axpayers engaged in business (whether corporations, engaged in business (whether corporations, partnerships or individual proprietorships) are allowed certain deductions (such as charitable deductions), which are denied to taxpayers not engaged in business' and that this is a discrimination violating due process and equal protection." The court flatly rejected that argument. Mahin, 43 Ill. 2d at 48, 250 N.E.2d at 639. Congress' decision to give distinct treatment to persons engaged in a trade or business and those not so engaged has been upheld by federal courts (*e.g.*, Sullivan, 356 U.S. at 28-28, 78 S.Ct. at 514; Lutz v. Commissioner, T.C. Memo. 2002-89, 83 T.C.M. (CCH) 1446 (April 4, 2002)), and Mahin resolves the same issue, for purposes of Illinois law. Taxpayers cited to no case in which the Illinois General Assembly's decision to use AGI as the starting point for calculating an individual's Illinois income tax liability was held to violate due process, equal protection, or uniformity.

The legislature manifested its intent clearly in § 203(h). No modifications are allowed to be made to the amounts of income, loss, or deduction that were taken into account when determining AGI, unless such modifications are expressly set forth in § 203. 35 **ILCS** 5/203(h). The deductions that are set forth in IITA § 203(a) do not include the one sought by taxpayers. 35 **ILCS** 5/203(a)(2). While § 203(a)(2)(N) grants a deduction for amounts that are required by the United States and/or Illinois Constitutions, or federal or state law, taxpayers have not cited to any constitutional provision, or to any federal or state statute, that requires recreational gamblers to be allowed to shield from Illinois taxation the amounts they choose to risk, and which they lose, in wagering transactions. Taxpayers' pleas for a deduction for gambling losses must be directed to the Illinois General Assembly.

Finally, taxpayers argue that, by failing to include a deduction for gambling losses, § 203 constitutes a tax on gambling, and therefore violates the single subject rule, as set forth in the Article IV, § 8(d) of the Illinois Constitution. Taxpayers' Brief, p. 18. The single subject clause of the Illinois Constitution provides, in relevant part: "Bills, except bills for appropriations and for the codification, revision or rearrangement of laws, shall be confined to one subject." Ill. Const.1970, art. IV, § 8(d). The single subject rule regulates the process by which legislation is enacted, and it is designed to prevent the passage of legislation that, if standing alone, could not muster the necessary votes for enactment. People v. Olender, 222 Ill. 2d 123, 854 N.E.2d 593, 599 (2005). Section 203 was first enacted in 1969, as part of the original IITA. That section has always defined the term base income. That section has also been amended scores of times, pursuant to various legislative enactments. Yet here, taxpayers fail even to specify which particular public act they claim constitutes a violation of the single subject rule. Taxpayers' single subject argument is so vague that it cannot be meaningfully addressed.

The Amended NODs

Most of taxpayers' constitutional arguments are premised upon the tax proposed in the amended NODs, and because of the manner by which the Department calculated the tax proposed to be due in those amended NODs. *See* Taxpayers' Brief, p. 11. The propriety of the amended NODs, however, does not require a resolution of any constitutional question. In re S.G., 175 Ill. 2d 471, 478, 677 N.E.2d 920, 924 (1997) ("A court should avoid constitutional questions where the case may be decided on other grounds.").

The Department issued the amended NODs after it reviewed documents produced by taxpayer during discovery. Department's Brief, pp. 4-5, 9-10. The amended NODs reflect the Department's determination that taxpayers' federal returns did not reflect the true amount of their AGI that was properly reportable for federal income tax purposes. Department's Brief, p. 4. The Department determined that the true amount of taxpayers' Illinois base income and net income could only be measured by adding to the amount of AGI reported by taxpayers for 2000 through 2002, or determined by the IRS for 1999, certain amounts that were set forth within "documents that summarized [taxpayers'] wagering activities at various casinos for the tax years at issue." *Id*.

