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MEMORANDUM FOR GAMING ISP

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SUBJECT: Prenegotiated Debt Discharge in Gaming Industry

DISCLOSURE STATEMENT

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ISSUE

Whether, under the circumstances described below, a casino patron (customer) realizes discharge of indebtedness income when a casino accepts less than the face amount of the customer's marker (a debt instrument) in full satisfaction of the marker pursuant to a prearranged agreement with the customer.

CONCLUSION

We conclude that the prearranged discount on a gaming customer's marker should be treated as a purchase price adjustment under the facts presented. Purchase price adjustment treatment is appropriate in this case because the facts in this situation indicate that the intent and purpose of the parties was to effect a discount to the cost of the gambling services and entertainment, i.e., the customer's wagering losses. Among the salient facts so indicating are that the discount was negotiated prior to the customer's visit to the casino for the purpose of inducing the customer's visit to the casino, and was noted in writing in the casino's books prior to the signing of the marker. Although the absence of such prenegotiations and written record do not necessarily indicate that the discount results in cancellation of indebtedness income, we believe the presence of these factors offer a greater

degree of support for our conclusion. We prefer to consider other factual scenarios on a case by case basis. We also express no opinion on the federal tax consequences of other amenities offered by casinos to attract and retain patrons.

FACTS

According to representatives of the casino industry, foreign gaming customers with significant wagering histories are often offered attractive incentives to visit casinos in the United States. One such incentive is the marker discount whereby the foreign customer may negotiate or be offered a discount at which he may settle his marker if in a net loss position at the end of the visit. The terms of the discount are set at or before the signing of the marker and the agreement is informally noted in the casino's records. If a customer wins, the full amount of the marker is required to be paid. The marker is generally paid within several months after the marker is signed. If the customer does not pay the discounted marker, the casino attempts to collect the full amount of the marker together with any interest allowed under local law.

The foreign customer signs a marker and receives chips equal to the face amount of the marker. The chips can be used only to wager in that casino and cannot be exchanged for cash that could be applied by the foreign customer to some other purpose.

For financial accounting purposes, the casino treats the face amount of the marker as part of gross revenues, and treats the prenegotiated marker discount as an adjustment to gross revenues in arriving at gross income, i.e., the amount of the prenegotiated discount is a separate entry for financial accounting from the reserve for bad debts.

LAW AND ANALYSIS

Purchase Price Adjustment

Two inquiries must be addressed in determining whether the prenegotiated marker discount described above may be characterized as a purchase price discount. First, is a casino a purveyor of goods and services such that a consumer has purchased something the price of which may be discounted? And, assuming that the answer to the first inquiry is affirmative, second, was the purpose and intent of the parties to provide a formula for adjusting the price?

With respect to the first inquiry, we believe that a casino is in the business of providing entertainment and gambling services and that a customer's wager may be likened to the purchase of such services. Although the purchase price discount authorities our research uncovered deal mostly with adjustments to the purchase price of property, the theory is likewise applicable to the purchase of services. See,

Gunn, Alan, Another Look at the Zarin Case, 50 Tax Notes 893 (February 25, 1991). One might argue that a casino is merely providing a gaming forum so that customers may gamble against each other and against the house. If such a view is accepted, then a gaming customer is not purchasing goods or services when the customer engages in wagering activity and any rebate would simply be a reimbursement of wagering losses by a third party. However, we believe an observation of the gaming industry belies that characterization and that the better approach is to treat the casinos as providers of entertainment. See the Tax Court opinion in Zarin v. Commissioner, 92 T.C. 1084 (1989) at 1099, rev'd on other grounds, 916 F. 2d 110 (3d Cir. 1990), in which the court characterizes the gambler as purchasing the opportunity to gamble as well as incidental services. See also, Marroni, Mark J., Zarin v. Commissioner: Does a Gambler Have Income From the Cancellation of a Casino Debt, 27 New Eng. L. Rev. 993, 1009 (Summer 1993).

With respect to the second inquiry, the standard for determining whether a payment from a vendor to a customer is a purchase price discount or a payment for separate consideration may be found in Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), acq., 1962-2 C.B. 2. In that case, the Tax Court concluded that amounts paid by a milk producer to buyers were purchase price discounts because the "intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price." Pittsburgh Milk at 717. Thus, what distinguishes purchase price discounts from payments for other purposes or separate consideration is the purpose and intent of the parties.

This "purpose and intent" test has been followed in other cases. For example, in Sun Microsystems, Inc. v. Commissioner, 66 T.C.M. 997 (1993), the Tax Court determined that stock warrants granted in order to induce the purchase of computer workstations should be treated as sales discounts and should be excludible from the seller's gross income. The stock warrants were granted if the purchaser purchased a certain number of workstations within a certain period of time, and the court states "It is unlikely that the deal would have been consummated without that further inducement." Sun Microsystems at 999. The court concludes that the stock warrants should be treated as sales discounts in spite of the fact that the amount of the discount was not determinable at the inception of the agreement, and notes that "the negotiations clearly show that the warrants were included as an incentive to the purchase of the workstations .... " Sun Microsystems at 1005. This conclusion was based on a finding that, under the facts and circumstances, the purpose and intent of the parties was to adjust the sales price of the workstations. (See also Computervision v. Commissioner, 71 T.C.M. 2450 (1996)).

