The Morning After: Tax Planning for Lottery Winners

01.31.1999

In a past issue of the *Journal of Taxation*, Farhad Aghdami wrote an article titled, "The Morning After: Tax Planning for Lottery Winners." As the subject is once-again rather timely, we have reposted the full article below:

For some taxpayers, the dream of a sudden windfall can turn into a awful tax headache. Winning a major lottery prize requires an immediate examination of the winner's situation, often including a choice of whether to take the award in a lump sum or as an annuity, determining if there was a preexisting agreement to share costs and winnings, deciding on whether to make gifts—charitable or otherwise—and calculating the impact on the winner's potential gross estate.

Every day, in 37 states and the District of Columbia, lottery contestants take a chance on becoming instant millionaires. If they win, their lives will forever be changed by new social, family, and financial pressures. Among the issues they must immediately confront are the tax implications.

INCOME TAX ISSUES

From an income tax perspective, the issues include the timing of income recognition, application of the constructive receipt and economic benefit doctrines, withholding, the ability to offset losses, and the potential to assign or sell the lottery proceeds.

Inclusion in Income

There no longer is any question (if ever there was) but that winnings from lotteries and raffles are gambling winnings included in gross income under Section 61 .[1] In addition, Section 74(a) states that "gross income includes amounts received as prizes and awards."[2] Section 102(a) provides an exclusion from income for gifts, but a lottery prize is received in exchange for the purchase of a lottery ticket and not from the "detached and disinterested generosity" of the lottery.[3]

In some instances, when a lottery prize is payable in installments, the lottery may purchase a bond oran annuity, and a portion of each annual installment may be designated as interest on the unpaid balance. Section 103(a) provides that "gross income does not include interest on any State or local bond." Given the fact that a portion of each annual installment of a lottery prize is designated as interest, there is at least a colorable argument that the interest being paid falls within the scope of Section 103(a).

Nevertheless, Rev. Rul. 78-140, 1978-1 CB 27 , states that amounts designated as interest to be paid on the unpaid annual installments of the grand prize of a state lottery, with the interest and the installments totaling the stated amount of the prize, will not be excludable from gross income of the winner under Section 103(a).

The new "qualified prize" option. Virtually all individual taxpayers are on the calendar year and report income using the cash receipts and disbursements method. Section 451(a) and Reg. 1.451-1(a) provide that an item of gross income is includable in income for the tax year in which actually or constructively received by the taxpayer. [4] Under the "constructive receipt" doctrine, a lottery winner who is given the option of receiving either a lump-sum distribution or an annuity is required to include the value of the lottery prize in gross income, even if the annuity option is exercised. State lotteries are able to circumvent the application of the constructive receipt doctrine by requiring lottery contestants to irrevocably choose between a lump-sum payment or annuity prior to purchasing a ticket.[5]

Many lottery contestants, however, do not give careful consideration to the tax and financial implications of either a lump-sum distribution or annuity. The Tax and Trade Relief Extension Act of 1998 (P.L. 105-277, 10/21/98) affords some relief in this regard. Newly enacted Section 451(h) provides that a lottery winner may be able to elect (subject to the state's adopting the necessary legislation or regulations), within 60 days after winning the lottery, to receive a lump-sum distribution or an annuity. This new statute overrides the constructive receipt doctrine and permits lottery winners to consult with their family, attorneys, accountants, and financial planners after winning the lottery in order to determine which payment option is most consonant with their goals and objectives. The tax and financial considerations associated with a Section 451(h) election are discussed under "Planning," below.

The new law, which is effective for individuals winning the lottery after 10/21/98, creates a "qualified prize option" and a "qualified prize." [6] A "qualified prize" is "any prize or award which (i) is awarded as a part of a contest, lottery, jackpot, game, or other similar arrangement, (ii) does not relate to any past services performed by the recipient and does not require the recipient to perform any substantial future service, and (iii) is payable over a period of at least 10 years." A "qualified prize option" is an "option which (i) entitles an individual to receive a single cash payment in lieu of receiving a qualified prize (or remaining portion thereof), and (ii) is exercisable not later than 60 days after such individual becomes entitled to the qualified prize." Section 451(h)(1) provides that, for a cash-method taxpayer, a "qualified prize option shall be disregarded in determining the taxable year for which any portion of the qualified prize is properly includible in gross income of the taxpayer." Section 451(h)(3) also instructs Treasury to issue Regulations for the application of the new rules to partnerships or other pass-through entities consisting entirely of cash-method individuals.

A significant transition rule gives previous lottery winners a one-time option to receive a lump-sum cash payment. Section 5301(b)(2) of P.L. 105-277 provides that, for an 18-month period commencing on 7/1/99 and continuing to 12/31/00, previous lottery prize winners receiving payment in the form of an annuity may elect a lump-sum distribution equal to the present value of the remaining annuity payments. [7] As noted above, Section 451(h) and the transitional rule do not automatically apply to all lottery winners; a lottery must amend its rules to permit a qualified prize option. Nevertheless, it is anticipated that most lotteries will begin offering the qualified prize option to prospective lottery contestants and prior lottery winners on 7/1/99.

Unfortunately, Section 451(h) creates a class of prize winners who are not afforded its benefits. Under the statute, there are three classes of prize winners:
(1) Prize winners prior to 10/22/98 ("pre-effective date winners").
(2) Prize winners after 10/21/98 and before 7/1/99, the date on which it is anticipated that most lotteries will begin to offer a qualified prize option ("interim winners").
(3) Prize winners after 6/30/99 ("qualified prize option winners").

Thus, as of 7/1/99, the pre-effective date winners can make the one-time "18-month election" to receive a lump sum. Similarly, all qualified prize option winners will be given 60 days to choose between a lump sum or annuity prize. But the interim winners are not permitted to make the 18-month election because their lottery prize was won after the effective date of Section 451(h); similarly, they are not permitted to make a 60-day election because the local lottery rules have not been changed to provide for a qualified prize option. The omission of the interim winners was most likely unintentional. While legislation may be needed to cure the defect, it may be possible for the IRS to rule that it will not apply the constructive receipt doctrine to interim winners who are given an 18-month election to choose between a lump sum or an annuity.

