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No. A05-656

STATE OF MINNESOTA
IN SUPREME COURT

Estelle Busch,

Relator,

vs.

Commissioner of Revenue,

Respondent.

RESPONDENT'S BRIEF

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LEGAL ISSUES

1. In 2004 the Internal Revenue Service examined Relator's 2001 federal income tax return and, without considering the question presented by this case, made certain adjustments not relevant here. Did these actions foreclose Respondent from auditing Relator's 1999, 2000, and 2001 Minnesota income tax returns and making the adjustments at issue in the instant case?

The Tax Court held in the negative.

The most apposite authorities include: *Bond v. Comm'r of Revenue*, 691 N.W.2d 831 (Minn.), *cert. denied*, ___ U.S. ___, 125 S. Ct. 919 (2005); *Weed v. Comm'r of Revenue*, 550 N.W.2d 285 (Minn. 1996); and *Specktor v. Comm'r of Revenue*, 308 N.W.2d 806 (Minn. 1981).

2. Under Minnesota's statutory framework, a taxpayer may deduct gambling losses in computing alternative minimum tax liability only to the extent that during the taxable year, the taxpayer was engaged in the trade or business of gambling. In the instant case, did Respondent Commissioner of Revenue permissibly determine that in no taxable year during the period in question was Relator engaged in the trade or business of gambling?

The Tax Court held in the affirmative.

The most apposite authorities include: 26 U.S.C. §§ 55 and 165; Minn. Stat. §§ 289A.37 and 290.091 (2004);[1] and *Comm'r v. Groetzinger*, 480 U.S. 23, 107 S. Ct. 980 (1987).

[1] For convenience this brief will refer to the current editions of all cited statutes. Relevant provisions are identical to those in effect during the period in question in the instant case.

STATEMENT OF THE CASE

In this case Relator Estelle Busch appealed (App. A-104)[2] to the Minnesota Tax Court from a March 7, 2003, Order (App. A-69) of Respondent Commissioner of Revenue. That Order followed the Commissioner's audit of Relator's Minnesota income tax returns for the 1999, 2000, and 2001 taxable years ("audit period"). In it, the Commissioner determined that in computing her Minnesota alternative minimum tax ("AMT") liability for each of the three years in the audit period, Relator was not entitled to deduct gambling losses. Consequently, the Commissioner determined that Relator was liable for Minnesota alternative minimum income taxes for the audit period, plus interest computed through March 7, 2003.

The case was tried to the Court in St. Paul on December 22, 2004. On March 2, 2005, the Tax Court issued its Findings of Fact, Conclusions of Law, and Order (App. A-1), affirming the Commissioner's assessment. On March 18, 2005, the trial court issued a supplemental Order (App. A-12) correcting clerical errors in its earlier Order.

Relator timely obtained a writ of certiorari from this Court (App. A-156) to review the Tax Court's decision. Relator filed her Brief and Appendix ("Rel. Br.") on July 15, 2005.

[2] This abbreviation refers to Relator's Appendix.

STATEMENT OF FACTS

Relator retired in 1999 at the age of 65 (App. A-7). Until her retirement, Relator had worked as an administrative assistant, police dispatcher, teacher, landlord, and building renovator (App. A-7; Tr. 19).

From 1999 through 2001 Relator's reported income from non-gambling sources consisted of interest, maintenance from her former spouse, and social security benefits. Relator's federal income tax returns (App. A-18, A-33, A-37) showed the following non-gambling income:

YEAR	TAXABLE INTEREST	ALIMONY	SOCIAL SECURITY
1999	$14,843	$1,467	$5,982
2000	$9,635		$6,264
2001	$2,087		$6,348

Before 1998 Relator did not gamble (Tr. 8). In 1998 she began visiting local casinos, primarily Mystic Lake. In that year, her gambling winnings totaled $26,266 (App. A-169). Relator expanded this activity greatly during the three years comprising the audit period. From 1999 through 2001 she typically spent from 40 to 60 hours a week playing slot machines (App. A-3). Relator was not interested in other available forms of casino gambling (Tr. 9). The vast majority of Ms. Busch's gambling activity took place at the Mystic Lake casino (Tr. 8). All of Relator's gambling income during the audit period consisted of slot machine winnings. For each year in the audit period, Ms. Busch's slot machine losses exceeded winnings for that year (Tr. 21).

