

A COMPARATIVE STUDY BETWEEN SOUTH AFRICA, THE UNITED STATES AND AUSTRALIA OF THE TAXING OF INCOME FROM GAMBLING ACTIVITIES

by

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Submitted in partial fulfilment of the requirements for the degree

Magister Commercii in Taxation

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

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Date of submission:
2010-11-22

ACKNOWLEDGEMENTS

I would like to extend my gratitude to the following:

- My Lord, upon guiding and carrying me through another journey in my life.
- My wife, Annelize, for her support and assistance whilst also busy with her Master's degree.
- My baby son, WJ, for his understanding that Dad and Mom had to spend most of his first year on their studies.
- My parents and in-laws for their prayers, support and interest in my studies.
- My study leaders for their assistance and guidance throughout the study.

ABSTRACT

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Gambling has proven to be an ever growing industry and triggered tax regulating authorities in different countries to review the taxation on the income of the providers and even the individuals constantly entering into gambling transactions. South Africa is no exception to this and during the 2010 budget speech the National Treasury has indicated their intention to review the taxation of gambling winnings in the hands of the gambler. Currently only the professional gambler is taxed on his gambling winnings in South Africa.

Although prior research has been performed on the taxation of gambling winnings in the United States and Australia, no research on this topic has been performed from a South African perspective. This study extends on these prior studies by performing an analysis of the taxation of gambling winnings in the hands of the individual from a South African perspective.

The aim of this study is to determine how South Africa can amend the current income tax legislation effectively to include gambling winnings in the personal income tax of all gamblers. From a theoretical perspective, the study aims to identify alternative ways to tax gambling winnings which is currently not included in South African legislation and practices.

Although the provision and participation in interactive gambling remain illegal within the borders of South Africa, this study aims to investigate the legalisation and/or regulation thereof as an alternative to the taxation of gambling winnings in the hands of all gamblers.

This study discusses the administrative burden on the tax payer and the gambling provider if the National Treasury considers taxing gambling winnings in the hands of all gamblers and concluded that the *status quo* against the taxation of gambling winnings of the casual gambler should prevail. Consideration should be given to legalise and regulate interactive gambling as an alternative in order to broaden the tax base.

Keywords:

Gambling activity

Gambling winnings or gains

Gambling losses

Interactive gambling

OPSOMMING

'N VERGELYKENDE STUDIE TUSSEN SUID-AFRIKA, DIE VERENIGDE STATE EN AUSTRALIË AANGAANDE DIE BELASTING VAN INKOMSTE UIT DOBBELAKTIWITEITE

deur

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Dobbelary groei van krag tot krag en dit is juis as gevolg van hierdie groei dat die belastingowerhede in verskeie lande besluit het om die belasting op die inkomste van dobbelopers en dobbelaars gereeld te hersien. Suid-Afrika is geen uitsondering nie en die Nasionale Tesourie het tydens die 2010 begrotingsrede aangedui dat hulle die belastinghantering van inkomste verkry uit dobbelary in die hande van die dobbelaar gaan hersien. Tans word slegs die inkomste van die professionele dobbelaar in Suid-Afrika belas.

Alhoewel die belastinghantering van inkomste uit dobbelary voorheen in die Verenigde State en Australië nagevors is, bestaan geen navorsing van hierdie aard oor die situasie in Suid-Afrika nie. Hierdie studie is 'n uitbreiding van hierdie vorige navorsing deur middel van 'n analise van die belastinghantering van inkomste uit dobbelary in die hande van dobbelaars in Suid-Afrika.

Die studie het ten doel om vas te stel hoe Suid-Afrika se huidige inkomstebelastingwetgewing effektief gewysig kan word om inkomste uit dobbelary in die persoonlike inkomstebelasting van alle dobbelaars in te sluit. Vanuit 'n teoretiese perspektief poog die studie om alternatiewe belastinghanterings van inkomste uit dobbelary te identifiseer wat tans nie in Suid-Afrikaanse wetgewing en praktyke vervat is nie.

Alhoewel interaktiewe dobbelary onwettig is in Suid-Afrika, ondersoek hierdie studie die bekragtiging en regulering van die voorsiening en deelname daaraan as 'n alternatief tot die belasting op inkomste uit dobbelary in die hande van elke dobbelaar.

Die studie bespreek die administratiewe las op die dobbeloperateur sowel as die dobbelaar indien die Nasionale Tesourie sou oorweeg om die inkomste uit dobbelary in die hande van elke dobbelaar te belas en kom tot die slotsom dat die huidige hantering waar inkomste van die geleentheidsdobbelaar nie belas word nie, in plek moet bly. Oorweging moet geskenk word aan die bekragtiging en regulering van interaktiewe dobbelary as 'n alternatief om sodoende die belastingbasis te vergroot.

Sleutelwoorde:

Dobbelaktiwiteit

Inkomste uit dobbelary

Dobbelverliese

Interaktiewe dobbelary



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LIST OF ABBREVIATIONS

CGT	Capital gains tax
IRS	Inland Revenue Services of the United States of America
SARS	South African Revenue Service
UK	United Kingdom
US	United States of America
VAT	Value Added Tax

CHAPTER 1

INTRODUCTION AND PROBLEM STATEMENT

1.1 BACKGROUND

The 40th President of the United States of America (hereafter referred to as the US), Ronald Reagan (1986), once said that: “[g]overnment’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidise it”.

The casino industry in South Africa generated revenues of R212,127 billion in the 2008/09 financial year. It contributed R20 billion to the gross domestic product during the same period and R143 billion since 1996. Provincial and indirect taxes on this industry amounted to R6 billion in 2008. (CASA, 2009:1.). Prior to 1996, all gambling activities were illegal in South Africa. The South African Government, in recognising the potential contribution to state revenue, promulgated the National Gambling Act 33 of 1996 to regulate and tax the land-based casino gambling industry. However, under current South African legislation, interactive gambling still remains illegal and unregulated and winnings from such activities are only taxable as capital gains, which will be discussed in Chapter 2.2 (Snail, 2007b:51). According to Global Betting and Gaming Consultants (Wood & Williams, 2009:18) worldwide online gambling revenues are estimated to reach \$20–\$24 billion in 2010.

Rodrigues (2008:24) and Snail (2007a:73; 2007b:51) highlighted the continuous growth in the gambling industry and acknowledged that the introduction of interactive gambling now calls for more effective regulation of this industry. In his Budget Speech for 2010, the Minister of Finance, Pravin Gordhan (2010:15), announced the Government’s intention to review the current tax treatment of gambling winnings in the hands of individuals. The current South African tax treatment of gambling winnings depends mainly on whether the gambler is carrying on a business of gambling activities, or whether the taxpayer is simply engaging in gambling for entertainment purposes. Receipts from gambling as a business constitute gross income according to section 1 of the Income Tax Act 58 of 1962 as

amended (hereafter referred to as the Income Tax Act) and are taxed accordingly. Receipts from gambling as entertainment (or as a hobby) are receipts of a capital nature. Such capital receipts are specifically excluded from capital gains tax in terms of paragraph 60 of the Eighth Schedule of the Income Tax Act.

Internationally, different treatments regarding the taxation of gambling winnings are followed. Australia appears to follow a similar approach to South Africa (Deutsch, Freizer, Fullerton, Gibson, Hanley & Snape, 2005:133). However, the US requires the inclusion of all gambling receipts into adjusted gross income, whether from a professional gambler or from gambling as a hobby (Smith, 2002:446). The US allows gambling losses to be deducted with certain limitations (Blau, 2001:12; Blau & Coutant, 2003:319).

This study will investigate the tax treatment of winnings in the hands of individuals in the US and Australia and critically compare these to the current South African treatment in order to make recommendations regarding an efficient and effective tax treatment for individuals in South Africa, as suggested by the National Treasury (Gordhan, 2010:13). With regard to interactive gambling, specific reference will be made to the United Kingdom (hereafter referred to as the UK), where online gambling was legalised. The taxation of gambling winnings in the UK, however, will not be investigated.

The suggestion to tax gambling winnings is accompanied with challenges such as the high administration and compliance burden relating to these taxes (Alarie & Igelman, 2007:15; Blau, 2001:14). Consideration will also possibly need to be given to allow gambling losses as a deduction if winnings are required to be included in taxable income (Kee, 1995:2). These challenges will also be investigated in this study.

1.2 PROBLEM STATEMENT

Although several authors studied and produced articles on the regulation, problems, policy and taxation of gambling winnings, very little academic research could be found from a South African point of view. Due to the limited literature available, appropriate studies older than 10 years such as Kee (1995:1-8) and Kreiser and Jowitt (1993:1-9) were referred to as these were the only available literature on similar studies to this. A search

on SABINET identified one prior research study from a South African perspective on tax on gambling (“belasting op dobbelary”). This study commenced in 1997, but was never completed. The question therefore remains: How can South Africa amend the current income tax legislation effectively to include all winnings in the personal income tax of a gambler, as proposed by Gordhan (2010:15)?

1.3 PURPOSE STATEMENT

The main purpose of this study is to establish alternative treatments of the taxation of gambling winnings in the hands of the South African gambler. This study proposes a comparison between the current South African tax treatment and practices in the US and Australia in order to determine how South Africa can amend their current income tax legislation to effectively tax the winnings as income in the hands of gamblers.

