**Internal Revenue Service**

Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B8
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Date:
May 03, 2005

In Re:

Legend: Taxpayer =

X =

Dear :

This responds to your request for a ruling that provides guidance for Taxpayer regarding the proper method under § 6041 of the Internal Revenue Code of reporting income to the players of the hereinafter described on-line game-playing tournaments sponsored by a website (the Site) operated by Taxpayer.

You indicate that the Site is located on the Internet and sponsors on-line tournaments for various games, such as checkers, golf, 9-ball pool, and mah-jongg. The Site also sponsors tournaments for word games, games of strategy, and arcade-style games. Aside from an introductory period for new players, the Site does not provide games for general entertainment purposes. After the introductory period, a player must enroll on the Site and provide the Site with a credit card in order to establish an account. The player makes withdrawals from the account in order to pay the required entry fees for participation in the tournaments. Winnings from a tournament are credited to the player's account. Taxpayer receives a payment for each tournament that is computed as a percentage of the entry fees for that tournament. Taxpayer also receives revenues from other sources such as on-line advertisement.

The tournaments are arranged into five categories:

1. : These tournaments designate the maximum number of players accepted into the tournament as well as pre-established winnings. These tournaments are also time limited; that is, if the tournament does not fill before it is closed, the leader of the tournament is awarded the full prize.

2. : These tournaments do not have a limited number of players, but will terminate at a specified date and time. Minimum prizes are pre-established. The number of players competing and

the size of potential prizes can increase over the period of competition. If the tournament does not fill before it is closed, the leader of the tournament is awarded the stated minimum prize.

3. : These are competitions between two individual players who challenge each other in an agreed upon game. Upon closure of the tournament, the winner is declared and a predetermined prize is awarded.

4. : These tournaments operate in the same manner as a tournament except that Taxpayer furnishes a prize, usually in the form of personal property, such as a television set.

5. X : Players compete against their own past performances. Those performances are established based on historical game play scores of the player. Here again, prizes are predetermined.

For all its tournaments, Taxpayer will pay the specified prizes (whether in cash or in kind) to the winning players, as established at the outset of the tournament, and such prizes are payable to the winners regardless of the number of players who enter the tournament. Taxpayer states that players competing in each tournament are categorized by skill proficiency in each game, thus allowing Taxpayer to limit participants in a particular tournament to players of similar skill. Also, Taxpayer states that it "has developed various mathematical formulas to ensure that all of its games are structured to eliminate the element of chance (other than the element of random chance inherent in the game itself)" so that "individuals who win the tournaments are those whose skills and game-playing strategies are superior to other players." Taxpayer suggests that it provides "identical game circumstances" because in tournaments, all players will receive the same first "hand;" subsequent "hands" will be of similar difficulty, a determination based on a proprietary game rating analysis software. In tournaments, players will receive hands of similar difficulty, again based on a proprietary game rating analysis software.

Taxpayer recognizes that there are situations it is required to report to the Service amounts it paid to players during a year. To comply with the reporting requirements, Taxpayer discusses three possible methods it could use when applying information reporting requirements to the tournaments. The methods are as follows:

Gross Method: Under this method, Taxpayer totals up the gross amounts credited to a player's account during a year, and if the total is $600 or more, Taxpayer will report this amount on a Form 1099-MISC.

Net Method: With this method, Taxpayer totals up the gross amounts credited to a player's account during a year, and subtracts the entry fee from each tournament the player received some kind of prize. Assuming this net amount is $600 or more, Taxpayer will report this on a Form 1099-MISC.

Cumulative Net Method: Under this method, Taxpayer totals up the gross amounts credited to a player's account during a year, and subtracts all entry fees paid during the year, regardless of whether the player received a prize from that tournament. Assuming this net amount is $600 or more, Taxpayer will report this on a Form 1099-MISC.

Taxpayer agrees that information reporting under § 6041 is required for prizes it pays to winning players, assuming it pays $600 or more in income to a player during a year. Taxpayer requests a ruling that the proper method of computing income from tournament play for information reporting purposes is the cumulative net method.

Taxpayer argues it should be able to deduct all entry fees from income paid by a player during a year under the cumulative net method. Under this method, Taxpayer subtracts all entry fees the player pays during a year from the total amount it paid to the player, and will report this net amount to the Service if it exceeds $600. Taxpayer argues that the cumulative method best reflects deductions the various players would be entitled to pursuant to §§ 162, 165, and/or 183 and, accordingly, best reflects the income paid to a player.