Relator viewed her slot machine playing as "plain hard work" (Tr. 23). Relator's desire was to win as much money playing slot machines as possible (Tr. 8). The overall success of this endeavor depended on the extent to which Ms. Busch could surmise in advance whether, on a given play, a slot machine would pay out. Ms. Busch understood that this would happen only when the machine's mechanism "rolled" favorably to the player (Tr. 28-30).

Relator sought to predict the pay-out tendencies of particular machines through observation and discussions with other Mystic Lake patrons (Tr. 10). Ms. Busch offered no evidence that these observations or discussions enhanced the accuracy of these predictions. Rather, she testified (Tr. 24):

> Q. ... What was the source of your expectation that you'd make a profit playing slot machines? ...
> A. I think that anyone that goes out and gambles thinks they're going to make money. ... I would think that's common knowledge, if you're going to go to a casino, you think you might make money.
> Q. You think you might make money?
> A. You hope you will. And I guess at times you think you will.

Ms. Busch testified (Tr. 28) to having read some published materials concerning slot machine play. However, she produced no examples of the materials, could not recall where she had read them, and did not state that these publications helped her to predict slot pay-outs more accurately (Tr. 28).

Ms. Busch was otherwise unfamiliar with how slot machines worked. She stated (Tr. 9): "Q. But you were familiar with slot machines? A. I wasn't familiar with slot machines except it didn't take a great deal of knowledge to play a slot machine." Ms. Busch later stated: "Well, I'm not an expert in chips in slot machines... " (Tr. 25), and "I

don't profess to be an expert, I was just playing the slot machines and that was my work." (Tr. 29).

On her 1999, 2000, and 2001 federal income tax returns (App. A-18, A-33, A-37), Ms. Busch respectively reported slot machine winnings of $79,482, $430,280, and $972,980. On her original 1999 and 2000 returns, Ms. Busch reported gambling losses equal to her gambling winnings as itemized deductions on Schedule A. On her 2001 return (App. A-37, A-41), she reported an amount in excess of her gambling winnings as a loss from the operation of a gambling trade or business on Schedule C. In 2004 Ms. Busch amended her 2000 federal return to similarly report gambling losses on Schedule C rather than Schedule A (App. A-80). Ms. Busch has not amended her 1999 federal return.

In August and September of 2004, the Internal Revenue Service conducted an examination of Ms. Busch's 2001 federal return (App. A-98 - A-103).[3] In the letter advising Ms. Busch of this examination (App. A-100), the auditor stated: "It appears you are treating your gambling activity as a business. If so, what are your reasons for treating this as a business?" The record contains no evidence as to whether, during the examination, the auditor pursued this question further. Ultimately, the IRS made certain adjustments to Ms. Busch's 2001 federal return (App. A-100a). None of these adjustments related to gambling winnings or losses.

[3] Approximately three months earlier, the IRS advised Ms. Busch (App. A-95 - A-97) that it had processed her amended 2000 federal return and that no additional assessment was then being made. The IRS has taken no further action with respect to Relator's 2000 return.

For each year in the audit period Ms. Busch carried her reported federal taxable income, which reflected her claimed gambling losses for that year, to her Minnesota income tax return. On none of her audit period Minnesota returns did Ms. Busch calculate a Minnesota AMT liability.

During 2002 the Commissioner audited Ms. Busch's 1999 through 2001 Minnesota returns in light of the large ratio Ms. Busch's itemized deductions bore to her adjusted gross income (Tr. 34). The audit's purpose was to determine Relator's audit period Minnesota AMT liability (Tr. 33). Under the Minnesota statutory structure, gambling losses are deductible in computing AMT only if the taxpayer was engaged in the trade or business of gambling during the taxable year.