1.4 RESEARCH OBJECTIVES

The study will be guided by the following specific research objectives:

- to analyse research studies and other literature on the taxation of gambling income in South Africa in order to establish the theoretical construct for this study;
- to analyse the taxation of gambling in the US and Australia; and
- to analyse and compare the taxation of gamblers in South Africa, the US and Australia, making use of the theoretical construct as underpin.

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

From a theoretical perspective the proposed study will make three valuable contributions to the existing body of knowledge on the taxation of gambling income: Firstly, as far as could be determined, this will be one of only two studies performed on the taxation of gambling winnings in South Africa. Secondly, this study will aim to make a contribution to the South African income tax legislation in that it will investigate alternative tax treatments for the winnings in the hands of the gambler. Thirdly, the study will investigate possibilities

to broaden the tax base by considering the taxation of interactive gambling in South Africa under its current status as being illegal and under a suggested regulated environment.

From a practical perspective, the findings might assist the Government in their proposal to review the current treatment of gambling winnings in the hands of individuals. Furthermore, depending on the Government's choice between a self-assessment system and a system of withholding taxes, the findings could assist the South African Revenue Service to identify effective methods of collecting tax revenues from the winnings of gamblers.

1.6 DEFINITION OF KEY TERMS

The foundation of this study is developed around the key concepts of *gambling activity* and *interactive gambling*. The manner in which these key terms are defined for the purpose of this study is considered below.

Gambling activity

“An activity is a gambling activity if it involves placing or accepting a bet or wager ...” or “placing or accepting a totalisator bet ...” or “making available for play, or playing bingo or another gambling game ...” or “an amusement game, to the extent that applicable provincial laws require such games to be licensed” (South Africa, 2004:18). Chapters 2 and 3 of this study deals with the winnings and losses from gambling activities in more detail.

Gambling winnings or gains

When the return on a bet or wager is in excess of the cost to place such bet or wager.

Gambling losses

When the cost of placing a bet or wager is in excess of the return from such bet or wager.

Interactive gambling

An interactive game (see Chapter 2.6) for the purposes of this study is defined as “... a gambling game played or available to be played through the mechanism of an electronic agent accessed over the internet, other than a game that can be accessed for play only in licensed premises, and only if the licensee of any such premises is authorised to make such game available for play” (South Africa, 2004:14). Interactive gambling can also be referred to as internet gambling, online gambling or remote gambling.

1.7 RESEARCH DESIGN AND METHODS

This is a non-empirical study in the form of an extensive literature review in order to establish a theoretical construct which will be critically analysed and compared from a South African perspective.

This study will critically review literature sources on the taxation of gambling winnings in the US and Australia in order to obtain an understanding of their tax treatment and present alternatives to the current South African tax treatment of gambling winnings in the hands of a gambler. Literature on the legalisation of online gambling in the UK will be reviewed strictly from a point of reference to the section of interactive gambling in this study.

Similar studies have not been performed from a South African perspective. This study will consider earlier research on the taxation of gambling winnings in the US and Australia by Kee (1995) and Kreiser and Jowitt (1993), who performed related studies in the form of literature reviews. The findings in these studies will be supplemented by more recent literature available on concepts regarding the changing legislation as well as South African case law and income tax legislation.

1.8 DELIMITATIONS

This study will only venture into the income tax considerations on gambling activities from a South African perspective. This study will:

- not consider the income tax consequences for bookmakers which are dealt with as professional gamblers under the current income tax legislation;

- focus on casino-style gambling, both interactive and land-based, and will not consider lotteries and sports betting;
- only consider the taxation of gambling income in the hands of the individual and not in the hands of the gambling operator or provider;
- not consider the possible socio-economical factors, problem gambling, the question regarding morality, money laundering and underage gambling issues contributable to gambling;
- not consider the effect of any double taxation agreements or any other international tax rules;
- not investigate the possible adverse effect that taxation of gambling gains will have on the gambler's propensity to gamble; and
- only consider the current income tax treatment of gambling income in the US and Australia as compared to South Africa. Reference to the UK will only be made in the section dealing with interactive gambling, because this country legalised interactive gambling.

1.9 ASSUMPTIONS

The study made the following assumptions in formulating a conclusion:

- it is assumed that the levying of personal income tax on an individual's gambling winnings will have a negative effect on the gambler's propensity to gamble; and
- US and Australian courts have been reluctant to rule gambling to be a profession. Current South African tax treatment of gambling winnings will not entice the gambler to identify him as a professional gambler. It is accepted, though, that if South African courts have to rule on the matter, the same rulings as in the US and Australia will apply.

1.10 OVERVIEW OF THE CHAPTERS

This chapter provided a background to the study and presented the problem and purpose statements as well as the research objectives. The benefits of the study were highlighted

followed by defining the key terms used throughout the study. This is a non-empirical study in the form of an extensive literature review. Several delimitations exist and assumptions were made to conclude on this study.

Chapter 2 provides an overview of current legislation, developments and taxation of gambling winnings in South Africa, the US and Australia. The theoretical construct so gathered are critically analysed and compared in Chapter 3 in order to present alternatives to the current South African tax treatment of gambling winnings.

Chapter 4 concludes the study and highlights the benefits of the study and identifies an area for further research.

CHAPTER 2

AN OVERVIEW OF CURRENT LEGISLATION, DEVELOPMENTS AND TAXATION OF GAMBLING WINNINGS

2.1 INTRODUCTION

The literature review provides an understanding of the current tax treatment of gambling winnings in South Africa, the US and Australia and also reviews the tax treatment of interactive gambling winnings.

Prior research on the taxation of gambling winnings in South Africa is very limited and this study makes specific reference to the Income Tax Act of South Africa and compares this to the legislation and case law in the US and Australia. Reference is made to the treatment of interactive gambling in the UK, since this country has legalised and regulated interactive gambling since 2005.

2.2 TAX TREATMENT OF GAMBLING WINNINGS IN SOUTH AFRICA

Whether income is taxable in the hands of the South African taxpayer, is determined by the definition of gross income in section 1 of the Income Tax Act. Gross income is very widely defined in the Income Tax Act and has the effect that a resident is taxed on amounts (in cash or otherwise) received or which has accrued to the resident during a year of assessment. Before 1 October 2001, receipts or accruals of a capital nature were excluded from gross income except for receipts and accruals specifically included under the subparagraphs of the definition of gross income in section 1 of the Income Tax Act. However, with the introduction of capital gains tax, capital receipts after 1 October 2001, which are not specifically included in gross income, are caught in the capital gains tax net as provided for in the provisions of the Eighth Schedule of the Income Tax Act.

In *Morrison v CIR*, 1950 (2) SA 449 (A) (16 SATC 377), the judge held that proceeds from gambling activities systematically undertaken, to the extent that they become a business or scheme of profit-making, are income of nature and should be included as gross income. If, however, a gambler engages in gambling activities merely for entertainment or as a

hobby (casual gambler), such proceeds will be capital of nature. Since gambling capital gains are not specifically included under paragraphs (a) to (n) of the specific inclusions under the definition of gross income, such gains should be evaluated under the Eighth Schedule of the Income Tax Act. Paragraph 60 of the Eighth Schedule disregards a capital gain or loss arising from an authorised/legal gambling activity conducted under the laws of South Africa. Such winnings will therefore not be subject to income tax at all. However, a capital gain or loss from a foreign gambling source and from illegal gambling games and competitions within the borders of South Africa, are not disregarded in terms of paragraph 60 and are subject to capital gains tax.

From a current South African tax perspective it is therefore important to distinguish between receipts of an income nature versus receipts of a capital nature as well as whether the receipts were from legal or illegal gambling activities. Whether receipts are capital of nature is a question of fact which is not contained in the Income Tax Act and ruled by courts to be judged on the merits of each case. In the *Lace Proprietary Mines Ltd v CIR*, 1938 AD 267 (9 SATC 349) the court held that the intention of the taxpayer should be determined during acquisition, the period the asset was held and at the time of disposal in deciding whether the receipt is income or capital of nature.

According to section 82 of the Income Tax Act, the onus to prove an amount to be capital of nature rests upon the taxpayer. South African courts have considered the intention of the taxpayer by looking at several objective factors to decide on the nature of a receipt. These factors include:

- the conduct of the taxpayer in relation to the transaction;
- the nature of the taxpayer's business or occupation;
- frequency of similar transactions;
- continuity of activities;
- the length of time for which the asset was held;
- activities of the owner in relation to the asset up to the time of deciding to sell it;
- documentary evidence;
- history of the taxpayer's holding of an asset;

- circumstances of the realisation;
- accounting treatment of the proceeds;
- the ability of the taxpayer's financial resources to accommodate his professed intention; and
- the involvement in a scheme of profit-making. (Jordaan, Koekemoer, Stiglingh, Van Schalkwyk, Wassermann & Wilcocks, 2009:28.).

Therefore, currently, if reference is made to these factors as well as the Morrison case, a professional gambler in South Africa will be taxed on the individual's winnings, similar to the treatment of business income. A casual gambler engaging in legitimate gambling activities will not be liable for normal or capital gains tax on the winnings.