Two other points require some clarification. First, many lotteries already offered a choice between a lump sum or an annuity. In order to avoid the constructive receipt doctrine, the lottery contestant had to irrevocably elect the form of the prize prior to purchasing the ticket. Regulations should clarify that pre-effective date winners and interim winners who chose to receive their prize as an annuity may nevertheless make the 18-month election to receive a lump-sum payment of the unpaid lottery prize.

Second, Section 451(h)(2)(b)(iii) requires that the lottery prize in the form of an annuity be payable over at least ten years. Regulations should clarify, with respect to pre-effective date winners, that the annuity must be initially payable over ten years, as opposed to having at least ten years remaining on the annuity.

Example: On 3/15/87, Harold won a lottery prize payable in 20 annual installments. On 7/1/99, the lottery board gives prior lottery winners a one-time 18-month election to receive a lump-sum payment. Since Harold received 13 annual installments from 3/15/87 to 3/15/99, there are only seven remaining payments with respect to his annuity prize. Regulations should clarify whether Harold is entitled to make the 18-month election. Arguably, he should be, because his prize was initially payable over 20 years.

Other Constructive Receipt Issues

The constructive receipt doctrine has been applied in other contexts with respect to lottery prize winners. Reg. 1.451-2(a) provides, in pertinent part, that "income is not constructively received if the taxpayer's control of its receipt is subject to *substantial limitations* or restrictions." (Emphasis added). In *Paul,* TC Memo 1992-582, RIA TC Memo ¶92582, 64 CCH TCM 955, 1992 WL 238774 , the taxpayer won the New Jersey lottery on 12/29/87 but did not receive payment until 1/22/88. The Tax Court held that winnings were includable in income in 1988, the year in which the payment was actually received. In arriving at its decision, the court rejected the Service's argument that the taxpayer could have driven 68 miles to Trenton in the last two days of the year to demand payment "on the spot." The court considered such a requirement a "substantial limitation," thereby negating the application of the constructive receipt doctrine.

The treatment of the constructive receipt doctrine in *Paul* raises an issue with respect to lottery winners after the enactment of Section 451(h) . If a lottery contestant wins on December 15th and is given 60 days to choose between a lump sum or an annuity, the contestant may argue that she is not required to include any portion of the lottery prize, whether a lump-sum distribution or an annuity installment payment, until the date on which she makes an election, possibly in January or February of the following year. The IRS presumably would argue that the lottery contestant is given an election that may be exercised immediately, and therefore the existence of the election does not create a substantial limitation on the lottery winner's control or receipt of the lottery prize, in whatever form.[8] If the intent of Section 451(h), however, is to give lottery winners the opportunity to make an informed decision, after considering all of the various tax and financial consequences associated with a lump-sum payment, it may not be reasonable to expect a taxpayer to assemble all the financial advisors and make such a decision within a narrower time period.

Economic Benefit Doctrine

The economic benefit doctrine is a related but separate income tax accounting concept that also should be considered. This doctrine provides that income is taxable under Section 61 even though it is not actually or constructively received in the form of cash. Unlike the constructive receipt doctrine, it is not necessary that the taxpayer's interest in the property be assignable or for the taxpayer to be entitled to immediate possession; rather, it is only necessary that there be an identifiable property interest over which the taxpayer's rights have vested.[9] For example, a lottery winner receives a taxable economic benefit when the prize proceeds, though not currently payable to the winner, are irrevocably placed in a fund for the winner's benefit, to be paid at a later date.[10] In *Pulsifer*, , 64 TC 245, 1975 WL 3200 , winnings from the Irish Sweepstakes were deposited in a bank account for the benefit of a minor until he reached age 21 or until application for release of the funds was made on his behalf by his legal guardian. The Tax Court held that the winnings were taxable to the minor in the year they were deposited into the account for his benefit, not in the year of actual receipt.[11]

The economic benefit doctrine is potentially applicable in any instance where the lottery purchases an annuity in order to pay a lottery prize winner. Fortunately, certain restrictions in the lottery statute or rules avoid the application of the economic benefit doctrine.[12] Where the lottery purchases an annuity to pay a lottery winner, the lottery, and not the prize winner, is designated as the annuity recipient. Moreover, lottery rules typically provide that the winner has only an inchoate, contractual right to receive annuity payments from the lottery.[13] Finally, lottery rules typically provide that no part of the prize is subject to the claims of the lottery winner's creditors until the prize is actually paid by the lottery to the winner.[14] These restrictions are sufficient to avoid the application of the doctrine.

Withholding on Lottery Winnings

Section 3402(q)(1) provides that "[e]very person, including the Government of the United States, a State, or a political subdivision thereof, or any instrumentalities of the foregoing, making any payment of winnings which are subject to withholding shall deduct and withhold from such payment a tax in an amount equal to 28 percent of such payment."[15] Generally, proceeds exceeding $5,000 are subject to withholding.[16] Many states require that state income tax be withheld as well.[17] Lottery winnings and tax withheld are reported on IRS Form W-2G, Certain Gambling Winnings. Individuals who receive lottery winnings won by someone else or members of a group of winners on the same winning ticket must report their winnings on IRS Form 5754.

Many lottery winners, especially large prize winners, are often dismayed to learn that, even after their lottery prize is substantially reduced by income tax withholding, they may be required to pay additional income tax. Given the disparity between the 28% federal withholding rate and the 39.6% top marginal income tax rate for individual taxpayers, many large prize winners will have to pay more in income tax than the amount originally withheld.

Gambling Losses

Lottery winnings are considered gambling gains.[18] Section 165(d) provides that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions." Therefore, gambling losses may not offset other income or be used as an NOL carryback or carryover. The gambling loss deduction can be applied two ways:

(1) If a taxpayer's gambling activities constitute a trade or business, substantiated gambling losses are deductible in arriving at the taxpayer's adjusted gross income.
(2) If a taxpayer's gambling activities do not constitute a trade or business, the IRS takes the position that the taxpayer must deduct such losses as itemized deductions.

