Zarin v. Commissioner, 91 T. C. 1047 (1988)

The discharge of gambling debt can result in taxable income even if the debt is legally unenforceable.

Summary

In Zarin v. Commissioner, the Tax Court held that the discharge of a gambling debt for less than its full amount resulted in taxable income to the gambler. David Zarin incurred significant gambling debts at Resorts International Hotel, which he later settled for a fraction of the amount owed. The IRS argued that the difference between the debt and the settlement amount constituted income from discharge of indebtedness. The court agreed, finding that Zarin received full value for the debt in the form of gambling chips and other benefits, despite the debts being potentially unenforceable under New Jersey law. The decision emphasized that legal enforceability is not determinative for federal income tax purposes and that the discharge of such debts can result in taxable income.

Facts

David Zarin, a professional engineer, gambled compulsively at Resorts International Hotel in Atlantic City, accumulating $3. 435 million in gambling debts by April 1980. Resorts extended credit to Zarin in the form of chips, which he used to gamble. After Resorts sued Zarin for the debt, they settled the claim for $500,000. The IRS asserted that the difference between the original debt and the settlement amount was taxable income to Zarin as discharge of indebtedness income.

Procedural History

The IRS issued a notice of deficiency for Zarin's 1980 and 1981 tax years, initially asserting income from larceny by trick and deception, but later abandoning that position. In its answer, the IRS claimed additional income from discharge of indebtedness for 1981. The Tax Court found that the IRS bore the burden of proof on this new matter and ultimately decided in favor of the IRS, holding that the settlement of Zarin's gambling debt resulted in taxable income.

Issue(s)

1. Whether the discharge of Zarin's gambling debt for less than its full amount resulted in taxable income to him under section 61(a)(12) of the Internal Revenue Code.
2. Whether the legal enforceability of the gambling debt under New Jersey law is determinative for federal income tax purposes.
3. Whether the settlement with Resorts should be treated as a purchase price adjustment under section 108(e)(5) of the Internal Revenue Code.

Holding

1. Yes, because the discharge of the debt resulted in an increase in Zarin's net worth, which is taxable as income under section 61(a)(12).
2. No, because legal enforceability is not required for the recognition of income from discharge of indebtedness for federal tax purposes.
3. No, because the settlement cannot be construed as a purchase-money debt reduction arising from the purchase of property within the meaning of section 108(e)(5).

Court's Reasoning

The court reasoned that Zarin received full value for his debt in the form of gambling chips and other benefits, which he used to gamble. The court cited United States v. Kirby Lumber Co. to support the principle that the discharge of indebtedness can result in taxable income. The court rejected Zarin's argument that the unenforceability of the debt under New Jersey law should preclude taxation, citing James v. United States for the principle that legal enforceability is not determinative for tax purposes. The court also distinguished the case from United States v. Hall, where the gambling debt was not liquidated, and found that Zarin's debt was liquidated and thus subject to taxation upon discharge. The court further held that the settlement with Resorts did not qualify as a purchase price adjustment under section 108(e)(5) because the "opportunity to gamble" did not constitute "property" within the meaning of that section.

Practical Implications

This decision clarifies that the discharge of gambling debts can result in taxable income, even if the debts are legally unenforceable. Practitioners should advise clients that the IRS may treat the difference between a gambling debt and a settlement amount as income from discharge of indebtedness. This case also highlights the importance of understanding the distinction between purchase price adjustments and discharge of indebtedness income, as the former is not taxable under certain conditions. Future cases involving the settlement of debts, especially in non-traditional contexts like gambling, should consider Zarin as precedent for the tax treatment of such settlements.