The professional gambler should include in income all income from gambling in cash or otherwise. This would include a car as a prize. The fair market value of the car would be included in income and would therefore not be classified as a receipt of capital nature (SARS, 2010:358). The casual gambler would not be required to include the value of the car in income and will, upon sale of the car, not be liable to pay CGT, since it will be classified as a personal use asset under the Eighth Schedule of the Income Tax Act.

2.3 TAX TREATMENT OF ILLEGAL GAMBLING ACTIVITIES AND RECEIPTS IN SOUTH AFRICA

According to Gupta (2008:106), "[t]axation, in theory, knows no morality". Whether a taxpayer earns income from ordinary business activities or criminal activities, a receipt which falls within the scope of the Income Tax Act will be taxed and similarly, deductions which fall within the scope will be allowed as a deduction for tax purposes in terms of section 11. The legality of the receipt is therefore not a determining factor as to how receipts from gambling activities should be taxed, but rather whether the elements of business are present as discussed in Chapter 2.2.

Paragraph 60 of the Eighth Schedule of the Income Tax Act determines that capital gains and losses from gambling will not be subject to capital gains tax, unless they:

- are derived by companies, close corporations or trusts; or
- arise in respect of foreign gambling, games and competitions; or
- are derived from illegal gambling, games and competitions in South Africa.

The National Gambling Amendment Act 10 of 2008, to regulate interactive gambling, as well as the Interactive Gambling Tax Bill 2008, to impose a tax on interactive gambling providers, was assented to during 2008, but the effective date of these has not yet been announced. Consequently, under current South Africa legislation, interactive gambling remains illegal and such winnings are taxable as capital gains and must not be disregarded in terms of paragraph 60 of the Eighth Schedule of the Income Tax Act.

The latest development sees the Northern Gauteng High Court on 20 August 2010 in *Casino Enterprises (Pty) Ltd (Swaziland) v Gauteng Gambling Board and Others*, 2010 ZAGPPHC 89, ruling against the application of Piggs Peak Casino to advertise in South Africa. This ruling affirms South African laws that interactive gambling taking place in South Africa currently remains illegal (NGB, 2010:1). The National Gambling Board (2010:2) reiterated in its press statement that "... none of the entities advertising or offering the South African public to engage in online gambling on their websites have been licensed in terms of South African laws, and therefore remain illegal to advertise and operate in South Africa". The National Gambling Board (2010:2) furthermore stated that it is aware of the challenges that come with interactive gambling, as it evolves and penetrates South Africa and that this ruling will give regulators the opportunity to understand these and allow them to proceed with the best approaches to legalise and police interactive gambling.

It is however submitted that the principles applied in the *MP Finance Group CC (in liquidation) v CSARS*, 2007 SCA 71 (69 SATC 141) case, could also be applied to illegal forms of gambling such as online gambling. In this case, Ms Prinsloo operated an illegal and fraudulent investment enterprise commonly called a pyramid scheme through various entities and entered into contractually with investors by providing them with convincing looking documentation when deposits were made. The court ruled that an illegal contract

is not without all legal consequences and that the amounts paid to the scheme were accepted by the operators with the intention of retaining it for their own benefit and were therefore received within the meaning of gross income as defined by the Income Tax Act. Similarly are gambling winnings derived from illegal gambling activities received for the benefit of the gambler and such winnings will be included in the gross income of the gambler if it can be proven that the taxpayer is carrying on a business of gambling.

2.4 TAX TREATMENT OF GAMBLING WINNINGS IN THE US

Under tax laws in the US, all gambling gains, whether obtained from gambling activities conducted as a business or a hobby should be included as gross income and are taxed accordingly. The Inland Revenue Services of the United States of America (IRS) and US courts ruled gambling gains to be the “full amount of winnings less the cost of placing the winning bet” (Blau & Coutant, 2003:319). According to section 61 of the US tax laws, the IRS deems each bet on a different possible winning combination to be a separate wagering transaction. This view, that the gambler should only be allowed as a deduction the cost of the bet resulting in the winning-combination and not the cost of all the bets leading thereto, is also supported by Kee (1995:4).

The following example serves to illustrate the above: A gambler playing a R5 denomination slot machine will incur a cost of R50 worth of bets when betting 10 times. If spin number 10 results in the gambler winning R100, the gambling gain will amount to R95 being the win of R100 less only the cost of the winning bet of R5. The remaining R45 cost will be regarded as a gambling loss.

The Internal Revenue Code (hereinafter “Code”) of the US has been enacted by Congress in Title 26 of the United States Code (26 USC). Section 165(d) of the Code, commonly known as the Loss limitations code, determines that gambling losses are allowed to be deducted to the extent of the gains from all gambling transactions. The gambler will therefore not be allowed to deduct a gambling loss against other business income or other non-gambling income. Gambling losses may not be carried forward or back and is only available to offset gains from gambling transactions during the same tax year (Blau, 2001:12).

The main difference between the tax treatment of professional and casual gamblers is to be found in the treatment of deductions. Section 162 of the Code determines that the professional gambler may deduct business expenses ordinary to a gambling business as well as necessary business expenses. The casual gambler is not allowed to claim these business-related expenses and can only claim the betting cost as discussed above. Gambling expenses such as flight tickets, accommodation and food and beverage will not be allowed as a deduction for the casual gambler. Section 165(d) of the Code, however, limits these deductions to the extent of gains from gambling transactions for both the casual and the professional gambler.

In the annual tax returns, professional gamblers, where gambling can be proven to be a business, will be allowed to claim deductions “above the line”. This merely entails that a deduction for ordinary and necessary gambling expenses and gambling losses will be allowed in full, but are, however, still limited to the extent of gambling gains as discussed. The casual gambler, gambling as a mere pastime or hobby will only be allowed a deduction “below the line” as an itemised deduction but not subject to the so-called 2% of adjusted gross income rule, and will also not be allowed to create a loss from this “hobby”. Simplified, the itemised deductions subject to the 2% rule will entail the deductions to be allowed when it is in excess of 2% of adjusted gross income, which is revenue less business expenses. Therefore, although the deduction is claimed “below the line”, gambling losses for the casual gambler will be subject to the same limitations as for the professional gambler being limited to gambling winnings.

The above can best be explained by means of an example. Mr X and Mr Y are both professional businessmen and due to the regularity, time and effort Mr X spends on gambling, he is also recognised as a professional gambler. Mr Y does not gamble often, but when he does, he compulsively spends a lot of money. During the 2009 financial year Mr X and Mr Y’s income and expenses were similar. Their business income were \$100 000, while they incurred tax deductible business-related expenditure to the amount of \$75 000. Gross gambling income from all gambling transactions entered into during the financial year amounted to \$100 000. In terms of accommodation, food & beverage and flight tickets, they spent \$5 000, \$2 500 and \$5 000, respectively. Gambling costs incurred in terms of the winning bets and losses from bets which did not materialise in winnings

totalled \$80 000 for the 2009 financial year. Both these men had irrecoverable business debt owing to them of \$1 000, a deduction for depreciation on their computers of \$1 000 and paid \$500 to the local tax practitioner to complete their tax returns. Their tax returns would be completed as follows:

	Mr X		Mr Y	
	US\$	US\$	US\$	US\$
Other business income		100,000		100,000
Business expenses		(75,000)		(75,000)
Gross gambling income		100,000		100,000
Ordinary and necessary gambling expenses incurred - (Section 162 of the Code)				
- Accommodation		(5,000)		-
- Food and beverage		(2,500)		-
- Flight tickets		(5,000)		-
Gambling losses - (Section 165 of the Code)		(80,000)		-
Adjusted gross income		32,500		125,000
Itemised deductions subject to the 2% limit				
- Business bad debt	(1,000)		(1,000)	
- Depreciation on computer	(1,000)		(1,000)	
- Tax preparation fees	(500)		(500)	
Total of itemised deductions subject to the 2% limit	(2,500)		(2,500)	
2% of adjusted gross income	650	(1,850)	2,500	-
Itemised deductions not subject to the 2% limit				
Gambling losses – (Section 165 of the Code)		-		(80,000)
Taxable income		<u>30,650</u>		<u>45,000</u>

Mr X, being the professional gambler, will be allowed a deduction for his ordinary and necessary gambling expenses incurred and will therefore be allowed a deduction for the gambling losses “above the adjusted gross income line” on the return. Mr Y, however, will not be allowed this deduction above the line since his gambling is seen as a mere pastime. The result of this is a considerable difference between Mr X and Mr Y’s adjusted gross income and consequently the 2% limit of Mr X will be lower than that on Mr Y. In other words, Mr X will be allowed to claim a bigger deduction in respect of itemised deductions subject to the 2% limit than Mr Y will be. Mr Y will subsequently be allowed a deduction for the gambling losses incurred “below the adjusted gross income line”. Mr Y will be worse off by declaring \$14 350 more in taxable income than Mr X and it is therefore clear why the US gambler would be enticed to claim to be a professional gambler.

In order to illustrate the limitation of section 165(d) of the Code, the same facts can be used, except that both men incurred gambling losses of \$120 000.