In *Groetzinger*, 480 US 23, 107 S Ct 980, 94 L Ed 2d 25, 55 USLW 4175, 87-1 USTC ¶9191, 59 AFTR 2d 87-532 , the Supreme Court considered whether a taxpayer's gambling activities rose to the level of a trade or business. The taxpayer spent 60 to 80 hours per week on pari-mutuel wagering with the intent of earning a living. The Court rejected the Service's argument that the taxpayer had to hold himself out as offering goods and services to others and ruled that, if the taxpayer's gambling activity was pursued full time, in good faith, and with regularity for the production of income for a livelihood, it was a business.

The distinction between the treatment of a gambling loss as a reduction of gross income or as an itemized deduction is significant because a taxpayer who is required to itemize wagering losses will be subject to a higher floor for deducting casualty losses, medical expenses, and miscellaneous itemized deductions. In addition, the taxpayer cannot use the standard deduction and the amount of itemized deductions subject to reduction under Section 68 will be greater.

Another issue faced by lottery winners is whether installment payments of a lottery prize won in one year retain their character as gambling gains when paid in a successive year.

Example: Kevin engages in gambling as a trade or business. He spent $21,000 in 1998 on lotterytickets and won a $1 million lottery prize, payable over 20 years in installments of $50,000 each. Kevin reports $29,000, the net amount of his 1998 gambling gains ($50,000) over his 1998 gambling losses ($21,000), on his 1998 income tax return. In 2000, Kevin spends $35,000 on lottery tickets and wins nothing; he also receives his $50,000 lottery annuity payment. The lottery prize retains its character as a gambling gain in 2000 and Kevin reports $15,000 of net gambling income.[19]

Assignment of Lottery Proceeds

An individual who wins a major lottery prize often is presented with more wealth and income than he or she has theretofore experienced. The lottery winner may be eager to share the wealth (and the income tax burden) with other family members or friends. Consequently, the winner may consider assigning some or all of the proceeds to one or more such persons. Whether an assignment of all or part of a lottery ticket is effective to transfer the income tax liability on any winnings depends on when the transfer is made. If the lottery ticket is assigned, in whole or in part, before it becomes a winning ticket, any subsequent winnings are taxed to the assignee or donee.[20] If the winning lottery ticket is assigned after it becomes a winning ticket, the proceeds are taxed to the assignor and not the assignee or donee.

Example: Bernard purchases a lottery ticket and then assigns a one-half interest in the ticket to his girlfriend, Marlene, by executing an assignment agreement. The next day, the ticket is selected as the winning ticket in the lottery. Bernard recognizes one-half of the income from the lottery, while Marlene recognizes the other half.[21]

The cases involving an assignment of a lottery ticket prior to winning largely turn on the facts surrounding the assignment, and the taxpayer's ability to prove that there was an intent to share the winnings at the time the ticket was purchased.[22] It is difficult, if not impossible, to overstate the high burden on taxpayers to prove a pre-existing agreement to share lottery winnings. The absence of a written agreement, while not fatal, adds considerably to that burden. In the absence of a written agreement, proof of a sharing agreement may be less difficult where there is a regular pattern of buying tickets or an "office pool" arrangement.

If a group of taxpayers enter into an agreement to purchase lottery tickets and to share the winnings, they are required to include only their share of the prize in income—even if the agreement is unenforceable under state law.[23] If, however, the person who collects the prize fails to honor the unenforceable agreement, the amount retained is included in that person's income.[24]

Example: Sam, Simon, and Seymour live in North Carolina and regularly travel to Virginia to purchase lottery tickets. They agree that they will split the lottery prize equally. Seymour travels to Virginia and purchases a ticket that turns out to be a winner. Despite their agreement, Seymour decides not to share the lump-sum lottery prize with Sam and Simon. Sam and Simon sue Seymour, but the North Carolina court declares that because lotteries are illegal in that state their agreement is unenforceable. Seymour is required to include all of the lump-sum prize in income in the year of winning the lottery.[25]

As discussed above, if the lottery ticket is assigned, in whole or in part, *after* it is a winning ticket, the assignment will not be effective for the purpose of shifting any of the income tax liability. The purported assignor will be responsible for the entire income tax liability associated with the winnings.

Example: Wade wins the lottery; his prize is payable in 20 annual installments. Wade had no preexisting agreement to assign, transfer, or share any part of his lottery prize with any other person. After winning the lottery, Wade decides to share his good fortune with his three friends, Jane, Mary, and Beth. Wade plans to make gifts, evidenced by an "irrevocable declaration of gift," of $5,000 per year to Jane, Mary, and Beth for the next 19 years. The "irrevocable declaration of gift," an unequivocal, unconditional written instrument, binding under local law, which evidences the transfer of a portion of the lottery proceeds to Jane, Mary, and Beth, is not effective to transfer the income tax liability to Jane, Mary, and Beth. Wade must include each lottery prize installment as income, including any portion distributable to Jane, Mary, and Beth, for the tax year in which each installment is actually or constructively received.[26]

Sale of Lottery Proceeds

Similarly, lottery winners who receive the payment of a lottery prize as an annuity may wish to sell the right to receive a future income stream of annuity payments in exchange for a lump sum. There are private companies that will purchase a lottery winner's future installment payments in exchange for a discounted sum.

Several states have amended their lottery statutes to provide that a lottery winner may voluntarily assign the prize, provided that certain procedural rules are followed.[27] New Section 451(h) may make it difficult for private finance companies that purchase a lottery winner's future annuity income stream to convince lottery winners to sell their future annuity payments. Lottery winners who exercise the 18-month election to receive a lump sum will, in all likelihood, receive a larger payment from the state lottery than that offered by the private finance companies (which must provide a reasonable rate of return to their shareholders or other investors).

GIFT TAX ISSUES

In the event a lottery winner decides to give a portion of the winnings to another person, the transfer will be subject to gift tax. Under Section 2511 , the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. A gift is complete when the donor "parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another."[28]
Section 2503(b) provides a $10,000 annual exclusion (indexed for inflation in $1,000 increments after 1998) for gifts of present interests. Effective use of the gift tax annual exclusion can be a powerful planning device for many lottery winners.