Ms. Busch incurred her audit period gambling losses entirely from slot machine play. Paul Makousky, who conducted the Commissioner's audit, determined (Tr. 36-37) that especially in light of the nature of slot machines, Ms. Busch employed no skill in her slot machine play. Moreover, as illustrated on Commissioner's Ex. A (App. A-169), Ms. Busch was using other income sources to finance her gambling activities. These factors led Mr. Makousky to conclude (Tr. 36) that Ms. Busch's gambling losses had not been incurred in the operation of a trade or business, but instead partook of a hobby or recreation. He accordingly concluded that no deduction should be allowed for gambling losses in computing Ms. Busch's Minnesota AMT liability for any of the three taxable years at issue.

Based on these conclusions, the Commissioner issued Orders on August 14 (App. A-23) and December 4 (App. A-45), 2002, determining that Ms. Busch was liable for

total additional Minnesota AMT for the audit period of $94,996 plus interest. Ms. Busch instituted administrative appeals from these Orders (App. A-28, A-59). In a Notice of Determination on Administrative Appeal dated March 7, 2003 (App. A-69), the Commissioner affirmed these assessments with updated interest calculations.

Relator appealed the Commissioner's Order to the Tax Court (App. A-104). In its Order of March 2, 2005 (App. A-1), the Tax Court affirmed. The trial court initially rejected Ms. Busch's contention that the actions of the IRS foreclosed the Commissioner's assessments. The trial court stated (App. A-6): "[I]n reviewing Appellant's 2000 and 2001 amended federal returns, the IRS had no occasion to make a determination as to whether she was engaged in the trade or business of gambling. ... In the instant case ... the Commissioner is not barred from basing an assessment on a claim with respect to which the IRS has taken no action."

The Tax Court then upheld (App. A-9) the Commissioner's determination that during the period in question, Ms. Busch had not been involved in the trade or business of gambling:

> Typically, a taxpayer's carrying on of a trade or business coincides with the taxpayer's expenditure of skill or effort to accomplish a particular task. ... In the gambling context, this task is the maximization of profits. ... [A]nyone who goes out and gambles does so with the expectation—or at least the hope—she will win. But being engaged in a trade or business involves more than wishful thinking; the expectation of making a profit must be a realistic one. Appellant's use of slot machines, however, involved strictly a matter of chance.

On March 18, 2005, the Tax Court issued a supplemental Order (App. A-12) correcting clerical errors in the March 2 decision. This certiorari proceeding followed.[4]

ARGUMENT

I. STANDARD OF REVIEW

It is well settled that factual findings of the Tax Court, like those of other trial courts, may be reversed on appeal only if they are clearly erroneous. On the other hand, the Tax Court's legal conclusions are subject to *de novo* appellate review. "Although review of [the Tax Court's decision on] questions of fact is limited, this court has plenary power with respect to questions of law." *Nagaraja v. Comm'r of Revenue*, 352 N.W.2d 373, 376 (Minn. 1984); *accord, e.g.*, *Watlow Winona, Inc. v. Comm'r of Revenue*, 495 N.W.2d 427, 431 (Minn. 1993); *Benoit v. Comm'r of Revenue*, 453 N.W.2d 336, 339 (Minn. 1990).

Minn. Stat. § 271.06, subd. 7 (2004), makes the Minnesota Rules of Civil Procedure, where practicable, applicable to Tax Court proceedings. Thus, on appeal from a Tax Court order: "Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses." Minn. R. Civ. P. 52.01.

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[4] Another case involving the deductibility of gambling losses in computing Minnesota AMT liability is also pending in this Court. *See Pisarenko v. Comm'r of Revenue*, Supreme Court File No. A05-881. The taxpayers in *Pisarenko* do not contend that they were engaged in the trade or business of gambling. They argue instead that gambling losses should, on public policy grounds, be deductible in computing Minnesota AMT liability. *See* Respondent's Brief in *Pisarenko* at Resp. App. 9.