	Mr X		Mr Y	
	US\$	US\$	US\$	US\$
Other business income		100,000		100,000
Business expenses		(75,000)		(75,000)
Gross gambling income		100,000		100,000
Ordinary and necessary gambling expenses incurred – (Section 162 of the Code)				
- Accommodation		(5,000)		-
- Food and beverage		(2,500)		-
- Flight tickets		(5,000)		-
Gambling losses				
- Total	120,000			
- Not allowed to create a loss – (Section 165 of the Code)		(87,500)		-
Adjusted gross income		25,000		125,000
Itemised deductions subject to the 2% limit				
- Business bad debt	(1,000)		(1,000)	
- Depreciation on computer	(1,000)		(1,000)	
- Tax preparation fees	(500)		(500)	
Total of itemised deductions subject to the 2% limit	(2,500)		(2,500)	
2% of adjusted gross income	500	(2,000)	2,500	-
Itemised deductions not subject to the 2% limit				
Gambling losses				
- Total	-		120,000	
- Not allowed to create a loss – (Section 165 of the Code)		-		-100,000
Taxable income		<u>23,000</u>		<u>25,000</u>

Gambling losses for both Mr X and Mr Y will be limited to gambling income. The remaining gambling loss “not utilised” in the 2009 financial year by Mr X and Mr Y will be \$32 500 and \$20 000 respectively. Section 165(d) of the Code, however, further determines that these losses will not be allowed to be carried forward and will also not be allowed as a deduction against other income. Mr Y will be able to claim \$100 000 of his gambling losses as an itemised deduction not subject to the 2% limit appose to the \$87 500 of Mr X. Mr Y’s adjusted gross income will, however, still be higher than that of Mr X and therefore, similar to the first example, he is still worse off, since he will not be allowed a deduction for his itemised deductions subject to the 2% limit.

2.5 TAX TREATMENT OF GAMBLING WINNINGS IN AUSTRALIA

Section 25(1) of the Australian Income Tax Assessment Act 38 of 1997 determines what should be included and defined as assessable income. It states that assessable income includes gross income derived directly or indirectly from all sources except for income that is specifically exempted from taxation in terms of the Australian Income Tax Act. No specific provision is included in the Australian Income Tax Assessment Act dealing with gambling winnings. It is, however, proposed that the only way gambling winnings will not be taxable is if it can be argued to be of a capital nature (Kreiser & Jowitt, 1993:76).

Under Australian tax laws, gambling gains are classified as windfall gains and are not income of nature, except if the activity constitutes a business. Section 118-37(1) of the Australian Income Tax Assessment Act, however, exempts gambling winnings from CGT and does not allow the deduction of gambling losses (Deutsch *et al.*, 2005:355).

2.6 TAX TREATMENT OF INTERACTIVE GAMBLING WINNINGS

2.6.1 Introduction

According to Global Betting and Gaming Consultants (Wood & Williams, 2009:18), “worldwide online gambling revenues amounted to \$600 million in 1998; \$5,6 billion in 2003 and \$16,6 billion in 2008 and is estimated to reach \$20–\$24 billion in 2010”. The industry grew so fast that even some of the largest online gambling sites, such as PartyPoker.com, 888.com and Paradise Poker publicly traded on the London Stock Exchange (LSE) (Alarie & Igelman, 2007:1).

In the 2010 Budget Speech the Minister of Finance acknowledged the revenue challenges that South Africa faces and suggested broadening the tax base as a solution to raise revenues, together with the closing of loopholes and improvement of tax compliance (Gordhan, 2010:13). The National Treasury will consider implementing measures to limit money laundering and unlicensed online gambling (Gordhan, 2010:15). Revenues to the magnitude suggested by Wood and Williams therefore presents the ideal opportunity to investigate the regulation of online gambling, which will broaden the tax base and may

raise state revenues. In order to investigate alternatives to the current treatment of interactive gambling, reference will be made to studies performed by Devaney (2009:273-283), Grahmann (2009:167-177), Griffiths and Parke (2004:295-299) and Wood and Williams (2009:1-152). Reference will also be made to the treatment of interactive gambling in the UK being one of the exceptions by legalising and regulating interactive gambling.

According to Devaney (2009:274), “[r]estrictions placed on online gambling range from almost no restriction to almost complete restriction” and “internet gaming can be grouped into four categories, namely maximum protection/compliance, prohibition, laissez-faire and tolerance” (Devaney, 2009:276). With so many options available it is apparent that South Africa is not the only country who faces the challenge to choose the most viable option.

2.6.2 US

Grahmann (2009:167-177) and Griffiths and Parke (2004:295-299) suggest the journey of the US on this matter goes as far back as the Wire Act of 1961 and Travel Act of 1961, which prohibited any gambling business to accept any bet or send information assisting in bet placement over interstate or international telecommunication wires. Technological innovation in Wireless Internet Technology (Wi-Fi) has, however, placed these acts redundant and the US invested in alternatives by the means of the Illegal Gambling Business Act of 1970, the Internet Gambling Prohibition Act of 1998/1999 and the Internet Gambling Enforcement Act of 2002 which prohibits internet gambling in the US. The Unlawful Internet Gambling Enforcement Act of 2006 prohibits online gambling by getting the financial institutions on board. Bet placing by means of a debit or credit card is not allowed, since credit card associations stipulate that payment systems can only be used for legal transactions.

Wood and Williams (2009:18) estimate that approximately 150 different online payment methods are in use. Affiliated members would deny the use of their payment structure by using transaction codes to identify internet gambling activity. However, all financial institutions do not fall within the borders of the US and the transaction codes can furthermore not distinguish between legal and illegal gambling activities, consequently

resulting in more loopholes. Gamblers can also make use of payment providers such as PayPal where funds are deposited from credit cards, which can then be used to pay online services. PayPal was developed to facilitate the growth on e-commerce and therefore transaction codes from such institutions will not be denied. E-cash also exists and is used in Cyberspace for virtual transactions. The latest development in this area saw the Internet Gambling Regulation and Tax Enforcement Act of 2009 being enacted, which amended the Internal Revenue Code of 1986 to regulate and tax Internet gambling. The purpose of this act is to raise revenue for the US Treasury primarily through ensuring that applicable individual taxes, corporate taxes and license fees on regulated Internet gambling activities are collected.

Griffiths and Parke (2004:298) is of the opinion that: “[t]rying to prohibit transfer of Internet gambling Web site data is believed to be virtually impossible. GoCorp Ltd believed that the only way to restrict illegal data transfer into a country would be to unplug the Internet” (Griffiths & Parke, 2004:298). This is because the prohibition of internet gambling is not possible and a global agreement on prohibition of online gambling is unlikely, because underdeveloped economically deprived nations would not be able to reject the investment. It is therefore proposed that the most effective way to deal with interactive gambling would be the regulation of the industry.

2.6.3 UK

The UK, on the other hand, has taken a different approach to interactive gambling and recognised that the internet posed a threat to government revenue streams and to the competitiveness of the UK gambling industry (Paton, Siegel & Williams, 2002:296). By passing the Gambling Act 2005, the UK posed to allow online gambling operators to be licensed and taxed within the borders of the UK and ever since grew to the fourth-largest provider of internet gambling (Wood & Williams, 2009:24). The act deployed a Gambling Commission in 2007 to oversee all regulatory and licensing aspects of remote gambling. UK residents are allowed to participate in remote gambling, as the act refers to it. The act contains three licensing objectives:

- the protection of children and other vulnerable people from being harmed or exploited by gambling;

- to avoid gambling being a source of or being associated with crime and supporting crime; and
- to ensure that gambling is conducted in a fair and open way.

This act recognises the significant technical changes in the gambling industry, especially the regulation of gambling where the player is not present on the operator's premises by gambling via remote communication.

2.6.4 Australia

By means of the Interactive Gambling Act 84 of 2001, Australia regulates online gambling operators within its borders. The act prohibits these Australian-based operators from providing internet gambling services to the Australian residents and customers in certain designated countries and also prohibits the advertising of internet gambling. This act established a complaints-based system which will be dealing with internet gambling services.

2.6.5 SA

It can be suggested that South Africa is aware of the challenges as the National Gambling Amendment Act 2008 has been accepted but has not been made effective as yet. The amendments to the existing National Gambling Act of 2004 included in the National Gambling Amendment Act 2008 mirror the UK situation and will be referred to in Chapter 3.4.2.

2.7 CONCLUSION

This chapter summarised the literature reviewed for this study. No prior studies comparing the tax treatment of gambling winnings from a South African perspective have been performed. For this reason, the chapter referred to the Income Tax Act of South Africa as well as relevant case law and explained how the tax treatment of gambling winnings in South Africa differs from and corresponds to that of the US and Australia.

The study determined that the Australian tax treatment of gambling winnings and losses is very similar to the South African tax treatment thereof. In order for the National Treasury to investigate the taxation of gambling winnings, reference will have to be made to the US treatment for alternatives to the current treatment.

This chapter specifically referred to the treatment of interactive gambling in the UK, since this country legalised interactive gambling providers to operate from within the borders of the country. South Africa aimed at legalising online gambling and suggested means to regulate this environment through the National Gambling Amendment Act 2008 and the Interactive Gambling Tax Bill 2008, but has yet to conclude on this. Consequently, the provision of interactive gambling and the participation in these activities remain illegal in South Africa.