Example: Andy wins the lottery; his prize is payable in 20 annual installments. Andy plans to execute unequivocal, unconditional declarations of gifts consisting of annual $10,000 payments to Amanda, Mary, and Frances for the next 19 years. Each declaration of gift is a binding obligation under local law. Accordingly, Andy is deemed to have made a completed gift to Amanda, Mary, and Frances at the time each declaration is made. Each payment will be a present interest gift eligible for the gift tax annual exclusion.[29] Assuming Andy lives for an additional 19 years and completes all of the gifts to Amanda, Mary, and Frances, Andy has reduced the value of his gross estate by $570,000. At a flat 55% estate tax rate, this produces an estate tax savings of $313,500. (In theory, the savings should be even greater. If Andy can afford to give away $30,000 each year, presumably he does not need the money, would not have otherwise consumed it, and would have invested it and reinvested the after-tax earnings. The compounded amounts over 19 years could have substantially increased his gross estate.)

Given the fact that a gift of lottery proceeds, in excess of $10,000 per donee per year, is subject to gift tax, taxpayers who purchase lottery tickets together may be able to avoid the application of the gift tax by establishing joint ownership in the winning ticket. For example, in TAM 9217004, an unmarried couple living together purchased a winning lottery ticket with funds that the couple pooled together. As evidence of their ownership of and interest in the winning lottery ticket, the couple entered into a "Separate Ownership Agreement" providing, in part, that:

(1) Effective on and before 12/2/88, B and A agreed that each had an equal and separate interest in any and all proceeds that might result from the purchase of any and all lottery tickets by the parties from their joint funds.
(2) The winning lottery ticket purchased 12/2/88 at the convenience store was purchased with joint

funds and B and A each had a separate and distinct interest in one-half of the proceeds, and thus the proceeds of such lottery ticket were to be divided 50% to A and 50% to B.
(3) An "agreement manager" would receive the funds and disburse the funds to the couple.

The IRS concluded that the parties intended and understood that, from the time the ticket was purchased, the couple had equal interests in the ticket and the proceeds. The Service viewed the Separate Ownership Agreement as recognition of their ownership interests, as opposed to a gift or other transfer between the couple.

In another instance, a family was able to avoid the application of the gift tax by establishing the existence of a family partnership prior to the purchase of a winning ticket. In *Estate of Winkler*, TC Memo 1997-4, RIA TC Memo ¶97004, 73 CCH TCM 1657, 1997 WL 1229 , a married couple and their five children regularly purchased lottery tickets during recurring out-of-town trips. One of the tickets purchased by the family won the Illinois lottery. The Winkler family agreed to split the prize 25% each for the parents and 10% each for the children. After they learned that they were the holders of a winning lottery ticket, they drafted an agreement for a family partnership and the partnership claimed the lottery prize. The IRS argued that there was no valid partnership and that the Winklers made taxable gifts to their children. The Tax Court disagreed and held that, at the time Mrs. Winkler purchased the winning ticket, the Winkler family had entered into a valid partnership. The court, relying heavily on the facts and the testimony of the family, disregarded the absence of a preexisting written partnership agreement. Rather, it found that the routine pooling of money to purchase the family's tickets was the regular and consistent conduct of an enterprise that rose to the level of a partnership. The court found that capital was a material income-producing factor of the enterprise and that each family member owned a capital interest, thereby satisfying the requirements of Section 704(e) and Reg. 1.704-1(e)(1)(iv) . The Tax Court noted that each member contributed capital in the form of dollar bills and that each contributed services by occasionally purchasing tickets for and on behalf of the partnership. The court concluded that Mrs. Winkler purchased the winning ticket on behalf of the preexisting family partnership and did not make gifts to her children based on the value of the ticket.

As discussed above in the context of the assignment of lottery proceeds, taxpayers bear an extremely high burden of proof when it comes to showing a preexisting agreement to share lottery winnings. The absence of a written agreement, while not fatal, adds considerably to that burden. The relationship between the alleged partners—especially family relationships—makes these types of arrangements particularly susceptible to heightened scrutiny. The ticket buyer/owner is potentially liable for the payment of gift tax and, in the case of transfers to grandchildren, generation-skipping transfer tax.[30]

ESTATE TAX ISSUES

The remaining amount of any lottery prize held in a lottery winner's estate is includable in the gross estate for estate tax purposes.[31] A unified credit against the gift and estate tax is available to all individual taxpayers; in 1999, the credit is equivalent to $650,000 and goes up in steps to $1 million by 2006. Estate tax rates for taxable estates over $650,000 begin at 37% and quickly increase to 55% for estates valued at $3 million or more. For taxable estates larger than $10 million, the lower marginal tax rates and credits are phased out so that such estates are taxed at a flat rate of 55%.[32] In addition to federal estate taxes, many states impose a state death tax. A limited federal credit for state death taxes is available.[33]

Inclusion and Valuation Principles

When a lottery winner dies, the value of the remaining portion of a lump-sum payment received by the lottery winner, to the extent it has not been spent or given away during lifetime in the form of nontaxable gifts, is subject to inclusion in the lottery winner's gross estate. Similarly, for lottery winners receiving payments as an annuity, the present value of the unpaid annuity payments is included in the lottery winner's gross estate.[34]

Example: Elizabeth won the lottery on 1/4/99 and received a lump-sum payment of $10 million on that date. Elizabeth died the next day. In addition to the income taxes payable with respect to the lottery prize, Elizabeth's estate is required to pay estate taxes on the lottery prize included in her estate. Assuming that the lottery prize is the only asset in Elizabeth's estate, that she made no taxable gifts during her lifetime, and that she is subject to a flat, combined 45% income tax rate, she would be required to pay income taxes of $4.5 million and estate taxes of $2,454,500, thereby leaving a total of $3,045,500 in after-tax assets for her heirs and beneficiaries.[35]

