Tax Research Memorandum

To: Bruce Wilson

From: Tax Accountant, CPA

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Re: Tax Treatment of Lottery Winnings

Facts

You won $2,000,000 in the state lottery. The lottery pays out the prize money in 20 annual installments of $100,000 each. After receiving three $100,000 installments ($300,000), you sold the remaining $1,700,000 for $1,000,000. You want to report the $1,000,000 as long-term capital gain, on which the tax rate is 15%, rather than reporting it as ordinary income, on which you would be required to pay your 35% marginal tax rate.

Issue

The issues are (1) whether lottery winnings can be taxed at the long-term capital gains tax rate, and (2) whether selling the right to the cash flow from the winnings for a lump sum after owning the right to such cash flow for more than one year qualifies for long-term capital gains tax treatment.

Rule

Lottery rights are not a capital asset, and selling those rights, even after holding them for over one year, falls under the "substitute for ordinary income doctrine, which provides that when a party receives a lump sum payment as essentially a substitute for what would otherwise be received at a future time as ordinary income, that lump sum payment is taxable as ordinary income as well." *R.W. Womack v. Comm'r*, 510 F. 3d 1295 (11th Cir. 2007).

Analysis

It is well established that Lottery rights are not a capital asset. *Watkins v. Comm'r*, 447 F. 3d 1269 (10th Cir. 2006); *Lattera v. Comm'r*, 437 F. 3d 399 (3d Cir. 2006), cert. denied, 127 S. Ct. 1328 (2007); *United States v. Maginnis*, 356 F. 3d 1179 (9th Cir. 2004); *Davis v. Comm'r*, 119 T.C. 1 (2002). Although 26 U.S.C. §1221 defines Capital Asset quite broadly, and does not specifically except lottery winnings from the definition, the 11th Circuit has found that "the statutory definition of capital asset has never been read as broadly as the statutory language might seem to permit, because such a reading would encompass some things Congress did not intend to be taxed as capital gains." *Womack*, 510 F.3d 1295; *Maginnis*, 356 F.3d at 1181;. All of these decisions are based on the so-called substitute for ordinary income doctrine, which provides that when a party receives a lump sum payment as "essentially a substitute for what would otherwise be received at a future time as ordinary income, that lump sum payment is taxable as ordinary income as well." *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260, 265, 78 S. Ct. 691, 694 (1958). *Womack*, 510 F.3d 1295. The courts have focused

on two significant factors in determining that lottery rights are not a capital asset and, therefore, the sale of such asset would not constitute a long term capital gain:

1. The taxpayer did not make any underlying investment of capital in return for the receipt of the lottery right, and

2. The sale of the right did not reflect an accretion in value over cost to any underlying asset held by the taxpayer.

The first factor goes to the treatment of the initial distribution of the winnings and, to quote the 11th Circuit, "Lottery Rights are a clear case of a substitute for ordinary income. A lottery winner who has not sold the right to his winnings to a third party must report the winnings as ordinary income whether the state pays him in a lump sum or in installments." 26 U.S.C. §165(d). As to the second factor, the court focused on the difference between lottery rights and "the typical capital asset,…shares of stock. [In the case of stock], the taxpayer makes an underlying investment in the stock, owns the shares for longer than a year, and then sells them at a higher price. The gain represents an increase in the value of the original investment. Lottery rights involve no underlying investment of capital…[and] gain from their sale reflects no change in the value of the asset. It is simply the amount [the] taxpayers would have received eventually, discounted to present value. Furthermore, when a lottery winner sells lottery rights, he transfers a right to income that is already earned, not a right to earn income in the future. A capital asset has the potential to earn income in the future based on the owner's actions in using it. Lottery winners, by contrast, are entitled to the income merely by virtue of owning the property." *Womack*, 510 F.3d 1295.

Conclusion

Based on the analysis above, it is clear that, notwithstanding the sale of the remaining payments for a lump sum after owning them for more than one year, you will have to pay income taxes on the $1,000,000 at your 33% marginal rate. Any other action will ultimately result in your owing interest and penalties to the IRS.