CHAPTER 3

THE TAXATION OF GAMBLING WINNINGS FROM A SOUTH AFRICAN PERSPECTIVE

3.1 INTRODUCTION

This chapter discusses the problems associated with the various treatments of gambling winnings as identified from the literature review in Chapter 2. Reference is made to the distinction between a professional gambler and a casual gambler, as well as the contentious issue of allowing gambling losses as a deduction. The chapter continues with a critical analysis from a South African perspective on the question whether to tax or not to tax gambling winnings in South Africa and closes with options and challenges to tax gambling winnings in South Africa.

This chapter refers to previous studies by Kreiser and Jowitt (1993) and Kee (1995). Kreiser and Jowitt (1993) performed a comparative study on the taxation of gambling winnings in Australia and the US, whereas Kee (1995) reviewed the taxation of gambling winnings from an Australian perspective. Although none of these studies referred to the South African treatment of gambling winnings, notice was taken of the findings and the practicality of the suggestions and comparisons of the studies performed. This study aims to expand on these studies from a South African perspective.

Chapter 2 established that one consistent approach is followed in the countries included in this study, being the taxation of gambling winnings of the professional gambler. The following section of this study will therefore focus on the determination of a gambler as either being a professional gambler or a casual gambler and the relevant case law applicable to the concept.

3.2 PROBLEMS ASSOCIATED WITH THE VARIOUS TAX TREATMENTS OF CASINO GAMBLING WINNINGS

3.2.1 Distinction between professional and casual gambling

Distinguishing between whether gambling activities constitutes a business for the professional gambler or a hobby for the casual gambler is challenging. Different outcomes on the decision whether gambling should be classified as being a hobby or a business were reached in two US tax court rulings, *Myers v Commissioner*, TC Summary Opinion 2007-194 and *Ferguson v Commissioner*, TC Summary Opinion 2007-30 with similar facts (Watson, 2008:40).

The US Tax Courts refer to the Treasury Regulations section 1.183-2(b) when considering whether gambling activities constitutes a business. These regulations set out the following nine non-exclusive factors:

- the manner in which the taxpayer carries on the activity with reference to the gamblers' record keeping and comparing this to the extent of record keeping required in conducting a business;
- the expertise of the taxpayer or advisors to determine whether the gambler engaged with people with know-how in order to better strategies or in order to gain general knowledge on gambling;
- the time and effort expended by the taxpayer in carrying on the activity. A physically comparison of the time spent gambling to the time spent on a full-time occupation for instance would be required;
- the expectation that assets used in the activity may appreciate in value;
- the gambler's involvement in other business activities and comparing the time spent on this in comparison to the time spent gambling;
- the gambler's success rate or the lack thereof by reviewing the taxpayer's history of income or losses with respect to the gambling activity;
- a review of the gambler's gambling records in order to determine the amount of occasional profits, if any, which are earned. This needs to be evaluated together with

the gambler's expertise and his search to better his own chances in order to determine whether his activities might constitute a business;

- a review of the taxpayer's financial status would evaluate the motive to try and deduct gambling losses against other income or the urgency and effort to create funds in order to service debt or in order to launder money from illegal activities; and
- an evaluation of the elements of personal pleasure or recreation present which will assist in the decision. A gambler engaging in gambling as a hobby will do so for the pleasure thereof, versus a professional gambler which might find it stressful. (Watson, 2008:41.).

Based on these, the court in *Myers v Commissioner* ruled that Ms Myers was a professional gambler, since no pleasure was derived from gambling, the gambling activities constituted a trade or business due to it being conducted with continuity, regularity and with the purpose of earning a profit (Quinn, 2008:69). The IRS consequently allowed gambling losses of \$1,4 million as a deduction.

In *Ferguson v Commissioner* the court also referred to the Treasury Regulations and debated the distinction between business and a hobby for tax purposes. As Ferguson displayed poor recordkeeping, no strategy, did not seek assistance to better this and "only" spent the equivalent hours of a part-time job participating in gambling activities, the court concluded the activities to be a hobby and consequently did not allow the deductions of business expenses. (Watson, 2008:42.).

Under Australian tax laws, gambling gains are regarded as windfall gains and not income of nature. The exception hereto is when gambling activities will constitute a business and therefore do not lack regularity or periodicity of income. The Australian Income Tax Assessment Act defines the term *business* "... to include any profession, trade, employment, vocation or calling, but does not include occupation as an employee". However, although defined, Australian courts recognise that in order to establish whether a business exists or not is a question of fact which should be determined in an objective manner. Factors to consider are:

- the purpose and intention of the taxpayer;
- whether there is an intention to realise a profit;

- if the size and scale of the activities vouch for this in terms of repetition or regularity of engaging in the activities; and
- whether it is carried on in a systematic and businesslike manner usual for such a business. (Deutsch *et al.*, 2005:131.).

To expand on these general factors, the Australian courts more specifically defined the following factors in considering whether gambling activities constitute a business or a hobby:

- the degree to which the taxpayer's activities rely solely on chance without any system or organisation;
- the extent to which a taxpayer's involvement in the activity stems from a love of the activity, as opposed to gambling alone;
- the extent to which the entertainment/compulsion element is paramount, rather than a profit-making motive;
- the period of time engaged in the activity is normally irrelevant; and
- the scale of activities is important but the size of bets is irrelevant. (Deutsch *et al.*, 2005:133-134.).

These factors are very similar to the US Treasury Regulations, with maybe the exception of the time spent engaging in the activity which proved in *Ferguson v Commissioner* to be one of the deciding factors in ruling the activities to be a hobby rather than a business.

In *Brajovich v Federal Commissioner of Taxation*, 89 ATC 5227 it was held that it is difficult to prove that gambling is a business. The court laid down the criteria to determine whether gambling transactions constitutes a business. These include:

- whether the betting is conducted systematically;
- whether it is organised and conducted in a businesslike way;
- the scale of betting and whether the betting is related to, or part of, other activities of a businesslike character;
- whether the bettor appears to engage in his activity principally for profit or principally for pleasure;

- whether the form of betting chosen is likely to reward skill and judgement or depends purely on chance; and
- whether the gambling activity in question is of a kind which is ordinarily thought of as a hobby or pastime. (Kreiser & Jowitt, 1993:77.).

The court in *Brajkovich v. Federal Commissioner of Taxation* decided that it is hard to see how one could characterise, as a business, playing a game in which the results are purely random. There is a high probability that each player will lose in the long run and ruled in favour of the Commissioner that the taxpayer was not carrying on a business. (Kreiser & Jowitt, 1993:77.).

In *Babka v. Federal Commissioner of Taxation*, 89 ATC 4963, the court found that, despite the fact that the taxpayer used a system and devoted considerable time to gambling activities, it will be a rare case that a court will conclude gambling to be a business (Kreiser & Jowitt, 1993:78).

Although the gambler was successful over a five-year period, the court in *Evans v. Federal Commissioner of Taxation*, 89 ATC 4540 ruled the activity of betting not to be a business. In reaching the decision it was argued that a person cannot merely be taxed because he is successful, while another taxpayer with the same volume and magnitude of gambling and the same system and organisation or lack thereof might not be so lucky and will not be taxed. (Kreiser & Jowitt, 1993:78.).

In general it seems the US and Australian tax courts have laid down similar factors when considering gambling activities to be a business or a hobby and in doing so have been reluctant to rule gambling to be a business.

3.2.2 Recognition of gambling losses

The Income Tax Act does not specifically provide for a deduction of expenses relating to gambling. The expenses would therefore have to be evaluated under the general deduction formula in section 11(a) of the Income Tax Act. Courts in the *Port Elizabeth Electric Tramway Co Ltd v CIR*, 1936 CPD 241 (8 SATC 13) have ruled that sections 11(a)

and 23(g) of the Income Tax Act should be read together when considering the deductibility of an amount (Jordaan *et al.*, 2009:110).

Section 11(a) of the Income Tax Act provides for a deduction of the “... expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature”. No deduction shall be allowed according to section 23(g) of the Income Tax Act in respect of “... any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade”. It is claimed that section 11(a) serves as a positive test to determine which amounts may be deducted while section 23(g) is a negative test to consider which amounts may not be deducted.

The Income Tax Act does not define “losses” and the court in *Joffe & Co (Pty) Ltd v CIR*, 1946 AD 157 (13 SATC 354) held that the meaning was somewhat obscure and that it was not clear whether it meant anything different from expenditure (Jordaan *et al.*, 2009:111). Although not defined, gambling losses, as in the earlier example in Chapter 2.4, equates to actual wagers or bets (expenditure) and therefore satisfy the “actually incurred” and “losses” elements in terms of section 11(a) of the Income Tax Act.

The determining element of section 11(a) of the Income Tax Act would be the sentence “[incurred] in the production of income” and consideration should be given to two factors, one being the action that gave rise to the expenditure and secondly, whether this action is closely connected or necessary for the income-earning activity (Jordaan *et al.*, 2009:114). The action would be the engaging in gambling activities through wagering or betting which is most definitely closely connected to earning gambling income. Gambling losses (expenditure) would therefore be deductible.

However, income is also defined in the Income Tax Act under section 1 as “... the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax ...”. Gambling gains of a professional gambler will be included in gross income as discussed in Chapter 2.2 and will therefore be income as defined. Thus, gambling losses of the professional gambler will

under the current income tax legislation be allowed as a deduction since it is incurred in the production of income.