Example: Ann won the lottery on 10/31/94 and became entitled to 20 annual payments of $1 million each, payable on October 31 of each year. After receiving the first five payments, Ann died on 11/1/98. Under Sections 2031, 2039 , and 7520 , Ann's estate is required to include the present value of the remaining 15 annuity payments, calculated to be $10,104,600.[36]

Discount Based on Nonassignability

Reg. 20.7520-3(b) provides exceptions to the use of the standard actuarial factors and is effective for estates of decedents dying after 12/13/95. Reg. 20.7520-3(b)(1)(ii) states that generally a standard Section 7520 annuity, income, or remainder factor may not be used to value a "restricted beneficial interest." This is an annuity, income, remainder, or reversionary interest that is "subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances." Taxpayers have argued that lottery rules which prohibit or limit the assignability of the remaining annuity payments cause the annuity to be a restricted beneficial interest, thereby permitting a departure from the requirements of Section 7520. In TAM 9616004 , the IRS rejected this argument, however, noting that Reg. 20.7520-3(b)(2) discusses restrictions and limitations on *payment*, as opposed to *assignability*, of the annuity. Because there is no restriction on the payment of the lottery prize annuity, the taxpayer is required to use the standard Section 7520 annuity factors.

A recent case, *Estate of Shackleford*, 82 AFTR 2d 98-5538, 1998 WL 723161 , suggests that, for lottery winners dying between 4/30/89 and 12/13/95, departure from the Section 7520 annuity tables may be warranted. In *Shackleford*, the taxpayer died in 1990 after receiving the first three annuity payments of his lottery prize. His estate reported the value of the remaining annuity at $2.4 million, rather than the $4 million called for by the Section 7520 tables. The court noted that Reg. 20.7520-3(b) permits a departure from the annuity tables for decedents dying after 12/13/95; the Preamble to TD 8540, adopting the Regulations, states that for the period from 4/30/89 to 12/13/95, case law and rulings were relevant for determining whether a departure from the tables was warranted. The court concluded that a factual issue regarding the value of the annuity was in dispute, and therefore denied the Service's motion for summary judgment.[37]

Recently issued TAM 199909001 deals with a similar issue but adds several interesting twists. The taxpayer and her sister-in-law won a state lottery with a lottery prize payable as an annuity over 20 years. The taxpayer's sister-in-law executed an affidavit stating that they regularly pooled their money, that they had a preexisting agreement to share their lottery winnings, and that the winning lottery ticket was purchased on behalf of their preexisting partnership. The parties formed a limited partnership in which each was a 2% general partner and a 48% limited partner. The limited partnership claimed the winning lottery prize. After the first annuity payment was made to the partnership, the taxpayer died; it is significant that, as in *Shackleford,* the taxpayer died before 12/13/95, the effective date of Reg. 20.7520-3(b).

The taxpayer's estate listed the partnership interests on the estate tax return. The partnership interests were valued by first computing the sum of the underlying assets, cash and 19 lottery payments receivable. The estate then discounted the payments to present value using a discount rate based on the AAA-rated general obligation bond yield, as opposed to the Section 7520 factors. The estate further discounted each payment by 39.6% for federal income taxes and 25% for lack of marketability. Finally, the estate took an additional 20% discount for the partnership interests for lack of control and another 25% for lack of marketability.

The Service rejected the estate's argument that the Section 7520 factors should not be used and found that the annuity payments were not restricted beneficial interests. Based on the same rationale used in TAM 9616004, the IRS found that the nonassignability of the lottery prize did not affect the payment of the annuity. In addition, the Service found that the right of the partnership to receive payment of the lottery winnings had not been restricted in any way. The IRS concluded that the taxpayer's estate was required to use the standard Section 7520 annuity factors to value the annuity payments and that discounts for lack of marketability and income taxes could not be applied to the valuation of the annuity payments. The Service expressed no opinion on entity discounts for lack of marketability and lack of control that were applied to the partnership interests.

Alternate Valuation

Ordinarily, assets subject to the estate tax are valued as of the date of the decedent's death. Section 2032(a), however, provides that the executor may elect to value the assets in the gross estate on an "alternate valuation date," typically six months after the date of the decedent's death. If the property was distributed, sold, exchanged, or disposed of earlier than that date, it is valued on the date of disposition.

In TAM 9637006, a lottery winner was entitled to receive 16 additional annuity payments of $112,500 each at the time of his death. On the day he died, the Section 7520 interest rate was 8.4%. On the alternate valuation date six months later, the Section 7520 interest rate was 9.4%. The estate valued the decedent's interest in the 16 annuity payments as of the date of death, but used the 9.4% interest rate in effect on the alternate valuation date. The IRS ruled that an annuity is an interest that is affected by the mere lapse of time. Valuation changes due to interest rate fluctuations, however, are not changes due to the mere lapse of time. Changes due to mere lapse of time include changes attributable to the time value of money, the depletion of an asset, or the receipt of a benefit by an estate during the alternate valuation period. The IRS concluded that the estate properly valued the interest as of the time of death with the adjustment for the difference in its value as of the alternate valuation date due to the change in the applicable federal rate.

Thus, in an interest-rate environment where the Section 7520 rate increases between the date of death and the alternate valuation date, TAM 9637006 confirms that the alternate valuation date election provides an excellent opportunity to reduce the value of the taxable estate.

Liquidity Issues

Many lottery winners and their families are discouraged to learn that, along with the return, estate taxes are due nine months after the date of death. The estates of winners who received their prizes as an annuity are often placed in the difficult predicament of not having sufficient cash to pay estate taxes.

Example: The facts are the same as in the previous example, i.e., the present value of Ann's remaining lottery annuity is $10,104,600. Assuming that this is the only asset in Ann's estate (and that Ann made no taxable gifts during her lifetime), the estate taxes due will be $5,001,510. This amount is due on 8/1/99. Ann's estate will not receive another lottery annuity payment until 10/31/99. Because of the illiquid nature of the annuity, there is simply insufficient cash to pay the estate taxes.

