CASE COMMENT ON *COHEN V. CANADA*

By Stuart Hoegner

In early May of this year, before Justice Frank Pizzitelli of the Tax Court of Canada in Toronto, an appeal took place that once again tested whether the Income Tax Act[1] will compel the inclusion of gaming winnings into—or allow the deduction of gaming losses from—the income of a taxpayer in Canada. Once again, the answer came back that Canadian courts are reluctant to bring gaming winnings, except under very specific circumstances, into the taxation net.

The decision in *Cohen v. Canada*[2] is unsurprising in some senses. Steven Cohen, the appellant, disputed the denial of losses from his gaming business in 2006. He lost his appeal, but *Cohen* will offer some useful signposts for future taxpayers at the tax planning and litigation stages. With respect to planning in particular, the case should be read by anyone playing poker in Canada wondering whether his or her wins or losses are taxable or deductible, respectively. While *Cohen* is consistent with prior decisions dealing with gaming winnings and losses and provides some new guidance for taxpayers, certain elements may be confined to the facts of that particular case. There are also some conceptual questions raised but unanswered by *Cohen*. There are indications about how taxpayers are to behave, but this area of tax law in Canada is still not as clear as it could or perhaps should be.

Overview

The facts in *Cohen* are straightforward.[3] Steven Cohen was an associate at a large Toronto law firm. In late 2005, he decided to leave the firm to take up playing poker on a full-time basis effective in the 2006 taxation year. However, he did not resign his associate position. Instead, he avoided taking on new work and started passing along his client files to other lawyers in the firm in the expectation that his employment would eventually be terminated. This, in fact, happened on March 24, 2006. The appellant's termination agreement called for payment to him of his full salary for seven months after his dismissal. The arrangements (agreed to by Cohen) included a provision that he was to let his former employer know about any new business venture or employment started by him during the severance period, at which point he would be paid only 50 percent of the remaining severance entitlement from the date of the new venture or employment.

In the Statement of Business Activities (Form T2124) attached to his 2006 personal income tax return, the appellant reported income from "gambling" of just over $81,283[4] (representing "winnings or cash outs"[5]) and expenses of $203,274, for an aggregate loss for the year from a business of approximately $121,991. Included in the expenses were processing fees paid to Neteller in respect to funding his Internet poker play, travel expenses to attend land-based poker tournaments in Las Vegas, and books and a Camp Hellmuth seminar on poker.

Cohen testified that he had played poker since the age of 21 (he was 33 in 2006) as a hobby, initially concentrating on seven-card stud. In 2005, he transitioned to Texas hold'em and claimed he became successful in small-stakes games. Cohen gave evidence that, in 2006, he logged more than 2,500 hours of playing time—clearly he retained the lawyer's habit of measuring his business time in hours—mostly on four Internet poker sites. He apparently cashed in six of 45 tournaments entered on sundry trips to land-based events in Canada and the United States. (The judge noted that the appellant only chose land-based tournaments "where such tournaments were of course legal"[6] but makes no comment on the legality of hosting online tournaments or cash games in Canada in 2006. On Cohen's own testimony, he was playing on Internet poker sites that year.)

Irrespective of what the appellant claimed was his new business of playing poker, he did not advise his former law firm of the venture pursuant to his termination agreement and collected the full severance as if he had started no new employment or business venture during the severance period. This would come back to haunt him.

The Canada Revenue Agency (CRA) denied the loss claimed by

the appellant. Cohen appealed from this assessment to the Tax Court.

The Tax Court's Analysis

The court correctly put the central question of the appeal up front: Was Cohen's income from playing poker in 2006 income from a business source for the year?[7] In other words, did his poker-playing constitute a business carried on by him in 2006?

Justice Pizzitelli started by citing the leading case on whether a taxpayer's activities constitute a source of business or property income. In *Stewart v. Canada*,[8] the Supreme Court of Canada considered the deductibility of expenses in a real estate investment and a challenge to the then-dominant "reasonable expectation of profit" test under Section 9 of the Act. The court in *Stewart* stated that, whenever a taxpayer's venture "contains elements which suggest that it could be considered a hobby or other personal pursuit," there should be an inquiry to see if that venture "is undertaken in a sufficiently commercial manner."[9] If it is, the venture will be a source of income from and, in the case of Cohen, a source of business income. There must be a "predominant intention" on the taxpayer's part to profit from the activity, and that activity must have been "carried out in accordance with objective standards of businesslike behavior."[10] As the court in *Cohen* put it, "[t]here must be more than the mere hope or desire of winning,"[11] which every gambler presumably has. There must be a planned, deliberate and reasonable expectation of winning more than losing in order to make a profit.

> Pizzitelli expressly adopted the Stewart test and articulated a framework for assessing whether a taxpayer's poker winnings or losses should be within or outside of the Canadian tax net. This is new.

As a threshold matter, Pizzitelli found that there was a personal element in poker, not only because the appellant had been playing as a hobby for 12 years before "going pro" in 2006, but far more importantly, because the court simply believed, without much in the way of analysis, that playing poker is generally thought of as a personal activity, with professional players in the minority ranks. The nature of the activity in *Cohen* is just not one "that I or many courts before me, could find has no personal element."[12] This is effectively a presumption that may assist future taxpayers in keeping poker winnings out of the tax net.

Having established that there was a personal element in the appellant's playing Texas hold'em, the court turned next to a determination of whether he had an intention to profit and whether that intention was borne out by objective evidence. Here, Pizzitelli endorsed and employed the factors set out in *Moldowan v. Canada*,[13] namely: profit and loss experience in prior years; the taxpayer's training; the taxpayer's intended course of action, as set out in a business plan; and the capability of the venture to show a profit.[14]

The court only briefly addressed the profit and loss experience; on the appellant's own evidence, there was no business before 2006. As for the taxpayer's training, the court was unimpressed, holding that, notwithstanding the books purchased and the seminar attended, Cohen had submitted no "reliable evidence of any meaningful formal or other training or how it improved his level of play to a level of a professional poker player as he called himself."[15] Pizzitelli here highlighted the presence in materials before the court of an article titled "Some Percentages and Math"—in fact, it appears to be an excerpt from *Phil Gordon's Little Green Book: Lessons and Teachings in No Limit Texas Hold'em*, co-authored by Phil Gordon, Howard Lederer and Annie Duke—suggesting that what one needs to know of mathematics of poker "isn't all that complicated—it's nothing a reasonably able fourth grader couldn't handle with a little bit of practice."[16] The court would come back to this piece of evidence.

With respect to the taxpayer's intended course of action, the court found that the appellant's business plan was non-existent. It apparently comprised a listing of calculated odds, a list of considerations when contemplating a move, a summary of Mike Caro's laws of tells, typewritten notes on game strategy and some additional notes on specific World Series of Poker® strategy. In his first year of business, Cohen testified that he expected to make $150,000 in profit and, subsequently, up to $500,000 per year.

What Cohen may have thought was his strongest point turned out to be one of his weakest in the court's estimation. This hodgepodge of notes and calculations did not amount to a reasonable business plan or make out any systematic method of winning. There was no indication of how the appellant arrived at his $150,000 profit estimate for the first year. Cohen opened no bank account and obtained no credit card for the business, sought no financing, and did not get any tax, accounting or other advice. He did not keep good business records of the number of Internet poker games he played or won or how much he won or lost. The court's concluding paragraph on this criterion is worth quoting in full:

"Moreover, if the documents constituted his strategies or system to minimize risk, as he argued, he admitted that in April of 2006, he switched from low stakes games to higher stakes games, where more experienced players participate, at which he was not very successful and led to credit and financial problems, ultimately leading him to abandon the venture at the end of 2006. While he indicates he made a mistake in business judgment, the fact that the so-called plan was not even followed after the first three months of the year, during which time he was also in the employ of his law firm, hardly serves to lend credibility to it as being a well thought out and executed plan. In my view, the so-called plan documents are nothing more than a loose compilation of notes he compiled from his reading materials and experiences in playing, including during the 2006 year itself. It does not suggest a well thought out business plan created in advance of commencing commercial operations."[17]

Finally, with respect to the capability of the venture to show a profit, the appellant tendered no evidence of a budget or some

other specific plan to show a profit. That the appellant, in fact, lost money, should not have been relevant here (the best-laid plans of a businessperson can go awry), but the *only* evidence was the losses; there was no indication that there were systematic projections that the business could be ever be profitable.

The court also had significant problems with Cohen's credibility. The appellant's new law practice was in existence from March 2006, coinciding with his termination by the previous law firm. The court took this to mean that, in fact, the new law practice was his business and that poker remained a hobby. Also, the court expressed its displeasure that the appellant did not notify his old firm of the new venture, as was his obligation under the termination agreement. Again, the court concluded that he did not notify the old firm because he did not truly believe that he had started a new business. In effect, the court stopped him from claiming that he had a new business when he didn't advise his old employer that he had one.

The court had no difficulty dismissing Cohen's appeal, finding that there was no poker-playing business carried on by him in 2006. The court awarded costs to the respondent in the normal course.

Comments

Cohen is consistent with prior case law on key points related to the taxation of gaming winnings—and deductibility of gaming losses—in Canada. The decision also gives some helpful guidance to future poker-playing taxpayers on a couple of points. However, at least one aspect of the judgement is very fact-specific and may not assist future litigants. Also, there are some aspects of the judgement that raise more questions than they answer about this area of tax law.