The casual gambler will, however, not receive the benefit of the deduction under section 11(a) of the Income Tax Act, since gambling winnings from gambling as a hobby are of a capital nature. The winnings are therefore excluded from gross income and also from income. Gambling losses will therefore not be incurred in the production of income and will also be argued to be of a capital nature and not be allowed as a deduction.

If the South African Government therefore considers introducing a system where all gambling gains must be included in gross income, regardless of whether it was obtained from gambling as a business or a hobby, consideration should also be given to allowing gambling losses as a deduction. Kee (1995:2) presented that the Government would not be in favour of such treatment since most gamblers make losses rather than gains.

3.3 SHOULD ALL GAMBLING GAINS BE TAXED AS INCOME?

In his Budget Speech, Gordhan (2010:15) announced the Government's intention to review the current tax treatment where gambling winnings are not subject to personal income tax in the hands of a casual gambler. This could lead to the broadening of the existing tax base since all winnings will be subject to normal tax and will not be excluded, as discussed in Chapter 2.2.

Alarie and Igelman (2007:6-7) highlighted the importance of a comprehensive tax base. The taxation of gambling gains can be justified according to the conventional tax policy criteria. In order to achieve vertical equity a gambler winning large jackpots should contribute more in taxes compared with the gambler winning lesser. The former gambler will have a greater ability to pay because of the larger amount of winnings. Horizontal equity suggests that the gambler winning large jackpots should also contribute equally in taxes, when compared with an individual earning the same amount of money through employment or business activities, as both have the same ability to pay. Therefore, by not taxing all gambling winnings, the successful gambler will generally be in a better position when compared with the unlucky gambler and the individual earning taxable employment

or business income. This treatment therefore violates the vertical and horizontal precepts and supports the intention to review the current tax structure.

Equally important is economic efficiency that determines that income should be taxed to raise a desired level of revenue with minimal effect on the taxpayer behaviour (Alarie & Igelman, 2007:7). Provincial and State revenues are funded by taxes on the gambling operators in terms of gambling levies, corporate taxes and value-added tax (VAT). Although limited information is available, it is commonly believed that taxation of gambling gains would adversely affect an individual's propensity to gamble (Kreiser & Jowitt, 1993:81). Consequently, the additional personal taxes might merely fill the decline in Provincial and State revenues as a result of less gambling. This may effectively leave the State in exactly the same position as under the current tax legislation. Under economic efficiency it is therefore not as straightforward to support the taxation of gambling winnings and an empirical study, which is beyond the scope of this study, is necessary to determine the effect of personal income tax on an individual's propensity to gamble before an opinion on the financial viability can be made.

Kreiser and Jowitt (1993:81), in the comparative study on the taxation of gambling winnings in Australia and the United States, presented the arguments in Table 2 in favour of and against taxing gambling winnings.

Table 1: Gambling winnings: To tax or not to tax

To tax:

- Including gambling winnings in income would expand the income tax base and increase tax revenues.
- Some countries, including the United States, tax gambling winnings as income (gambling losses are deductible to the extent of gambling winnings.)
- Gambling winnings provide the taxpayer with the wherewithal to pay the income tax; therefore, the taxpayer should be taxed on the gambling winnings.
- Gambling winnings are essentially no different than salaries and wages in terms of being spendable inflows.
- Why should governmental tax authorities give preferred income tax treatment to gambling winnings (tax exemption) as opposed to other inflows such as salaries and wages which are subject to income taxation?
- Gambling taxes are paid by the willing. (Gamblers are interested in gambling, not the income tax effects of gambling.)

Not to tax:

- In many areas of the world, gambling activity is a significant source of governmental tax revenues. These revenues are derived from gambling taxes other than income taxes and from gambling profits going directly to governmental authorities. Tax authorities should not discourage gambling activity by taxing gambling winnings as income and, thereby lower overall governmental tax revenues.
- Taxes on gambling activity tend to be regressive taxes. Income taxation of gambling winnings will make the tax system more regressive.
- From a tax equity standpoint, if gambling winnings are subject to income taxation, gambling losses should be fully deductible.
- Studies indicate that pari-mutuel wagering demand is price elastic. The lower the state tax rates, the higher the level of betting. Taxing gambling winnings as income may lower overall governmental tax revenues from gambling activity.
- Income taxation of gambling winnings may lessen the attractiveness of gambling activity in attracting foreign tourists to a particular country and thereby have an overall negative impact on the economy of a country.
- Exclusion of gambling winnings from income taxation may increase gambling activity and encourage additional capital investment in gambling facilities.
- From a tax administrative standpoint, taxing gambling winnings as income amounts to a “heads I win, tails you lose” tax system. Gross revenues from gambling activity must cover the expenses and profits of gambling establishments and a heavy tax burden imposed by governmental authorities before any winnings are paid to the players. This system guarantees that there will be many more gambling losers than gambling winners. Is a tax system fair when a successful gambler is taxed and an unsuccessful gambler gets no tax deduction?
- Taxing legal gambling winnings will encourage illegal gambling activity.

Source: Kreiser and Jowitt (1993:81)

South Africa will be able to copy the reasons presented by Kreiser and Jowitt to submit a case to tax gambling revenues in order to broaden the tax base as suggested. Cognisance will, however, need to be taken of the challenges or arguments against the taxation thereof presented in Chapter 3.4 in order to maintain and protect the current provincial and national tax revenue flows.

This study proposes that the fact that the US tax gambling winnings, as noted by Kreiser and Jowitt in the table above, do not present an arguable reason to tax gambling winnings but may rather be used as a platform of reference when the option is investigated.

The other reasons to tax gambling gains presented by Kreiser and Jowitt in the table echo the presentation on vertical and horizontal equity as well as tax efficiency above and emphasises the importance of these tax principles. These arguments were also presented

by Kee (1995:2) which added that the taxation of some gains but not others will encourage a taxpayer rather to partake in activities where gains are not taxed.

On the contrary, it is reasoned that gambling is a mere pastime and should never be viewed as an income-generating activity and should therefore not be taxed. It is, however, also acknowledged that, for some gamblers such as professional poker players, income from gambling is their primary source of income and not taxing such income would undermine the horizontal equity principle (Kee, 1995:1).

The game of gambling is exactly what it says and involves pure chance. The gambler stands a chance of either achieving unexpected winnings or on the other hand realising gambling losses. This element of luck and risk is, however, not unique to the gambling environment, but ever so present in the business world with market preferences and economic conditions and therefore do not present a statement of merit not to tax gambling winnings (Kee, 1995:1).

Kee (1995:2) goes further to highlight the fact that gambling gains indirectly bear another kind of tax since an important source of state revenues is the state taxes on prizes and gambling. It is presented that taxes are recovered from racing and poker machine operations, casinos contribute a percentage of gross gaming revenue to taxes, bookmakers are taxed on their gross takings, and the TAB (Take a Bet) is taxed on its turnover.

In terms of current South African legislation, provincial gambling boards tax the land-based casino operators a fixed levy on the level of turnover in order to uphold the licence and thereby funding operations of these Boards. Gordhan (2010:15) also acknowledges that “gambling is subject to various forms of taxation at both provincial and national level”, thereby including the operators’ contribution to the state revenues by means of corporate taxes and VAT. Several requirements on the local environment, Broad-Based Black Economical Empowerment (BBBEE), corporate social investments and employment are also upheld by these operations.

Since 1996, the casino industry in South Africa has contributed R286 million in corporate social investments to the community (CASA, 2009:4). For the 2008/09 financial year it is estimated that 29% of turnover from the industry benefited government and a total of 48 000 industry-related jobs were provided (CASA, 2009:1). It is therefore evident that gambling gains indirectly contribute to state revenues. Taxation of these gains might result in lower state revenue and contributions in the mentioned areas if taxation of winnings deters or discourage people from gambling (Kee, 1995:2).

Kee (1995:2) touches on possibly one of the biggest challenges which will face the taxation of gaming winnings, being the difficulty of administration and compliance, which will be dealt with in more detail in Chapter 3.4.

Kee (1995:2) follows the arguments in Chapter 3.2.2 where it was concluded that the taxing authority which investigate the taxation of gambling gains should give equal attention to allow gambling losses as a deduction. This might be troublesome in that, as mentioned earlier, gambling is a game of luck and the odds would have it that most gamblers would realise losses rather than gains.

When reference is made to the conventional tax policy criteria and the studies of Kee and Kreiser and Jowitt, it is evident that equality and fairness can only be achieved by the taxation of gambling winnings in the hands of the gambler. It would be unfair for a hardworking businessman or salary earner to contribute a portion of their income towards state revenues while the gambler pockets gross winnings. If the principles of the US and Australian case law discussed earlier are applied in a South African context and it is accepted that it will be equally challenging to prove gambling as a business, then it might be argued that the South African gambler currently contributes very little to state revenues. This is presented since only the winnings of a professional gambler and a gambler engaging in illegal or foreign gambling activities are currently taxed in South Africa as discussed in Chapters 2.2 and 2.3.