Similarly, in Freedom Newspapers, Inc. v. Commissioner, 36 T.C.M. 1755, (1977), a payment made by a party other than the seller, but intimately tied to the purchase agreement, to induce the purchase of property was held to be a purchase price reduction that reduced the purchaser's basis in the purchased property rather than ordinary income. In that case, a broker promised to pay $100,000 to a purchaser of

newspapers if the broker failed to sell one of the purchased newspapers within a one year period. The sale failed to occur, and the $100,000 was paid to the purchaser. In finding that the payment constituted a reduction to the basis of the purchased newspapers, even though the agreement to pay the $100,000 was separate from the purchase agreement, the court stated

> In view of the circumstances, it is obvious that the agreement with [the broker] was intended to and succeeded in inducing petitioner's purchase of the Jackson County Floridan. Freedom Newspapers at 1758.
>
> Under these facts, the payment received by petitioner pursuant to the agreement, even though made several years after the purchase of the Floridan, was sufficiently tied to the purchase that its characterization must be made by reference to the original transaction. Id. at 1759.

Based upon these authorities, we believe that the prearranged discount described above should be characterized as a purchase price adjustment or rebate granted to the customer by the casino. The facts and circumstances indicate that the discount is granted in order to provide an incentive and inducement to the customer to frequent a particular casino, in the same manner as a purchase price discount is given as an incentive to a purchaser of goods or services. The fact that the discount was prenegotiated strengthens this characterization. As will be discussed more fully below, the discharge of debt is the means by which the vendor/creditor effects the purchase price reduction or rebate to the customer/debtor.

Consistent with the authorities cited above we note that, because the discount is treated as a purchase price adjustment, it will reduce the amount of the gaming customer's losses by the amount of the adjustment. Thus, for example, if the gaming customer prearranges a ten percent discount, and gambles and loses chips in the amount of $100, the customer is treated as having paid $90 for the gambling opportunity, and the customer's loss under § 165(d) is limited to $90.

Discharge of Indebtedness Income

As discussed above, we conclude that the prenegotiated discount should not be treated as discharge of indebtedness income. In general, gross income includes income from the discharge of indebtedness. Section 61(a)(12); United States v. Kirby Lumber Co., 284 U.S. 1 (1931). However, in some cases in which the creditor and debtor also have an additional relationship, a debt discharge is used as a medium of payment of another type of obligation between a debtor and creditor. This principle was enunciated in OKC Corp. and Subsidiaries v. Commissioner, 82 T.C. 638, (1984) as follows:

> The rule of Kirby Lumber is clearly applicable where the only relationship between the parties is that of debtor and creditor and where the creditor is willing to accept less than full payment in discharge of the debt because of his concerns about the debtor's solvency, or because a rise in interest rates has devalued the loan. However, in many cases, the parties' transactions involve more than just a debtor-creditor relationship. See Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 Tax L. Rev. 225, 231, (1959). The cancellation of a debt may not be, in and of itself, the source of income but may simply be the method by which a creditor makes a payment to a debtor. ... Whether such payment is ordinary income to the debtor depends upon the nature of the payment. For example, a discharge of indebtedness may constitute a payment for services ... ; or a constructive dividend ... in which cases such discharge is ordinary income. On the other hand, a discharge of indebtedness may constitute a contribution to capital ... or a gift ... , in which cases the forgiveness of indebtedness is not income to the debtor. OKC Corp. at 648.

The Tax Court in OKC Corp. also noted that

> Courts have on occasion recognized an exception to the Kirby Lumber principle where the buyer of property negotiates with the seller/creditor for a discharge of all or part of the purchase money indebtedness to reflect a decline in the value of the property. The resulting discharge of indebtedness has been characterized not as income but as a retroactive reduction of the purchase price. OKC Corp. at 647.

The Service in Rev. Rul. 92-99, declined to follow cases permitting a purchase price adjustment by third party lenders because "the seller has received the entire purchase price from the purchaser and is not a party to the debt reduction agreement." 1992-2 C.B. 35, 36. However, this case does not involve a third-party lender because the casino, which provided the purchased services, is also the lender. Therefore, we conclude that it is appropriate to treat the debt reduction in this case as a purchase price adjustment, and as the means by which the seller of the services and/or entertainment, the casino, makes a payment to the purchaser of the services, the gaming customer.