In the case under consideration, inasmuch as different information returns are required based on whether the payments are made in a wagering or a non-wagering transaction, it must first be determined whether the game-playing activities in the tournaments on the Site operated by Taxpayer constitute wagering or non-wagering activity. Based on the description of the tournament play, if the activities are to be classified as wagering, they must fall within the definition of either a "lottery" or a "wagering pool." However, these terms are not defined in the Code or regulations associated with federal withholding or reporting requirements. Thus, it is appropriate to look to dictionaries, court decisions, and other regulatory provisions to ascertain the ordinary meaning of the terms.

Wagering pool. The dictionary does not define a wagering pool. However, "pool" is defined as "all the money bet by a number of persons on the result of a particular event with the aggregate to be paid to the winner or divided among several winners according to conditions established in advance." Webster's Third New International Dictionary 1764 (1986). Similarly, Black's Law Dictionary defines pool as follows: "In various methods of gambling, a pool is a sum of money made up of the stakes contributed by various persons, the whole of which is then wagered as a stake on the event of a race, game, or other contest, and the winnings (if any) are divided among the contributors to the pool pro rata. Or it is a sum similarly made up by the contributions of several persons, each of whom then makes his guess or prediction as to the event of

future contest or hazard, the successful better taking the entire pool. Such pools are distinct from the practice of bookmaking." Black's Law Dictionary 1161 (6th ed. 1990).

United States v. Berent, 523 F.2d 1360, 1361 (9th Cir. 1975), notes that in "common usage the term pool connotes a particular gambling practice, an arrangement whereby all bets constitute a common fund to be taken by the winner or winners." State v. Duci, 727 P.2d 316, 319 (Ariz. 1986) notes that "pool selling" is generally defined as "the receiving from several persons of wagers on the same event, the total sum of which is to be given the winners, subject ordinarily to a deduction of a commission by the seller of the pool."

In connection with the tax on certain wagers imposed by § 4401 of the Code, § 44.4421-1(c)(1) of the Wagering Tax Regulations provides that a wagering pool conducted for profit includes any scheme or method for the distribution of prizes to one or more winning bettors based upon the outcome of a sports event or contest, or a combination or series of such events or contests, provided that such wagering pool is managed and conducted for the purpose of making a profit. Under § 44.4421-1(c)(3), a contest includes any type of contest involving speed, skill, endurance, popularity, politics, strength, appearances, etc., such as a general or primary election, the outcome of a nominating convention, a dance marathon, a log-rolling, wood-chopping, weight-lifting, corn-husking, beauty contest, etc.

Thus, these authorities suggest that a wagering pool is an arrangement to pool bets into a common fund, which are wagered on a sports event or contest, with the successful bettor (or bettors) receiving the pool proceeds, subject to the pool sellers commission. That contrasts with a situation where monies are received as entrance fees in order to compete for a preestablished prize offered by a third party that must be awarded in any case. Viewed under these criteria, we find that, although the tournaments offered on the Site involve fees paid to enter a contest operated by Taxpayer (who anticipates a profit from the endeavor), there does not appear to be an aggregation of the entrance fees into a common pool all of which (subject to commissions) is to be distributed by Taxpayer to the winner(s). Here, the minimum winnings or prizes of property are predetermined and must be awarded irrespective of the number of participants or the total of the entrance fees collected. Thus, the tournaments do not fall within a common usage definition of a wagering pool.

Lottery. Webster's Dictionary defines "lottery" as "a scheme for the distribution of prizes by lot or chance; esp: a scheme by which prizes are distributed among those persons who have paid for a chance to win them usu. as determined by the numbers on tickets as drawn at random (as from a lottery wheel)." Webster's Third New International Dictionary 1338 (1986). Black's Law Dictionary defines lottery as "a chance for a prize for a price. A scheme for the distribution of a prize or prizes by lot or chance, the number and value of which is determined by the operator of the lottery." Black's Law Dictionary 947 (6th ed. 1990).

U.S. Postal Service v. Amada, 200 F.3d 647, 651 (9th Cir. 2000), notes that where there is no applicable statutory definition of the term “lottery”, “the appropriate definition to apply is the common law lottery definition consistently used by the courts and described by the Supreme Court as the traditional tests of chance, prize and consideration.” (internal citations omitted.)