Should the South African Government pursue the taxation of gambling winnings in the hands of the gambler, it would be important to strive towards a balance between the taxation of the gambler and taxation of the industry, since the gambling industry is

currently an important contributor to state revenues. Taxation of gambling winnings may discourage gambling activities, which could result in lower operator revenues and consequently a lower contribution towards taxes. It is also presented that the casino industry makes valuable contributions in respect of corporate social investments and the alleviation of the unemployment rate in South Africa. Excessive taxation of this industry sees operators no longer being able to sustain such capital investments and consequently resulting in a possible increase in poverty.

Although this study does not venture into the socio-economical challenges related to gambling, it partners with the presentation by Kee (1995) as well as Kreiser and Jowitt (1993) in as far as that the excessive taxation of legal gambling winnings might encourage illegal gambling activities. Such activities can be argued to go hand in hand with problem gambling, underage gambling and other illegal activities which are currently regulated by the gambling laws in this country.

3.4 OPTIONS AND CHALLENGES

Government revenue associated with gambling needs to be preserved and in order to do so there are a number of choices. Alarie and Igelman (2007:15) debate possibilities, which include the introduction of taxation of net gambling winnings and the regulation of online gambling. This is, however, easier said than done and holds numerous challenges and factors to consider.

3.4.1 Taxation of gambling winnings

If the South African Government considers the taxation of gambling winnings in the hands of the gambler, a decision will have to be taken on whether to tax gambling winnings on a net or a gross basis. A tax on gross winnings without allowing gambling losses would be a transaction tax on gambling activity rather than an income tax (Alarie & Igelman, 2007:9). The taxing of net winnings will result in the need to review the interpretation of the “cost of placing the winning bet”. Referring to the VAT Interpretation Note 41 (SARS, 2007:11), the SARS already recognised this in stating that: “... in the casino industry, the nature of betting transactions, especially so with the table game of chance (e.g. roulette, poker),

makes it difficult to separate bets placed by customers and winnings paid to punters”. A final decision on this needs to be made if the National Treasury moves to tax gambling gains in order to avoid misinterpretation of the cost of placing a winning bet and allowing gamblers to deduct all bets placed leading to the eventual jackpot.

Once a decision on the above has been reached, the next concern would be how to recover taxes on these winnings effectively. South Africa may choose to refer to the current collection structure of the US in order to facilitate this question with reference to studies such as Blau (2001:14) for the choice between the self-assessment systems versus a system of withholding taxes with thresholds. Similar to South Africa, the US also requires the taxpayer to declare all receipts or accruals. However, in order to ensure continuous contribution to state revenues throughout the financial year, instead of once a year during assessment time, the US has implemented a system of withholding taxes. In general, proceeds of more than \$5 000 where odds are at least 300 to 1 such as a lottery, sweepstake and wagering pools, are subject to a withholding tax of 28% of proceeds. Proceeds will be determined by reducing the amount received by the cost of the wager, or where proceeds are not money, the fair market value will be used. (Blau, 2001:14.).

Here again it shows how important a conclusion on the cost of a wager would be. As for winnings from slot machines, keno or bingo, no withholding tax is applicable, except if winnings are made by foreigners. However, in order to make sure that the US citizen declares his proceeds from gambling activities, the IRS implemented a system where the gambling operators are required to report the taxpayers’ name and identification number to the IRS once the payout has been made. This reporting requirement is, however, also subject to thresholds in order to avoid excess administration. Payouts of winnings in excess of \$600 as a general threshold should be reported, as for slot machines and bingo, the threshold is \$1 200 and for keno winnings in excess of \$1 500. (Alarie & Igelman, 2007:10.).

Even the US system of reporting has shortcomings in that the reporting thresholds are high enough that a significant number of gambling winnings go unreported. It is also suggested that some operators set the payouts that most winnings will pass under the threshold in order to avoid the administrative liability of gathering and reporting gambler

information (Alarie & Igelman, 2007:11). It is furthermore argued that withholding a portion of the winnings of a gambler would reduce a gambler's liquidity and consequently the gambler would not be able to play to the extent previously done. This will ultimately result in reduced turnover for the operator and therefore a lesser contribution to state revenue in respect of taxes (Alarie & Igelman, 2007:11).

Although Alarie and Igelman present the study from a Canadian perspective, it is clear from the considerations in the study that Canada faced the same challenges as South Africa. Alarie and Igelman (2007:12) concluded that even if the equity and efficiency reasons can be addressed to tax net gambling winnings and all administrative considerations can be satisfactorily resolved, the political feasibility remains another issue altogether. It is therefore proposed that *status quo* against the taxation of gambling winnings of the casual gambler should prevail.

South Africa will be able to use the US system of reporting gambling winnings and withholding taxes. Cognisance will, however, need to be taken of the loopholes in reporting thresholds and the added administrative liability both on the part of the operator and SARS.

The gambler, on the other hand, does not come off lightly either. Including gambling winnings in the annual return and proposing to claim deductions and losses will require detailed records similar to what is currently required for any business or profession in South Africa. Blau (2001:15) elaborates on the fact that the IRS imposes the administrative liability on the US gambler to keep an accurate diary of all gambling winnings and losses, supplemented by verifiable documentation. The diary should stipulate details about the wager, the name, address and location of the gambling establishment, witnesses present and the amounts won and loss. Supporting documentation would include wagering tickets, credit records for deposit and withdrawals, hotel bills and airline tickets indicating the date, time and destination. For slot machine and table winnings the gambler will need to gather documentation from the player-tracking facility of the provider indicating the win and loss totals as well as machine and table numbers to supplement the above. Blau (2001:18) refers to several US case law where

failure to maintain adequate gambling records leads to the denial of gambling loss deductions, thereby reiterating the importance of detailed verifiable documentation.

The South African gambler will therefore need to be schooled in these disciplines in order to ensure compliance and to avoid this additional responsibility deterring the individual to gamble and ultimately defeating the purpose of imposing taxes on the gambler.

3.4.2 Online gambling

In conclusion, Alarie and Igelman (2007:18) supports an alternative option to leave the tax treatment as is and only investigate the possibility of regulating online gambling in order to establish an additional source of tax revenue and prevent illegal gambling moving underground. Two options exist, one being the license and regulation of third-party online gambling operators and the other being the empowerment of provinces to become online gambling site operators on their own.

The first option has the benefit that it involves no costs for the Government in terms of setting up the infrastructure as well as savings in the marketing and branding of these online gambling services. Gamblers will be able to choose the most attractive online gambling destinations without the provinces picking up the losses of the operations of the less attractive online sites. State revenues will therefore start benefiting as soon as the first operator is licensed. Devaney (2009:275), however, highlights the borderless nature of the internet and argues that interactive gambling providers will shop around for the most tax-competitive jurisdictions and will be enticed to rather locate and operate from such country, which might result in no additional revenue for South Africa.

However, effective regulation of such operators would provide the gambler with ease of mind to engage in the now legal activity of gambling on licensed gambling operator sites, which might increase the volumes of such activities. Increased volumes, however, do not guarantee an increase in state revenues, since the increase in online gambling activities might only be a natural dilution of gambling activities from the land-based casinos towards online gambling (Alarie & Igelman, 2007:17).

The second option for provinces to become online gambling site operators on their own has the advantage that no competition from other online gambling operators exists in the market. Gross revenues generated from these sites will be for the benefit of the state, compared to a percentage of the revenue in option one. However, provinces might become their own worst enemy in as far as that revenue dilutes from existing gambling operations, since no additional revenue will be generated, because what they will earn in revenue they might lose in taxes from the other sources (Alarie & Igelman, 2007:19).

Both these options allow the Government to regulate the environment more effectively, as opposed to a system of legalising interactive gambling in general. General legalisation will see South African gamblers being able to engage in online gambling on any available site regardless of the legislative environment. Such activities are virtually impossible to regulate and poses challenges such as difficulty to verify the fairness of games, concerns about the safety of deposits and personal information, lack of face-to-face contact, access to illegal online gambling providers and the convenience thereof contributing to socio-economical problems such as underage and problem gambling (Wood & Williams, 2009:9).

Wood and Williams (2009:11) present arguments that support the legalisation of online gambling which include the reasoning that it is nearly impossible to prohibit online gambling effectively. It is better for this environment to be regulated in order to reap the economical benefits than policing the illegality thereof. Revenue obtained in this way can be used to prevent or treat gambling problems and to ensure player protection. On the contrary, the purpose of law is not to conform to people's behaviour but rather to shape it; therefore, online gambling should be prohibited. It is also argued that some online gambling sites have unsatisfactory business practices and do not impose proper responsible gambling practices. This, combined with the increased availability, contributes to problem gambling and the additional revenue might not be sufficient to offset the harm caused. (Wood & Williams, 2009:12.).