In appeals from decisions of the Tax Court and its predecessors, this Court has consistently held that: "our jurisdiction in reviewing fact questions is limited to determining whether there is reasonable evidence to sustain the findings." *Red Owl Stores, Inc. v. Comm'r of Taxation*, 264 Minn. 1, 9-10, 117 N.W.2d 401, 407 (1962), *quoted in Morton Buildings, Inc. v. Comm'r of Revenue*, 488 N.W.2d 254, 257 (Minn. 1992). "Where sufficient evidence exists upon which the Tax Court could reasonably base its conclusion, this court will uphold the Tax Court's decision." *World Plan Executive Council v. County of Ramsey*, 560 N.W.2d 87, 88 (Minn. 1997) (internal quotations omitted).

In the instant case, the Tax Court's legal conclusion that the actions of the IRS did not foreclose the Commissioner's audit is subject to *de novo* review. By contrast, the trial court's determination that during the audit period Relator was not engaged in the trade or business of gambling is a factual finding, which may be reversed on appeal only if clearly erroneous. The former conclusion was clearly correct. The record likewise fully supports the trial court's factual findings. This Court should therefore affirm the Tax Court's decision.

II. STATUTORY BACKGROUND

Minn. Stat. § 290.091 (2004) imposes the Minnesota AMT on individuals, estates, and trusts. Under section 290.091, subd. 1, a taxpayer's AMT liability is equal to 6.4% of the excess of the taxpayer's non-exempt alternative minimum taxable income ("AMTI") over the taxpayer's regular Minnesota income tax for the taxable year. Section 290.091, subd. 2(a) defines AMTI for this purpose as "the sum of the following for the

taxable year: (1) the taxpayer's federal alternative minimum taxable income, as defined in section 55(b)(2) of the Internal Revenue Code; (2) the taxpayer's itemized deductions allowed in computing federal alternative minimum taxable income, but excluding [certain itemized deductions not relevant here]."

Section 55(b)(2) of the Internal Revenue Code, 26 U.S.C. § 55(b)(2) defines federal alternative minimum taxable income in relevant part to mean: "the taxable income of the taxpayer for the taxable year—(A) determined with the adjustments provided in section 56 and section 58, and (B) increased by the amount of the items of tax preference described in section 57." None of these adjustments or additions prohibits the deduction of wagering losses, to the extent allowed by 26 U.S.C. § 165(d), in computing a taxpayer's federal AMTI. In this computation, gambling losses are thus always an allowable itemized deduction.

On the other hand, Minn. Stat. § 290.091, subd. 2(a)(2) requires that in computing a taxpayer's Minnesota AMTI, certain itemized deductions, including the one for gambling losses, be added back to the taxpayer's federal AMTI. Thus, a taxpayer who claims gambling losses as an itemized deduction on her federal return may not deduct these losses in computing Minnesota AMTI.

If, however, a taxpayer can show that gambling losses comprise ordinary and necessary expenses of carrying on a trade or business, the taxpayer need not claim these losses as Schedule A itemized deductions, but instead may report them on Schedule C of a federal return. In that case, Minn. Stat. § 290.091, subd. 2(a)(2) does not apply, and the

gambling losses are deductible in calculating the taxpayer's Minnesota AMTI. In the instant case, Relator has attempted to follow this course.

III. THE IRS'S ACTIONS DO NOT FORECLOSE THE COMMISSIONER'S ASSESSMENT IN THIS CASE.

Under current federal law, the question whether a taxpayer is engaged in the trade or business of gambling has no general effect on the taxpayer's federal AMT liability. Thus, in reviewing Relator's 2000 and 2001 amended federal returns, the IRS had no occasion to make a determination on that question. In the instant case, therefore, Relator seeks to bar the Commissioner from basing an assessment on a claim with respect to which the IRS has taken no action.

It is well settled that in such an instance, the Commissioner is not foreclosed from pursuing the state tax assessment. In *Bond v. Comm'r of Revenue*, this Court recently stated:

> Minnesota tax assessments ... are independent from federal tax assessments and may differ from federal assessments ... the Commissioner may adjust a taxpayer's gross income based on the Commissioner's own independent investigation of the taxpayer. ... We have, therefore, rejected the argument that federal adjusted gross income was conclusive, observing that such an approach would nullify several state statutes which give the Commissioner of Revenue authority to examine tax returns and make assessments if deficiencies are found. Moreover, if federal gross income was controlling, state tax authorities would be powerless to correct the taxpayer's return if the federal adjusted gross income were the result of a mistake or fraud.

691 N.W.2d 831, 838 (Minn.), *cert. denied*, ___ U.S. ___, 125 S. Ct. 919 (2005) (citing and quoting *Weed v. Comm'r of Revenue*, 550 N.W.2d 285, 289 (Minn. 1996), and *Specktor v. Comm'r of Revenue*, 308 N.W.2d 806, 807-08 (Minn. 1981)).

Relator contends (Rel. Br. 33) that in this case, the IRS did a "thorough and complete in-depth audit" of her 2001 federal return. This is a significant overstatement.

The IRS auditor raised at one point the question of whether Ms. Busch could justify her claim to be in the business of gambling. Yet the IRS's final disposition consisted only of minor adjustments to a few items on Schedule A of Relator's 2001 return. The IRS took no action at all concerning Relator's gambling winnings or losses.

The instant case is clearly distinguishable from authorities such as *Tarutis v. Comm'r of Revenue*, 393 N.W.2d 667 (Minn. 1986), and *Deboer v. Comm'r of Revenue,* No. 6712, 1997 WL 675466 (Minn. T.C. Oct. 27, 1997). *Tarutis* and *Deboer* stand for the proposition that the Commissioner may invoke collateral estoppel to preclude a taxpayer from re-litigating at the state level an issue already definitively resolved in federal litigation. Here, there has been no federal resolution—administrative or judicial—of the issue now before this Court.

The principles of *Bond, Weed,* and *Specktor* control this aspect of the case at bar. This Court should reject Relator's contrary contention and proceed to a review of the merits of the Tax Court's decision.

IV. THE TAX COURT CORRECTLY AFFIRMED THE COMMISSIONER'S DISALLOWANCE OF GAMBLING LOSSES IN COMPUTING RELATOR'S MINNESOTA AMT LIABILITY.

Minn. Stat. § 289A.37, subd. 3 (2004), provides: "A return or assessment of tax made by the commissioner is prima facie correct and valid. The taxpayer has the burden of establishing its incorrectness or invalidity in any related action or proceeding." The issue on this appeal is whether the Tax Court properly held that Relator had not overcome the presumptive validity of the Commissioner's assessment.

Prior to 1982, the federal AMT statute—like Minnesota's current one—allowed deduction of gambling losses in computing a taxpayer's AMT liability only if the taxpayer was engaged in the trade or business of gambling. In *Comm'r v. Groetzinger*, 480 U.S. 23, 107 S. Ct. 980 (1987), the United States Supreme Court considered the issue in the context of this prior federal statute. During 1978, the year in question, the taxpayer in Groetzinger: "busied himself with parimutuel wagering, primarily on greyhound races. ... He went to the track 6 days a week for 48 weeks in 1978. He spent a substantial amount of time studying racing forms, programs, and other materials. He devoted from 60 to 80 hours each week to these gambling-related endeavors." 480 U.S. at 24, 107 S. Ct. at 981. In discussing the criteria for being in a trade or business, the Court stated:

> We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. ... [I]f one's gambling activity is pursued full-time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzinger satisfied that test in 1978. Constant and large-scale effort on his part was made. Skill was required and was applied. He did what he did for a livelihood, though with a less-than-successful result. ... [R]esolution of this issue requires an examination of the facts in each case.