Section 44.4421-1(b)(1) provides that “lottery” includes the numbers game, policy, and similar types of wagering. In general, a lottery includes any scheme or method for the distribution of prizes among persons who have paid or promised a consideration for a chance to win such prizes, usually as determined by the number or symbols on tickets drawn from a lottery wheel or other receptacle, or by the outcome of an event. The term also includes enterprises commonly known as "policy" or "numbers" and similar types of wagering where the player selects a number, or a combination of numbers, and pays, or agrees to pay a certain amount in consideration of which the operator of the lottery, policy, or numbers game agrees to pay a prize or fixed sum of money if the selected number or combination of numbers appear or are published in a manner understood by the parties. Also see Rev. Rul. 57-521, 1957-2 C.B. 779, which holds that a puzzle contest participants paid to enter is neither a wagering pool nor a lottery for purposes of § 4401. The ruling indicates that, as a general rule, contesting for a prize offered by another in a contest of mental or physical skill of the contestant, which the one offering the prize must award in any event, is not gaming; and the fact that each contestant is required to pay an entrance fee does not make the payment a bet or gaming transaction unless the entrance fees alone comprise the prize to be won by the successful contestant.

Thus, these authorities suggest that, in general terms, a lottery is a scheme to distribute prizes to participants who pay to win the prize by chance. Taxpayer argues that because, (1) it does not allow players of dissimilar skills to play in the same tournament and (2) it uses its game rating analysis software play, the element of chance has been minimalized in its tournament play and, as such, the tournaments lack a key requirement for them to be considered as lotteries. Based on these representations, we believe that the tournament games lack the essential element of chance and cannot be classified as a lottery.

With respect to Taxpayer’s reporting requirements, § 6041 generally requires that all persons engaged in a trade or business report on a return all payments of $600 or more to another person made in the course of such trade or business of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income.

Section 1.6041-1(a)(2) of the Income Tax Regulations provides that the returns required under § 6041 are Forms 1096 and 1099.

Section 1.6041-1(d) provides that amounts paid as prizes and awards that are required to be included in gross income under § 74 and § 1.74-1 when paid in the course of a trade or business are required to be reported in returns of information under

§ 6041. In Taxpayer's situation, prizes are made possible by a player having paid the entry fee to that tournament. Therefore, when the player wins a prize by successfully competing in one of Taxpayer's sponsored tournaments, the entry fee to that tournament is a return of capital. See, for example, Rev. Rul. 55-638, 1955-2 C.B. 35, which holds that proceeds from a sweepstakes ticket acquired by gift before it became a winning ticket is includible in the gross income of the donee to the extent the proceeds from the sweepstakes exceeds the price paid for the ticket. Therefore, the amount of the prize includible in gross income is the prize amount net of the fee. Accordingly, only such net amounts are considered income for purposes of § 6041.

Entry fees for tournaments where a player does not receive a prize, however, are not a return of capital, and cannot be subtracted by Taxpayer when determining the income paid to a player. Although it is possible that individual players may be entitled to deduct on their respective returns entry fees they paid to Taxpayer, the Code requires the individual players to report all of their income and take all applicable deductions on their individual tax returns. There is no authority allowing Taxpayer to effectively take a deduction on behalf of a player by reporting the net amount to the Service on a Form 1099. However, no opinion is expressed as to whether a deduction is available or the character of the deduction.

Based on the above, Taxpayer should use the net method in determining which players it paid $600 or more during a year. The proper form Taxpayer should use is a Form 1099-MISC.

CONSIDERATION OF § 7805(b)(8) RELIEF

Taxpayer requests that this ruling be applicable on a prospective basis only under § 7805(b)(8). In support of its request, Taxpayer argues that in the absence of published guidance on this issue, it relied to its detriment on the right to use any reasonable method of reporting.

Relief under § 7805(b)(8) usually is granted only if a taxpayer relied to its detriment on a published position of the IRS or on a letter ruling or technical advice memorandum issued with respect to that taxpayer. There is no prior letter ruling or technical advice memorandum to Taxpayer. Taxpayer relied on its own interpretation of the law. A taxpayer's erroneous interpretation of the law is not a basis for relief under § 7805(b)(8).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that this document may not be used or cited as precedent.

Sincerely,

Associate Chief Counsel
(Passthroughs and Special Industries)

By:

Frank Boland
Chief, Branch 8

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes

cc: