INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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[redacted]

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

This is in response to your request for technical advice dated July 18, 2003 concerning § 165(d) of the Internal Revenue Code.

LEGEND:

Taxpayer =

Corporation =

$*a* =

b =

$*c* =

ISSUE:

Whether winnings from a "no purchase necessary" marketing sweepstakes are gains from a wagering transaction pursuant to § 165(d)?

CONCLUSION:

The taxpayer's winnings are not gains from a wagering transaction for purposes of § 165(d) because the taxpayer did not furnish consideration for the chance to win the prize.

FACTS:

The taxpayer is an individual who presumably uses the cash receipts and disbursements method of accounting. Corporation promoted a sweepstakes in connection with the marketing of its product. The taxpayer won the grand prize of $*a* in a random drawing. The grand prize was payable in equal installments over *b* years. The taxpayer has incurred wagering losses in each of the applicable years.

To enter the sweepstakes contestants were required to submit an "entry" comprised of each of the "words" of a three-word phrase. One of the "words" was included in each of Corporation's products during the period the contest was held. A contestant could also receive a "word" through an alternate method of entry. The sweepstakes rules stated:

> No purchase necessary. You may obtain an Official Entry Form and official rules by sending a stamped, self-addressed envelope ... . Limit one Official Entry per written request. … Void where prohibited.

The taxpayer submitted approximately 15 to 20 completed entries. He obtained the "words" under the alternate method, by sending self-addressed stamped envelopes to Corporation. The taxpayer mailed away for at least 45, and probably in excess of 60 "words." The taxpayer calculates that the cost of postage and the required envelopes would have been $*c.* In addition, the taxpayer expended time and effort to address and mail the envelopes.

The taxpayer, who reported the deferred sweepstakes payments each year as income, has filed amended returns claiming deductions for wagering losses he sustained in other activities. The taxpayer's position is that these losses are allowable to the extent of each year's sweepstakes payments. The Appeals Office concluded that the sweepstakes payments are not gains from a wagering transaction. This request for technical advice followed.

LAW AND ANALYSIS:

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(d) provides that losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

Section 1.165-10 of the Income Tax Regulations provides that losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions.

To be eligible for offset against wagering losses under § 165(d), wagering gains must occur in the same year as the losses. The Appeals Office does not dispute that the deferred payments of a prize won by a cash-method taxpayer in an earlier year can be "gains during the taxable year" in which payment is made for § 165(d) purposes, and does not suggest that the prize was constructively received by the taxpayer or that the economic benefit of the prize was conferred in an earlier year. Cf. Rusnak v. Commissioner, T.C. Memo 1987-249. Rather the Appeals Office contends that taxpayer's winnings were not the result of a "wagering transaction."

Neither the Code nor the regulations specifically define the term "wagering transaction" as used in § 165(d). An entry in a sweepstakes, raffle, or lottery can be a "wagering transaction." See, for example, Rev. Rul. 83-130, 1983-2 C.B. 148, which concludes that a purchaser of a raffle ticket for a chance to win a house has made a wager for § 165(d) purposes. Similarly, in Rusnak, the Tax Court concluded that the taxpayer's lottery winnings were "gambling winnings."

Not all activities in which one can win a prize involve wagering, however. It is generally accepted, and the taxpayer agrees, that in order for a transaction to be a "wager," three elements must be present: (1) prize, (2) chance, and (3) consideration. See, e.g., Black's Law Dictionary, 1573 (7th ed. 1999) (defining "wager" as "money or other consideration risked on an uncertain event; a bet or a gamble," and "gambling" as "the act of risking something of value, esp. money, for a chance to win a prize"); Rev. Rul. 70-556, 1970-2 C.B. 326 (defining "lottery" for purposes of § 5723 to require consideration); FCC v. American Broadcasting Co., 347 U.S. 284, 290 (1954). The elements of a prize and chance are present here; the question is whether the requirement of consideration—the "wager" itself—is met.

Lotteries and sweepstakes conducted in various ways are often prohibited by Federal or local law. In order for a marketing sweepstakes to avoid these prohibitions the element of consideration must be removed. This is generally accomplished by providing that no purchase is necessary to enter the sweepstakes—see, for example, 39 USC § 3001(k)(1)(D) and (k)(3)(A)(ii)(I)—and by furnishing a free alternate method of entry.

Although there are no authorities directly on point in the context of § 165(d), the element of consideration, as it relates to the definition of "wagers" in the context of commercial promotions, has been addressed elsewhere in the Code and regulations.