487 U.S. at 35-36, 107 S. Ct. at 987 (internal quotations and citations omitted).

Minn. Stat. § 290.091 subd. 2(a) (2004) requires a taxpayer to compute Minnesota AMT liability with reference to federal law. The standards set forth in *Groetzinger* and other cases construing pertinent provisions of the Internal Revenue Code should therefore inform decision of the instant case.

Relator asserts (Rel. Br. 18-19) that under these standards she qualified as having been in the business of gambling during the audit period. But as the Commissioner and Tax Court concluded, salient factors in this case compel a contrary finding. Ms. Busch did spend considerable time at Mystic Lake, and doubtless hoped that her slot machine play would prove profitable. However, this did not prove to be the case. Throughout the audit period, Ms. Busch relied on other income sources both to finance her gambling losses and pay other expenses. Thus Ms. Busch was not earning a livelihood from her gambling activities.

In *Groetzinger*, the Supreme Court pointed to continuity, regularity, and expectation of profit as crucial factors in determining whether a taxpayer was engaged in a particular trade or business. Ms. Busch has satisfied only one of these criteria. Her gambling activity during the audit period was indeed continuous. However, the slot machine play in which Ms. Busch exclusively engaged required no skill and was reasonably found by the Commissioner and the Tax Court to essentially comprise a form of entertainment. Ms. Busch could remember no specific written materials she had studied concerning the art of slot machine play. As the Tax Court correctly observed, the possibility that Ms. Busch would profit from her slot machine play depended solely on chance. In this light, the Commissioner and Tax Court were far from erroneous in finding that Relator did not qualify during the audit period as having been engaged in the trade or business of gambling.

None of the recent federal decisions on which Relator relies (Rel. Br. 26-28) supports her position. In varying contexts, these cases have upheld the IRS's

disallowance of claimed gambling losses. *See, e.g., Praytor v. Comm'r,* T.C. Memo 2000-282, 2000 WL 1231531 (Aug. 31, 2000) (disallowing claimed gambling losses); *Kochevar v. Comm'r*, T.C. Memo 1995-607, 1995 WL 760397 (Dec. 26, 1995) (disallowing claimed gambling losses in excess of gambling winnings); *Neymeyer v. Comm'r*, T.C. Summ.Op. 2002-120, 2002 WL 31163665 (Sept. 18, 2002) (taxpayers were not engaged in the trade or business of gambling, and claimed slot machine losses disallowed); *Erbs v. Comm'r*, T.C. Summ.Op. 2001-85, 2001 WL 1922999 (June 13, 2001) (same); *Panages v. Comm'r*, T.C. Summ.Op. 2005-3, 2005 WL 15138 (Jan. 4, 2005) (same). *See also Mertz v. Michigan Dept. of Treasury*, No. 240435, 1998 WL 440931 (Mich. Tax Tribunal, April 9, 1998) at *3 (taxpayers were not engaged in trade or business of gambling where slot machine play was not source of their livelihood and required no skill).[5]

Whether Relator was engaged in the trade or business of gambling is an inherently factual issue. The Commissioner and Tax Court have correctly resolved that issue. This Court should reach the same result.

[5] Relator also points (Rel. Br. 31-32) to section 183 of the Internal Revenue Code, 26 U.S.C. § 183. This provision limits the deductibility of expenses incurred in an activity not engaged in for profit to the gross income derived from that activity. In the gambling context, section 165(d) of the Code provides an identical limitation, essentially superseding section 183. The latter section is thus of no independent help to Ms. Busch.

CONCLUSION

For the foregoing reasons, this Court should affirm in all respects the Tax Court's March 2 and March 18, 2005, Orders in the instant case.

Dated: August 15, 2005

Respectfully submitted,

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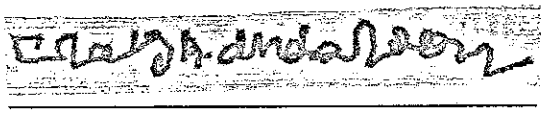

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