In Zarin v. Commissioner, 92 T.C. 1084 (1989), rev'd, 916 F. 2d 110 (3d Cir. 1990), the Tax Court determined that settlement of a gambling debt gave rise to discharge of indebtedness income. In that case the facts and circumstances clearly indicated that the purpose and intent of the parties was not to effect a purchase price discount or rebate because the debt was forgiven after the casino attempted, but failed to collect the full amount of the debt. In Zarin, the Tax Court determined that the taxpayer received full value for his debt. In addition, the court notes that Zarin

bargained for and received "the opportunity to gamble and incidental services, lodging, entertainment, meals and transportation." Zarin at 1099. However, this case may be distinguished from Zarin because in this case the taxpayer bargained for and received the opportunity to gamble at a reduced cost of less than the face amount of the chips received. We agree that discharge of indebtedness income results when, as in Zarin, a taxpayer bargains for the opportunity to gamble at the full face amount of the chips received and the debt is later reduced under circumstances that do not reveal the intent to effect a rebate. However, we believe that when a taxpayer bargains for and receives the opportunity to gamble at a cost of less than the face amount of the chips received, discharge of indebtedness income does not result. We believe that there is a significant difference between the settlement of a debt for less than its full amount, and the reduction in the purchase price of goods or services. The fact of prenegotiation in this case makes the contrast even starker.

In Zarin, the Tax Court also determined that § 108(e)(5) did not apply to the transaction. Section 108(e)(5) treats a debt reduction as a purchase price reduction "if (A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced, (B) such reduction does not occur in a title 11 case, or when the purchaser is insolvent, and (C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness." The Tax Court noted that

> The 'opportunity to gamble' would not in the usual sense of the words be 'property' transferred from a seller to a purchaser. The terminology used in section 108(e)(5) is readily understood with respect to tangible property and may apply to some types of intangibles. Abstract concepts of property are not useful, however, in deciding whether what petitioner received is within the contemplation of the section. ... We conclude that petitioner's settlement with Resorts cannot be construed as a 'purchase-money debt reduction' arising from the purchase of property within the meaning of section 108(e)(5). Zarin at 1100.

We do not rest our conclusion in this case upon the application of § 108(e)(5) to this transaction. In this transaction, we view the gaming customer as purchasing services from the casino. Although a customer may negotiate a purchase price reduction for services, section 108(e)(5), by its terms, applies only to a reduction of debt for the purchase of property. Therefore, like the Tax Court in Zarin , we would not view § 108(e)(5) as applicable to a gambling debt.

In addition, it may be questioned whether the rationale we adopt (i.e., that a purchase price adjustment rationale under case law applies to a prenegotiated discount when the debt proceeds are used to gamble) may be applied to a factual situation in which the debt reduction was not prenegotiated. We believe that this rationale may apply to a debt reduction that is not prenegotiated, but the burden

upon the parties to establish the existence of a rebate agreement will be a difficult one. The fact that the discount is prenegotiated is strong and convincing evidence that the purchaser and provider of the services are negotiating to adjust a specific gross purchase price to an agreed net price for the services. The determination as to whether or not a discount results in an adjustment to the purchase price of goods or services is essentially a factual determination that must take into account all the facts and circumstances of the situation. See Thomas Shoe Co. v. Comm., 1 B.T.A. 124, 126 (1924) acq., IV-1 C.B. 3 (1925); Pittsburgh Milk v. Comm. at 717. Accordingly, we express no opinion on factual scenarios other than those described in this memorandum[1].

This approach is consistent with United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991). In that case, the Supreme Court determined whether a "discharge of indebtedness" existed for § 108(a), an exclusionary provision, rather than, as in this case, for purposes of § 61(a)(12), an inclusionary provision. The Supreme Court found there was no discharge of indebtedness under § 108(a) when a bank paid less than the amount deposited on a certificate of deposit because the depositor owed an early withdrawal penalty to the bank.[2] The Court held that a discharge of indebtedness occurs for purposes of §108 when a creditor "agrees to release a debtor from an obligation assumed at the outset of the relationship" 499 U.S. at 584, and determined that "it is necessary to look both at the end result of the transaction and the repayment terms agreed to by the parties at the outset of the debtor-creditor relationship" to determine if the debtor has realized income by reason of a discharge of indebtedness. 499 U.S. at 581. The Court went on to find that there was no discharge for purposes of the statute. Therefore, the bank could not exclude from income the early withdrawal penalties. In addition, the Court found that the difference between the amount deposited with the bank and the amount repaid to the customer, while not discharge of indebtedness income, was an accession to income.

If such a rationale were to be applied in this case, the prearranged discount given to the gaming customers would not be characterized as "discharge of indebtedness income" because at the outset, the terms of the debtor-creditor relationship do not obligate the debtor to repay the full amount of the debt in the event that the debtor is in a net loss position at the end of his visit to the casino. However, under Centennial, the difference between the amount borrowed by the foreign gambler (the face amount of the markers or chips) and the amount repaid, is arguably an

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[1] In this memorandum, we address only the prearranged discount on certain markers, and not complimentary goods or services (comps) provided by a casino to a customer.

[2]The bank argued that the amount was discharge of indebtedness income under § 108 because it would have been able to exclude the income under § 108(a).

accession to income by the gaming customer, as it was to the bank in Centennial. However, because we conclude that this difference should be considered a rebate or purchase price adjustment, it is not includible in income.