For example, § 3402(q) provides for withholding from certain gambling winnings that are "proceeds from a wager." See § 3402(q)(3). In Example 10 of § 31.3402(q)-1(d) of the Employment Tax Regulations, "J" purchases a subscription to "N" magazine at the regular subscription price. All new subscribers are automatically eligible for a special drawing. The drawing is held and J wins $ 50,000. The regulation concludes that since J has not paid any more than the regular subscription price, J has not placed a wager or entered a wagering transaction. Therefore, N is not required to deduct and withhold from J's winnings.

A similar approach is followed in the excise tax context. Section 4401 imposes an excise tax on certain wagers. Section 44.4421-1(a) of the Wagering Excise Tax Regulations defines the term "wager," for this purpose as including any wager placed in a lottery conducted for profit. Section 44.4421-1(b)(1) defines the term "lottery" as any scheme or method for the distribution of prizes among persons who have paid or promised a consideration for a chance to win such prizes.

Rev. Rul. 68-600, 1968-2 C.B. 520, considers whether excise taxes under § 4401 apply to merchandising plans where merchants give chances for prizes in connection with the sale of merchandise. Similar to Example 10 of § 31.3402(q)-1(d), the ruling provides that if a customer does not pay more for merchandise in order to obtain such tickets or chances than the customer would otherwise pay for the merchandise alone, then generally no wager has taken place. Conversely, if a customer does pay more for merchandise in order to obtain a chance the excess amount constitutes consideration for the chance and is a "wager" subject to excise tax. The ruling provides factors to consider in determining whether a portion of the price of the merchandise represents additional consideration attributable to the chance to win the prize.

In the present case, the taxpayer agrees that consideration is a necessary element of a wagering transaction for purposes of § 165(d). He points out, however, that even relatively small consideration paid for a chance to win a prize, such as the purchase of a single lottery or raffle ticket, creates a wager, and argues that the costs of the postage, envelopes, and the time and effort he expended, at least in the aggregate, represented sufficient consideration. For several reasons, we disagree.

First, situations such as the raffle considered in Rev. Rul. 83-130 involve direct consideration furnished in return for the chance to win a prize. In the present case, by contrast, the amounts spent by the taxpayer for envelopes and postage were

consideration for goods and services that the taxpayer received, not amounts or additional amounts paid in exchange for the chance to win the prize.

The taxpayer argues that the envelopes and postal services he purchased were themselves "spent" in an effort to win the prize, that he also expended time and effort, and that amounts need not always be furnished directly to the counterparty to an agreement to constitute consideration. In this sense, the alternate method of entry was not literally "free." Although such factors may rise to the level of consideration in some contexts, we do not agree that they do so for § 165(d) purposes.

It is true that, taking into account not only federal but state and local law, there is no universally-accepted interpretation of what constitutes consideration in this area, and the answer can vary depending on the jurisdiction, court, and particular statute in question. We recognize, for example, that in some jurisdictions or for some purposes purchasing a merchant's product to enter a sweepstakes may constitute "consideration" for a wager, even though the entrant pays the regular price for the product. Similarly, in some jurisdictions or for some purposes, the mailing costs, the time and effort expended, or the promotional benefit to the merchant might be regarded as indirect consideration sufficient to bring even a "no purchase necessary" contest within the scope of a particular statute. In part to guard against this possibility, promotions such as Corporation's typically provide that they are "void where prohibited."

Regardless, however, of how the consideration element might be interpreted in a given jurisdiction or context, for federal tax purposes the definition of "wagering" in § 165(d) should be consistent with existing interpretations elsewhere in the Code. Under § 31.3402(q)-1(d), § 44.4421-1(b)(1), and Rev. Rul. 68-600, Corporation’s sweepstakes promotion was not a wagering transaction or a lottery for withholding or excise tax purposes. An entrant who obtained a chance to win the sweepstakes in the regular manner, by purchasing Corporation’s product, would not have made a wager for those purposes. We do not believe that an entrant who, like the taxpayer, used the alternate method of entry would have made one either, even though both entrants would be required to mail the entry to Corporation in order to be included in the drawing. We see no reason why a different interpretation should apply for purposes of § 165(d).

The taxpayer points out, correctly, that § 31.3402(q)-1(d) and Rev. Rul. 68-600 are distinguishable from his situation, in that he did not enter by purchasing a product. If anything, however, the distinction highlights the fact that his transaction did not involve consideration and was not, therefore, a wager. To state the obvious, in order to enter the sweepstakes the taxpayer was not required to pay more for Corporation's product than he otherwise would have paid; in fact, he was not required to purchase the product at all.

Although, in the aggregate, the taxpayer may have expended a greater than nominal amount on postage and envelopes, he did so with respect to many chances to win. With respect to each chance the costs incurred were relatively insignificant, and they were not paid directly for the chance to win the prize. Therefore, no wager was made and the sweepstakes winnings are not gains from a wagering transaction for § 165(d) purposes.

CAVEATS:

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.