From the suggested amendments to the National Gambling Act, it can be concluded that the South African legislature agreed with Alarie and Igelman's suggestion to investigate only the possibility of regulating online gambling. The amendments to the existing

National Gambling Act included in the National Gambling Amendment Act *inter alia* include the following:

- the application of the act has been defined in section 2 thereof to include all gambling activities within the Republic thereby acknowledging the regulation of gambling activities only within the borders of South Africa and not trying to regulate interactive gambling where the provider operates outside the South African borders;
- the purpose of the act has also been included after it was omitted from the previous version and proposes to administer and address the socio-economical challenges relating to gambling, as suggested by Wood and Williams (2009:11-12);
- specific reference is now made to interactive gambling and it stipulates that a person may participate in gambling activities by means of electronic communication. Gambling premises have now been redefined to include websites as well. The act also defines the commencement and conclusion of an interactive gambling transaction and prescribes the way in which winnings and prizes should be paid and delivered;
- in terms of section 6B the National Gambling Board will resolve any disputes that may arise between the provider and the gambler relating to an interactive game;
- section 6C provides that a foreign national player may participate in interactive gambling within the borders of South Africa and will allow any winnings to be deposited in foreign bank accounts;
- administrative details in terms of the registration as an interactive gambling provider, the registration of a player, the set-up of bank accounts and the administration of player details and funds are also addressed;
- the act includes a section on the monitoring requirements of the National Gambling Board similar to the requirements on land-based casinos in terms of licensing of the provider and employees, approval of software used, inspection of websites and equipment and the auditing of the operation and results. This also concurs with the UK Gambling Commission, which was deployed by the Gambling Act 2005 to oversee all regulatory and licensing aspects on remote gambling;
- probably one of the most important amendments to the National Gambling Act is the inclusion of section 24(4) which prescribes that the interactive gambling equipment must be situated within the borders of South Africa; therefore, specifically stipulating

the licensed environment and limiting the regulation of this industry to operations within the borders;

- the amendments also refer to the conditions under which a licence may be issued or revoked; and
- section 88A has been included to stipulate that tax in respect of interactive gambling activities will be imposed in terms of appropriate legislation. Appropriate legislation refers to the Interactive Gambling Tax Bill which is also not effective yet, but suggests a 6% tax on gross gambling revenues of the operators. Gross gambling revenue is defined in the Interactive Gambling Tax Bill as the aggregate amount debited to player accounts less the aggregate of amounts credited to these accounts, prizes collected by the winner and amounts paid to the State.

In 2008 South Africa has therefore already identified the possibility of regulating online gambling in order to benefit from the additional tax revenue. The onerous requirements and the practicability of some of the amended sections of the National Gambling Amendment Act might be reason for it not being effective as yet, but clarity does not exist. However, it seems as though the Government has chosen the first option discussed above and has not elected to operate gambling sites on their own. Several online gambling sites operate from neighbouring countries and although South African residents currently illegally play on these sites, the suggested 6% taxation might deter these operators from relocating to operate within the borders of South Africa. This supports Devaney's (2009:275) opinion that the internet is borderless and interactive gambling providers will shop around for the most tax-competitive jurisdictions. Gibraltar (1%) and the Isle of Man (1,5%), for instance, charge lower tax rates and online gambling operators might rather locate there and operate from a low tax environment (Online Casino City, 2010). South Africa might therefore need to reconsider the 6% tax rate in order to create a more attractive option.

3.4.3 Excise tax

Another option for South Africa would be to impose an excise tax on gambling, a so called sin tax similar to excise duties on tobacco and liquor. The US imposes these taxes at a rate of 0,25% on state-authorized wagers and 2% in respect of unauthorized wagers (Blau,

2001:19). This excise tax is, however, not paid by the gambler, but by the person accepting wagers. Similar to the discussion on the already onerous contributions by the South African operator, this study argues that this option is not viable.

3.5 CONCLUSION

The suggestion to tax gambling winnings in the hands of all gamblers holds numerous challenges for government. This chapter discussed some of the administrative liabilities for both the gambler and the operator, particularly in terms of the additional reporting requirements.

South African courts have yet to be engaged in determining if a gambler is a professional gambler, as opposed to a casual gambler. Proper guidance on this distinction will have to be included in proposed legislation to tax gamblers in order to avoid confusion and ensuring proper disclosure of winnings on their annual tax returns. The Government has the challenge to decide on either to tax gross gambling winnings or tax net gambling winnings. Clarity on allowing gambling costs and losses as a deduction will also have to be included in order to avoid the misinterpretation thereof and gamblers consequently under-declaring their gambling winnings for tax purposes.

Weighing up the options to tax or not to tax gambling winnings, this study concludes that South Africa should leave the tax legislation on gambling winnings as is and rather investigate the option to legalise and regulate interactive gambling in order to broaden the tax base.

CHAPTER 4

SUMMARY, CONCLUSION AND VALUE OF THE STUDY

4.1 INTRODUCTION

The main purpose of this study was to investigate the possible amendment of South African tax legislation to tax gambling winnings effectively in the hands of the gambler by reviewing alternative treatments of the taxation of gambling winnings in the hands of the South African gambler. This study compared the current South African tax treatment of gambling winnings to the tax treatment and practices in the US and Australia (Chapter 2) and critically analysed the problems associated with these various treatments from a South African perspective (Chapter 3).

4.2 RESEARCH OBJECTIVES

The study was guided by the following specific research objectives:

- Chapter 2 analysed research studies and other literature on the taxation of gambling income in South Africa in order to establish the theoretical construct for this study;
- Chapter 2 analysed the taxation of gambling in the US and Australia; and
- Chapter 3 analysed and compared the taxation of gamblers in South Africa, the US and Australia, making use of the theoretical construct from Chapter 2 as underpin.

4.3 CURRENT LEGISLATION, DEVELOPMENTS AND TAXATION OF GAMBLING WINNINGS

The tax treatment of gambling winnings in South Africa and Australia are basically consistent. Both countries recognise gambling winnings of the professional gambler as gross income and are taxed similar to any other professional or business income. Gambling winnings of the casual gambler are not taxed, with the exception of winnings from outside the borders of South Africa or illegal gambling activities.

This study identified alternative tax treatments of gambling winnings by referring to the legislation in the US where all gambling winnings are taxed, whether these winnings were obtained from engaging in gambling as a professional gambler or merely as a casual gambler.

Legislation governing interactive gambling in South Africa has yet to be implemented and consequently the provision of and participation in interactive gambling remains illegal within the borders of South Africa. Although gambling winnings from interactive gambling are subject to capital gains tax, it is also submitted that the principles laid down in the *MP Finance Group CC v CSARS* case might be applied to tax these winnings as income of a revenue nature.

4.4 THE TAXATION OF GAMBLING WINNINGS FROM A SOUTH AFRICAN PERSPECTIVE

In general, it seems the US and Australian tax courts laid down similar factors when considering gambling activities to be a business or a hobby and in doing so have been reluctant to rule gambling to be a business. It is accepted that the South African courts will also rule that gambling is not a profession, which will entail the government receiving very little tax revenue from gambler's gambling activities, should the current tax treatment prevail.

If the South African Government still considers introducing a system where all gambling gains must be included in gross income, regardless of whether it was obtained from gambling as a business or a hobby, consideration should also be given to allowing gambling losses as a deduction. This study partners with the conclusion of Kee (1995:2) that the Government would not be in favour of such treatment since most gamblers make losses rather than gains.

It would be important to strive towards a balance between the taxation of the gambler and taxation of the industry, since the gambling industry is currently an important contributor to state revenues. Taxation on gambling winnings may discourage gambling activities, which could result in lower operator revenues and consequently a lower contribution towards

taxes. It is also presented that the casino industry makes valuable contributions in respect of corporate social investments and the alleviation of the unemployment rate in South Africa. Excessive taxation of this industry sees operators no longer being able to sustain such capital investments and consequently resulting in a possible increase in poverty.

Numerous challenges exist in balancing the taxation of this industry and this study discussed some of the added administrative burdens if the National Treasury considers taxing the gambling winnings in the hands of all gamblers. The legalisation and regulation of interactive gambling in South Africa prove to be an alternative to investigate and give South Africa the option of either hosting its own interactive gambling sites or making use of existing operators. Both alternatives give South Africa the option to reap benefits from the taxation of this untapped market.

4.5 CONCLUSION

This study analysed prior research studies and other literature on the taxation of gambling income in the US and Australia. It identified the US tax treatment as an alternative treatment to the current income tax legislation and practices in South Africa. The administrative burden and constant amendments to the regulating US legislation, however, prove this system to be far from perfection and a continuous challenge.

Although it has been a topic of many debates, interactive gambling seems to prove a lucrative alternative to broaden the South African tax base. South Africa recognised this when the Legislator drafted the National Gambling Amendment Act and Interactive Gambling Tax Bill, but these have not been implemented yet. This study investigated the treatment of interactive gambling in the UK, since this country legalised and has been regulating interactive gambling since 2005 and has since grown to the fourth-largest provider of interactive gambling.

This study concludes that South Africa should investigate the opportunity to legalise and regulate interactive gambling and proposes that the *status quo* against the taxation of gambling winnings of the casual gambler should prevail.

4.6 CONTRIBUTIONS AND SUGGESTIONS FOR FURTHER RESEARCH

This study investigated alternative legislation and practices in the US and Australia in order to make a contribution to the current South African income tax legislation as well as options to broaden the tax base. These could assist the National Treasury in its proposal to review the current tax treatment of gambling winnings in the hands of the gambler as well as its search for effective ways to broaden the tax base in order to alleviate the budget deficit.

Other researchers may extend the findings of this research in order to investigate the effect of the taxation of gambling winnings in the hands of the gambler on the gambler's propensity to gamble.

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