This problem is a very real one that plagues many lottery winners. Fortunately, Section 6161(a)(2) provides a limited form of relief by permitting the payment of estate taxes over ten years, with interest accruing on the unpaid balance.[39] In order to qualify for relief under Section 6161, the taxpayer must apply for an extension of time to pay the estate tax and must show reasonable cause. Reg. 20.6161-1(a)(1), Example 2, Reg. 20.6161-1(a)(1), Example 2 Reg. 20.6161-1(a)(1), Example 2, indicates that reasonable cause exists where an "estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate."

A second, limited form of relief is provided by the Section 691(c) deduction for income in respect of a decedent (IRD); this deduction minimizes the impact of the double tax imposed by the income tax and the estate tax. The annuity income payable after the lottery winner's death is IRD and the recipient of the annuity income is thus entitled to an income tax deduction for the estate taxes attributable to the annuity.[40]

PLANNING

Although not always possible, the best time to plan for a major lottery prize is beforehand. Barring that, considerable savings can be achieved by undertaking a complete examination of the taxpayer's situation, from both and income and transfer tax perspective, as soon as possible after the prize is won.
Lump Sum or Annuity?

As a result of Section 451(h), most lottery winners will have an opportunity to closely examine (or reexamine) the tax and financial consequences associated with a lump-sum payment of a lottery prize. Current consumption needs, marginal income tax rates, estate tax rates, and rate of return on investments all must be taken into account.

If the lottery winner elects to receive a lump-sum payment of a lottery prize, all of the prize will be taxable in the year paid. This may push the taxpayer into a higher bracket, and leave less of the prize available for after-tax consumption or investment. If, however, the lump-sum payment can be invested at a relatively high rate of return, the lottery winner may be better off electing to receive the lump sum, paying the tax in the first year, and investing the balance.[41]

Charitable Lead Trusts

Lottery winners who (1) elect to receive a lump-sum payment of a lottery prize, (2) are somewhat charitably inclined, and (3) wish to pass a part of their winnings to their children or other family members, should consider using a charitable lead trust. Such a trust provides that an income interest, described as an annuity or unitrust amount, is payable to a charitable organization for a term of years or for the life or lives of one or more individuals, with the remainder interest passing to a noncharitable beneficiary. Charitable lead trusts fall into two broad categories, grantor charitable lead trusts and nongrantor charitable lead trusts.

In a nongrantor charitable lead trust, all income earned by the trust is taxed to the trust; the trust is entitled to a Section 642(c) deduction for the income paid to charity each year. A grantor charitable lead trust is taxed as a grantor trust pursuant to the grantor trust rules, i.e., all income earned by the trust will be taxed to the grantor.[42] On the initial funding of the grantor charitable lead trust, however, the grantor receives an income tax charitable deduction equal to the present value of the income interest passing to charity. This deduction is limited to 30% of the grantor's adjusted gross income, but any unused portion of the deduction can be carried forward for five years.[43] The grantor also will be entitled to a gift tax charitable deduction for the present value of the income interest passing to charity. No gift tax deduction or exclusion is available for the present value of the remainder interest passing to the noncharitable beneficiaries on expiration of the charitable lead trust term.[44] While grantor charitable lead trusts are not common, their use may be appropriate where an individual receives a large windfall of taxable income and is need of a large income tax deduction.

Example: Oscar wins $20 million in the lottery in 1999. He elects to receive a lump-sum payment that has a present value of $10 million. Oscar is in a combined, flat 45% income tax bracket that will required him to pay income taxes of $4.5 million in 1999, thereby leaving $5.5 million for consumption or investment. Oscar creates a charitable lead annuity trust (CLAT) funded with $2 million. The CLAT provides for a $120,000 annuity payment to a charity for 20 years. At the end of the 20 years, the assets in the CLAT (including any appreciation or depreciation) pass to Oscar's children. Assuming a Section 7520 rate of 6.2%, Oscar is entitled to a $1,354,320 charitable income tax deduction in the year he establishes the CLAT. Oscar is also treated as having made a gift to his children of $645,680; depending on Oscar's remaining applicable exclusion amount under the unified credit rules, Oscar may be required to pay gift tax. Because of the income tax deduction, Oscar's taxable income for 1999 is reduced from $10 million to $8,645,680, and his income tax is reduced from $4.5 million to $3,890,556. In each year, the income earned by the CLAT will be taxed to Oscar.

In the event Oscar dies before the expiration of the 20-year term, there will be a recapture of the unused portion of the previously allowed income tax deduction.[45] If, however, Oscar outlives the 20-year term, on expiration of the CLAT the remaining assets held in the trust will pass income tax and estate tax free to Oscar's children. Assuming that the CLAT assets are invested to produce a rate of return in excess of the 6% annuity payout, this may produce a substantially better after-tax result for Oscar and his family.

Gift Tax Planning

In many instances, the income and gift tax consequences associated with a lottery prize are governed by two basic queries:

• Who are the owners of the lottery ticket?
• Was the lottery ticket transferred before or after it became a winner?

The courts and the IRS have looked to the intent of the parties, the circumstances surrounding the purchase of lottery tickets, the existence of any agreements (whether written or oral) among the parties, statements among the parties, and the control of income and capital in determining ownership of a winning lottery ticket.[46] Groups of individuals, such as families and co-workers, who regularly purchase lottery tickets together and who intend to share the proceeds are well-advised to enter into partnership agreements or joint-ownership agreements that establish their intent to share any lottery winnings.[47] Ideally, written evidence of such agreements should be documented and memorialized prior to winning the lottery, but the fact that such agreements are memorialized after the fact has not proven to be fatal.[48] *Winkler* demonstrates the high burden taxpayers have to show the existence of a prior agreement to share lottery proceeds. The case also demonstrates that meeting such a burden, while difficult, is not impossible.

Marital Deduction Planning

Strategies for maximizing the benefits of the Section 2056 marital deduction are needed by all married individuals whose combined gross estates exceed the current applicable exclusion amount. Nevertheless, in light of the illiquid nature of a lottery annuity and the income tax attributes associated therewith, these techniques are especially important for married lottery winners who receive their prizes as an annuity.