There is a presumption against taxing the winnings of poker players in Canada. For most people, poker—in any of its variations—is just a hobby, even if it's a lucrative one. Pizzitelli as much as said so in *Cohen* when he stated that "[m]oreover, the nature of the activity, whether it be called gambling or poker playing, is in my view generally considered a personal activity."[18] This is a presumption against the taxation of poker winnings in all but name. Most poker players are safe from taxation on their profits in Canada. However, the court has wisely left the door open to the taxation of poker profits and the allowance of losses on the right facts and where the governing judicial tests are satisfied.

The other principle that seems to emerge from the case law and that is endorsed by *Cohen* is that winnings from poker playing are likely only taxable as income from a business. Texas hold'em winnings are conceptually distinct from wages, salaries or passive income, and Canadian courts have been reluctant to extend tax liabilities to cover unenumerated sources. All that really leaves, within the framework of source income that's embedded in the act, is income from business. The court in *Cohen* noted that the parties agreed that the only issue was whether the winnings were from a business source.

The court also correctly recognized that the *Moldowan* badges of subjective intention to profit are not exhaustive. While Pizzitelli focused on the four criteria expressly set out by the Supreme Court in *Moldowan* (the taxpayer's training and

intended course of action, etc.) he re-iterated and endorsed late Chief Justice Dickson's observation that the list is not static. There may be other factors that are particularly relevant in a Texas hold'em taxation case (e.g., risk minimization and whether a taxpayer is recognized as a professional poker player through an endorsement deal), and the court wisely left the door open to considering such factors in future cases.

At the same time, Pizzitelli expressly adopted the *Stewart* test and articulated a framework for assessing whether a taxpayer's poker winnings or losses should be within or outside of the Canadian tax net. This is new. Future taxpayers will have a more detailed route map to follow at the stage where they are determining whether poker profits are taxable and losses deductible. As useful is that they also now have a template of sorts to argue points before the Tax Court, assuming that things can't be resolved at the notice of objection stage. Taxpayers now know that they must, as with other endeavors, keep good business records to bring before the CRA and the court. They must also, for example, be able to articulate a clear and coherent business plan and how the venture will come to profit. It's not as though this information is new; *Stewart* was decided in 2002. But now the tax court has affirmatively applied the template to poker, both online and land-based, and given an indication of how it expects cases like this to be framed and to proceed in the future.

The distinction, or lack of one, between Internet poker and poker played in brick-and-mortar establishments is also worth noting. As noted above, Pizzitelli was careful to note that the appellant only played in live games where it was legal to do so but made no mention of the legality of Internet poker in Canada. (In all likelihood, it is not against the law to play real-money poker online in Canada.) The treatment of all poker winnings and losses (both from land-based and Internet activities) as conceptually the same in the holding means that there should be no distinction for Canadian taxation purposes between profits and losses from online or live play.

However, there is at least one part of the judgement that may not be useful to future litigants. The court was obviously displeased with what it perceived to be the appellant's lack of credibility with respect to a number of key points, including not letting his former employer know of his new Texas hold'em playing "business" and forgetting a gambling holiday to Las Vegas around the time that he made the decision to change careers. A disbelieving judge is the death-knell for many litigants. This factor may not have changed the result in this case. The evidence was that the appellant's business plan was still slap-dash and his books and records were in disarray, but the court's lack of trust in Cohen's credibility clearly did not help his cause. Future professional Texas hold'em players and taxpayers able to establish their own credibility with the Tax Court should have an easier time getting the court to believe the key points they wish to make. Whether that results in judgement in their favor should still depend on application of the objective tests to determine the intention to profit as set out in *Cohen*.

There are a couple of aspects of the judgement that merit comment and appear to raise their own questions. For example, the judge repeatedly refers to the fourth grade level of mathematics apparently required in poker in order to diminish

aspects of the appellant's business plan[19] and to suggest that Cohen was not "calculating," because, at the end of the day, a fourth-grader is supposed to be able to be just as calculating.[20] First of all, as a factual matter, the finite mathematics of poker appear to be considerably beyond most primary schools in this country.[21] Second, even assuming the court's fixation on this point is true, why does it matter? Must a hobby require an advanced understanding of mathematics in order to be a *bona fide* business if it otherwise conforms to the *Stewart* test? Should this really be part of the test for whether an activity is a business or not?

A more fundamental issue is left open by the court. What if Cohen had ticked all the boxes to demonstrate a business but had simply been a loser? That is, what if he had a business plan that completely satisfied the court, had an organized regimen for obtaining formal and experience-based training with a clear plan for improving his play, and had let his former employer know that he was starting a business based on playing poker for a living, but after all that, he just wasn't that good at poker? (The point about letting his old employer know about his activities is problematic all on its own. If the appellant had refused severance payments, the other facts would have been the same and the court's decision to dismiss the appeal would presumably be unchanged.) Would the court actually have allowed this appellant to deduct or carry forward losses of almost $122,000?

Technically, the answer must be yes. As Pizzitelli affirms, it is the commercial nature of the taxpayer's activity that's under the microscope, not his business acumen. Benjamin Alarie, in an excellent monograph on the taxation of poker last year, suggested that the best case that the Minister of National Revenue could muster would be to attempt to tax a poker player exhibiting consistently positive results over the long run.[22] He may very well be right. However, and in spite of the court's protestations, does that mean that the courts *will* question the taxpayer's business acumen after all? Does it boil down to this: "[S]ince you won, it proves you must have had a system and therefore a business. If you had lost, it would have proved you had no system and therefore no business and you could not have deducted your losses"?[23] This approach was expressly rejected in *Leblanc* precisely because it is so ends-driven.

The response might be that Cohen was bound to fail because of the lack of factors meeting the *Stewart* test, so the actual failure of the enterprise is just a byproduct of there being no business and not proof of the lack of a business. Perhaps. Conceptually, however, sustained success doesn't necessarily follow from a well-crafted business plan and intensive and disciplined training. Even for skilled players, swings and bad beats mean that fortune may not follow consistently, as any true professional knows all too well. In *Cohen*, the appellant gave up after less than a year, but what if he had kept at it? Is one year or even a few years enough time to truly assess whether someone has a legitimate business playing Texas hold'em? It will take further pronouncements by the Canadian courts to find out.

This is a case that will interest anyone that is ordinarily resident in Canada who plays poker. For most such players, poker (whether online or land-based) won't be a taxable activity. This general presumption is affirmed by *Cohen*. Steven Cohen's appeal also gives some useful signposts to future taxpayers finding themselves in a dispute with the CRA and before the Tax Court. Certain aspects of *Cohen* seem problematic and will need further decisions to address things more clearly. In general, however, we have a decision that is broadly consistent with prior case law. It's part of a trend that may give some comfort to poker players that make their living playing Texas hold'em and that consistently win.

1 R.S.C. 1985, c. 1 (the Act).

2 [2011] T.C.J. No. 199 (T.C.C.).

3 The facts are set out in more detail in *ibid*. at paras. 2-6, inclusive.

4 All amounts in this comment are in Canadian dollars.

5 *Supra* note 2 at para. 3, Pizzitelli T.C.J.

6 *Ibid.* at para. 6, Pizzitelli T.C.J.

7 Section 3 of the act describes the basic rules that determine the amount of a taxpayer's income for a taxation year. A taxpayer's income includes "all amounts ... from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer's income for the year from each office, employment, business and property." *Supra* note 1 at s. 3(a). The concept of "source" is essentially one of productive value; one's sources of income are one's productive sources of income only, whether from wages, rents, interest, or other like sources. Importantly, the parties in Cohen agreed that the only source from which Cohen's income and loss could be generated were from business. On the parties' consent, poker winnings and losses could not be from any other source, whether explicitly set out in section 3 of the Act or not.

8 [2002] 2 S.C.R. 645.

9 *Ibid*. at para. 52, Iacobucci & Bastarache JJ.

10 *Ibid*. at para 54, Iacobucci & Bastarache JJ.

11 *Supra* note 2 at 23, Pizzitelli T.C.J.

12 *Ibid*. at para. 18, Pizzitelli, T.C.J.

13 [1978] 1 S.C.R. 480.

14 *Ibid*. at 486.

15 *Supra* note 2 at para. 30, Pizzitelli T.C.J.

16 *Ibid*.

17 *Ibid*. at para. 40, Pizzitelli T.C.J.

18 *Ibid*. at para. 18, Pizzitelli T.C.J. See also supra note 12 and accompanying text.

19 *Ibid*. at para. 33.

20 *Ibid*. at para. 46.

21 See for example R.C. Hannum & A.N. Cabot, *Practical Casino Math*, 2nd ed. (Las Vegas: Trace, 2005) at 163-172. The criticism on this point may have as much to do with the evidence led by the appellant as anything else.

22 B. Alarie, "Income Taxation of Poker Winnings in Canada" (2010) Taxwiki.ca eBook #1, at 31.

23 *Leblanc* v. *R*., 2007 D.T.C. 307 (T.C.C.) at para. 42, D.G.H. Bowman C.J.T.C. Leblanc addressed the taxation of two brothers who consistently won at sports betting. They were held not to be taxable on the winnings.

STUART HOEGNER

Stuart Hoegner is a gaming attorney and an accountant in Toronto. He advises his clients on skill games, games of chance, auctions, contests, mergers and acquisitions, and tax matters. His clientele includes Internet gaming operators, software developers, marketing and advertising companies, and social media entrepreneurs. Follow him on Twitter @GamingCounsel.