Notwithstanding the admitted basis for the Department's decision to issue the amended NODs, each of the amended NODs for 1999 through 2001 includes a statement that the Department "changed your adjusted gross income to include a final federal change about which you did not timely notify us. [35 ILCS 5/506(a), (b)]". Department

Exs. 88, 90, 93 (May 17, 2005 amended NODs for 1999-2001), 91 (May 26, 2005 amended NOD for 2000), page 2 of each amended NOD. The record in this matter absolutely belies the correctness of those statements.

The parties stipulated to the admission of taxpayers' federal and Illinois income tax returns regarding the years at issue. Stip. Exs. 26, 48, 65, 83 (federal returns), 27, 49, 66 (Illinois returns). Comparing the federal returns with the original NODs shows that the IRS adjusted the amount that taxpayers reported as their AGI in their 1999 federal return. Stip. Ex. 26, p. 1, lines 21-22, 33; Department Ex. 87, pp. 2-3. On taxpayers' 1999 federal return, taxpayers reported, on line 21, W-2G income in the amount of $739,034.82, yet did not include that amount within their AGI. Stip. Ex. 26, p. 1, lines 21-22, 33. Taxpayers did not include that income in AGI because they had erroneously reported, on line 14, an equal amount of gambling losses, and had erroneously taken that loss into account when determining their AGI. *Id.*, lines 14, 21-22, 33. The IRS corrected that error by including the reported amount of W-2G income in taxpayers' AGI (Department Ex. 87, pp. 2-3), and by then allowing taxpayers to claim the losses as an itemized deduction to be taken into account when determining their taxable income, consistent with federal law. Lutz, T.C. Memo. 2002-89, 83 T.C.M. (CCH) 1446 (April 4, 2002); Hochman, T.C. Memo. 1986-24, T.C.M. (CCH) 311 (January 22, 1986).

The original NODs also show that the Department used the amount taxpayers reported on their federal returns as AGI as the starting point in calculating taxpayers' base income and net income for Illinois income tax purposes on the original NODs issued regarding years 2000 to 2002. Department Exs. 89, 92, 94. Thus, contrary to what the Department seems to suggest in the statement of facts section of its brief (Department's

Brief, p. 3), the IRS did not increase the amount of taxpayers' AGI for 2000 through 2002. Rather, the IRS merely notified the Department of what taxpayer's reported AGI was for those years. *Compare* Department's Brief, p. 3 *with* Department Exs. 89, 92, 94. At hearing, moreover, *Doe* specifically denied that the IRS ever made any adjustments to their AGI other than the one for 1999, which the Department also noted and used when determining the original NOD for 1999. Tr. pp. 162-63; Department Ex. 87.

Finally, in its brief, the Department admits that its amended NODs were based on its review of documents it received from taxpayers during discovery. Department's Brief, pp. 3-4. In sum, the only NOD the Department issued that was actually based on a final federal adjustment to taxpayers' AGI was the original NOD the Department issued regarding 1999. Department Ex. 87; Department's Brief, pp. 3-4. Section 403(a) of the IITA provides that "A final determination pursuant to the Internal Revenue Code adjusting any item or items of income, deduction or exclusion for any taxable year shall be correct for purposes of this Act to the extent such item or items enter into the determination of base income." 35 **ILCS** 5/403(b).

In sum, the amended NODs are not based on adjustments the IRS made to the taxpayers' AGI. Rather, it is the Department that is seeking, on its own, to increase taxpayers' AGI, based on the documents taxpayers received from Illinois casinos, and which they subsequently submitted to the Department in discovery. Department's Brief, pp. 3-4.