The marital deduction permits a married lottery winner to defer the payment of estate tax until after the death of the surviving spouse.[49] One technique has been applied successfully in several letter rulings.[50] In each ruling, the lottery winner designated a trust as the beneficiary of the remaining lottery annuity payments.[51] At the death of the lottery winner, the trust divides into one or more trusts, including a trust designed to shelter the remaining applicable exclusion amount and QTIP trusts intended to qualify under Section 2056(b)(7). This type of estate plan permits the lottery winner, at a minimum, to shelter as much of the prize proceeds from any estate tax at either spouse's death, while deferring the payment of estate tax on the balance until the surviving spouse's death.

Liquidity Planning

Winners who are receiving their lottery prize as an annuity should consider some form of liquidity planning to ensure that estate taxes can be paid. Those winners who are relatively old or in poor health should consider making the Section 451(h) election to receive a lump-sum payment of the remaining lottery prize in order to minimize liquidity concerns. If insurability is not an issue, other lottery winners should consider creating an irrevocable life insurance trust to own policies on the winner's life. The trust can be designed to keep the insurance proceeds outside of the winner's gross estate. At the winner's death, the proceeds will be available to assist the estate in the payment of estate taxes. Finally, some states permit the acceleration of lottery annuity payments at the death of a lottery winner.[52] This provides a source of immediate cash funds with which to pay estate taxes.

CONCLUSION

While winning the lottery presents wonderful opportunities for financial freedom, it also presents many complex and interrelated tax issues that require careful attention and planning. There is no "silver bullet" to solve a lottery winner's tax woes, but careful, thoughtful, and creative application of existing planning techniques can minimize or eliminate many of the adverse tax consequences associated with winning a lottery.

Practice Notes

Planning considerations include:

• Who owns the ticket.

• If there is more than one owner, when did that status arise, and how was it documented.

• Does the owner have the option under Section 451(h) to choose between an annuity payout or a lump sum, and if so, which option produces the better income and estate tax results (similar issues arise in connection with the private sale of the annuity for a lump sum).

• Is the winner in the trade or business of gambling, for purposes of offsetting the prize income with gambling losses.

• Will the winner be required to pay additional income tax over and above the 28% withholding rate for lottery prizes.

• Should the winner undertake a gift-giving program, evidenced by enforceable declarations of gift, to take advantage of the gift tax annual exclusion and substantially reduce the ultimate gross estate.

• In determining the estate tax value of an annuity prize, in an interest-rate environment where the Section 7520 rate increases between the date of death and the alternate valuation date, the alternate valuation date election can reduce the value of the taxable estate.

• A lump-sum payment or the appropriate use of insurance on the winner's life owned through an irrevocable trust may alleviate liquidity concerns for payment of estate taxes.

1

See, e.g., Paul, TC Memo 1992-582, RIA TC Memo ¶92582, 64 CCH TCM 955, 1992 WL 238774 ; Pulsifer, 64 TC 245, 1975 WL 3200 ; Anastasio, 67 TC 814, 1977 WL 3648 .

2

A lottery prize is not excludable under Sections 74(b) and (c) because it simply fails to meet the statutory criteria of those exceptions.

3

Duberstein, 363 US 278, 80 S Ct 1190, 4 L Ed 2d 1218, 60-2 USTC ¶9515, 5 AFTR 2d 1626 .

4

Similarly, Reg. 1.446-1(c)(1)(i) states that, under the cash method, "all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received."

5

Ltr. Rul. 8552002.

6

See Sections 451(h)(2)(A) and (B).

7

The Conference Report for the Tax and Trade Relief Extension Act of 1998 clarifies that "[a]ny offer of a qualified prize option must include disclosure of the methodology used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize to which the prize winner is entitled (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept any offer of a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize." H. Rep't No. 105-825, 105th Cong., 2d Sess. 1595 (1998).

8

The same argument should be true for a lottery winner who is given 180 days or one year to initially claim and collect a prize. A taxpayer should not be able to intentionally defer the recognition of income by merely waiting until the next year to claim the lottery prize.

9

See, e.g., Sproull, 16 TC 244, 1951 WL 302 , aff'd 194 F2d 541, 52-1 USTC ¶9223, 41 AFTR 849 (taxpayer was beneficiary of irrevocable trust established by employer, under which taxpayer's rights were vested and secured against claims of employer's creditors; court held this arrangement conferred an economic benefit on taxpayer).

10

See Rev. Rul. 68-99, 1968-1 CB 193 ; Ltr. Rul. 8552022 .

11

See also Rev. Rul. 67-203, 1967-1 CB 127 ; Sproull, supra note 9; Anastasio, supra note 1.

12

See Ltr. Rul. 8552022.

13

See, e.g., Va. Code Ann. section 58.1-4013(B), which provides "[i]nvestments of prize proceeds made by the Department to fund the payment of an annuitized prize are to be held in the name of the Department or the Commonwealth and not in the name of the prize winner. Any claim of a prize winner to a future payment remains inchoate until the date the payment is due under Department regulations." See also 20 Ill. Ann. Stat. ¶1605/27; Tex. Gov't Code Ann. section 466.403.

14

See, e.g., Va. Code section 58.1-4013(C), which provides that "no lottery prize or installment thereof may be subject to garnishment or to a lien of any kind until such prize or installment thereof has been paid or distributed."

15

Prior to 1993, the withholding rate was 20%. Notice 93-7, 1993-1 CB 297, clarified that the 28% rate applies to any payment (including an installment payment) of gambling proceeds won prior to 1993 and paid after 1992, if those proceeds (in the aggregate) would have been subject to withholding under Section 3402(q) had they been paid prior to 1993.

16

Section 3402(q)(3)(B). The proceeds from a wager are reduced by the amount of the wager. For example, if a lottery contestant purchased a $1 lottery ticket and won $5,001, the lottery proceeds would not be subject to withholding because the proceeds from the wager ($5,001 less $1) are not greater than $5,000. Section 3402(q)(4)(A); Reg. 31.3402(q)-1(d), Example 1, Reg. 31.3402(q)-1(d), Example 1 Reg. 31.3402(q)-1(d), Example 1 .