By statute, the Department's amended NODs are prima facie correct. 35 **ILCS** 5/904(a). In this particular case, however, the Department has made three separate determinations of the correct amount of tax proposed to be due for 2000 and 2002, and two separate determinations of the correct amount of tax proposed for 1999 and 2001. Department Exs. 87, 89, 91-92, 94-96. Clearly, the original and the amended NODs cannot both be correct. Just as clearly, the Department's position must be that the May 17, 2005 amended NODs corrected the original NODs, and that its May 26, 2005 amended NODs corrected the initial, amended NODs for 2000 and 2002. *See* Department's Brief, p. 4. The task here, then, is to determine which of the presumptively correct NODs are, in fact, correct.

The evidence that the Department relied upon when calculating the tax proposed in the amended NODs is the very same evidence that taxpayers want me to rely upon as proof that they, in fact, had a verifiable amount of documented losses that the United States and Illinois Constitutions require to be excluded from Illinois taxation. But I do not consider the casino reports to be credible evidence of the true and correct amount of taxpayers' actual, taxable winnings, *or* credible evidence of the true and correct amount of taxpayers' actual losses. Indeed, in the accompanying explanation letters the Hollywood Casino gave to taxpayers with the Hollywood Reports, the casino notifies a reader that, "these records are based on 'rating information' and are not accounting records." Stip. Exs. 21-22. The explanation letters from the Grand Victoria Casino are even more explicit:

> **Please note that these systems are used solely for Grand Victoria Casino's internal business use and do not constitute a definitive accounting of gaming activity nor do they denote actual winnings or losses.** This information should be used as a supplement to your own records and should be given to your tax advisor to determine the best way to use this information.

Stip. Exs. 28, 67, 69 (emphasis added).

Documents like the reports the parties rely upon here have been offered as evidence in contested federal cases before the tax court. For example, in Mayer v. Commissioner, T.C. Memo 2000-295, 80 T.C.M. (CCH) 393 (September 20, 2000), the tax court found as follows:

> At trial, petitioner submitted an unsigned letter from Caesar's Palace that indicated that for 1994 petitioner put an estimated $898,050 into slot machines and had estimated slot machine winnings of $837,570, for an estimated net gambling loss (just from slot machines and before taking into account lottery winnings) of $60,480. The letter states: "Please note the tracking system used to arrive at estimated win or loss information provides estimates only and does not constitute an accurate accounting record. *** This information should be used as a supplement to your own records or information." The Caesar's Palace letter we regard as highly suspect. It is unsigned. By its terms, it is only an estimate and is to be supplemented by petitioner's own records. We regard the letter as unreliable evidence and give it no weight.

Mayer v. Commissioner, T.C. Memo 2000-295, 80 T.C.M. (CCH) 393 (September 20, 2000). Similar to tax court's holding in Mayer, I conclude that the reports introduced here do not constitute a true and correct statement of the amount of taxpayers' taxable gains from wagering, on a per-transaction basis.

Here, the only NODs that were calculated consistent with the express text of §§ 202 and 203 of the IITA are the original NODs. Department Exs. 87, 89, 92, 94; Department's Brief, p. 4. Taxpayers' federal returns were admitted into evidence (Stip. Exs. 26, 48, 65, 83) and those returns reflect the best evidence of the true and correct amount of their AGI for the years at issue. 35 **ILCS** 5/403(a)-(b); Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239 (copy of federal return needed to support claim of entitlement for statutory exemption). Taxpayers, therefore, have offered documentary evidence that rebuts the presumptive correctness of the amended NODs. *See, e.g.*, Goldfarb v.

Department of Revenue, 411 Ill. 573, 104 N.E.2d 606 (1952); Balla, 96 Ill. App. 3d at 295, 421 N.E.2d at 238. The same evidence, moreover, clearly supports the presumptive correctness of the original NODs. 35 **ILCS** 5/202, 203(a), 403(b), 904(a).

Conclusion:

I recommend that the Director finalize the original NODs as issued, and the tax proposed be assessed, with interest to accrue pursuant to statue. I recommend that the Director cancel the amended NODs in their entirety.

Date: 11/16/2006

John E. White
Administrative Law Judge