17

See, e.g., Ga. Comp. R. & Regs. section 56-7-9-.39 (6% withholding for any Georgia lottery prize in excess of $5,000); 23 Va. Admin. Code 10-140-282 (4% withholding for any Virginia lottery prize in

excess of $5,000).
18
See, e.g., TAM 9808002 .
19
Id.
20
Rev. Rul. 55-638, 1955-2 CB 35; Braunstein, TC Memo 1962-210, PH TCM ¶62210, 21 CCH TCM 1132, 1962 WL 438 .
21
See Chelius, TC Memo 1958-29, PH TCM ¶58029, 17 CCH TCM 121, 1958 WL 696 , in which the taxpayer bought a ticket with a co-worker, intending at the time to share anything she won with her husband and children. The Tax Court held that a valid gift had been made, even though it had not been reduced to writing until after the ticket was drawn. Thus, the children's share of the winnings was not taxable on the joint return filed by the parents.
22
Id.
23
Voyer, 4 BTA 1192, 1926 WL 639 . See also Note, "Judicial Enforcement of Agreements to Share Lottery Tickets," 44 Duke L.J. 1000 (1995); Thompson, "Contracts to Split Lottery Prizes: What Happens When The Ticket Is A Winner?," 18 Am. J. Trial Advoc. 201 (1994).
24
Tavares, 275 F2d 369, 60-1 USTC ¶9297, 5 AFTR 2d 886 .
25
See Cole v. Hughes, 114 NC App 424, 442 SE2d 86, 1994 WL 136263 .
26
Ltr. Rul. 9022015.
27
In Ltr. Ruls. 9624009 and 9639016 , the IRS ruled that the amendment of two state lottery statutes to permit the voluntary assignment of a lottery prize by a lottery winner did not affect the income tax treatment of any other lottery winners who did not assign their prizes and continued to receive annuitized payments. See also Cal. Gov't Code section 8880-325; 72 Pa. Stat. Ann. section 3761-306.
28
Reg. 25.2511-2(b).
29
Ltr. Rul. 8940010.
30
See, e.g., Huntington, 35 BTA 835, 1937 WL 534 , acq.; Droge, 35 BTA 829, 1937 WL 533 ; Riebe, 41 BTA 935 , aff'd per cur. 124 F2d 399, 42-1 USTC ¶9168, 28 AFTR 773 ; Tessers, TC Memo 1966-172, PH TCM ¶66172, 25 CCH TCM 907, 1966 WL 926 .
31
Sections 2031, 2033 , and 2039 .
32
Section 2001(c)(2).
33

Section 2011.
34
Section 2039; Reg. 20.2031-7(d)(1) .
35
Although the $10 million prize is included in Elizabeth's gross estate, it is reduced, pursuant to Section 2053, by her unpaid income tax liability of $4.5 million, thereby leaving a taxable estate of $5.5 million.
36
This value is determined by reference to the Table B, Term Certain Remainder Factors Applicable After April 30, 1989, found in IRS Publication 1457. If Publication 1457 is unavailable, the applicable factor can be obtained by the following the procedure in Reg. 20.2031-7(d)(iv). The Section 7520 rate for November 1998 was 5.4%.
37
Given the fact that the period of limitations for a decedent's estate is three years after the due date of the federal estate tax return, which is nine months after the date of death, this case may have limited applicability. For a taxpayer dying on 12/1/95, the estate tax return was due on 9/1/96, and the period of limitations will expire on 9/1/99. For the estates of taxpayers who died before 1995, the ability to file an amended estate tax return and claim a refund, based on the district court's reasoning, will be limited at best.
38
The annuity factor at 8.4% is 8.6295; the annuity factor at 9.4% is 8.1114. The tax savings to the estate was $58,286.25, the difference between $912,532.50 ($112,500 × 8.1114) and $970,818.75 ($112,500 × 8.6295). In an estate taxed at the 55% marginal tax bracket, this represents an estate tax savings of $32,057.44.
39
For a good discussion of the problems associated with the payment of estate taxes by a lottery winners receiving annuity payments, including detailed calculations showing the payment of estate tax over the ten-year period specified in Section 6161, see Note, "Who Gets a Dead Man's Gold? The Dilemma of Lottery Winnings Payable to a Decedent's Estate," 28 U. Richmond L. Rev. 443 (1994).
40
See Sections 691(a)(1) and (c) . The deduction for IRD is taken ratably over the period in which the income is recognized. For example, if estate tax of $1 million is paid with respect to an annuity payable over a period of five years, a $200,000 deduction can be taken in each of the five years during which the annuity is paid.
41
Lottery annuity prizes often are invested in U.S. Treasury bonds that yield a fairly low rate of return, as compared with equity investments. If a lottery winner is able to invest a lump-sum payment at 2% to 3% greater than that offered by such bonds, a lump sum election may be warranted.
42
Sections 170(f)(2)(B) and 671 et seq.
43
Sections 170(f)(2)(B), 170(b)(1)(B) , and 170(b)(1)(C)(ii) .
44
Section 2522(c)(2)(B).
45

Reg. 1.170A-6(d)(2)(ii).
46
Estate of, Winkler TCMemo 1997-4 .
47
Id.; TAM 9217004.
48
Id.
49
Section 2044 requires inclusion of any qualified terminable interest property (QTIP), as described in Section 2056(b)(7), in the surviving spouse's estate; Section 2041 requires inclusion of any assets over which the surviving spouse had a general power of appointment, such as a marital trust qualifying under Section 2056(b)(5); Section 2031 requires inclusion of any assets owned outright by the surviving spouse, such as assets passing directly to the surviving spouse for which the marital deduction was taken under Section 2056(a).
50
Ltr. Ruls. 9043045, 9052020 , 9352015 , 9613016 .
51
Some state lottery statutes specifically permit a lottery winner to designate a trust as the beneficiary of the remaining lottery annuity payments after the winner's death. See, e.g., Cal. Gov't Code section 8880.326; 20 Ill. Ann. Stat. ¶1605/13; La. Rev. Stat. Ann. section 47:9025.
52
For example, the Multi-State PowerBall Lottery grants discretionary authority to the lottery board to accelerate payment of a deceased lottery winner's annuity.

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