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Lottery Proceeds: Ordinary or Capital Gains?

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In the last few years, lottery-winning taxpayers have attempted to turn ordinary income into capital gain. The reason is obvious: Lottery winners will be in the highest tax bracket, and long-term capital gains are taxed at a maximum of 15%. That's a big incentive to change the classification of lottery income. In 2004 alone, there were four cases where taxpayers attempted this conversion. The taxpayers were 0-4.

In the typical scenario, the taxpayer wins a lottery, collects annual or monthly winnings for more than a year, and then sells the right to collect future income to a third party. The taxpayer maintains that the sale of the right to future income is the sale of a property right and should result in a long-term capital gain. We'll review the taxpayers' arguments and summarize the IRS's and courts' position. Taxpayers who intend to attempt a reclassification will need to think of arguments other than those we present. They all failed to convince the court.

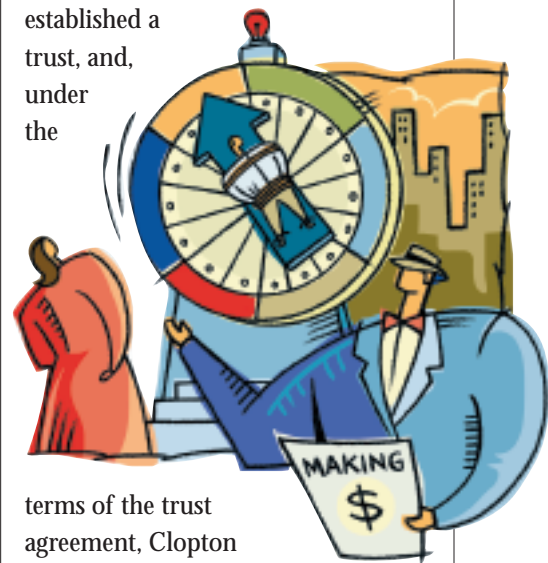
Taxpayer Arguments

In *Maginnis* [2004-1 USTC ¶50,149 (CA-9, 2004)], the taxpayer argued

that the definition of a capital asset found in IRC §1221 should be broadly construed. Section 1221 defines a capital asset as property held by the taxpayer except inventory; depreciable property or real estate used in a trade or business; copyrights, musical, or artistic works created by the taxpayer; and some other miscellaneous categories. Maginnis argued that his lottery right didn't comply with any of these excluded categories and, therefore, is a capital asset. In addition, Maginnis argued that his lottery right meets the definition of a debt instrument as found in IRC §1275. That section states "debt instrument means a bond, debenture, note, or certificate or other evidence of indebtedness." Maginnis likened

his lottery right to a bond that produces ordinary income from interest payments but a capital gain upon the sale of the instrument. Likewise, the lottery right as a capital asset would yield a capital gain upon its sale to a third party.

In *Clopton* [T.C. Memo 2004-95], Clopton and two co-workers won \$9 million. The winners immediately established a trust, and, under the



terms of the trust agreement, Clopton and the other trustors granted, assigned, and delivered all their rights, title, and interests in the lottery ticket to the trust. The trust was required to pay to the beneficiaries of the trust any proceeds received from the Texas Lottery Commission. In 1999, Clopton sold and

assigned his interest in the trust to a finance company for a lump sum payment. The finance company issued a 1099-B Proceeds From Broker and Barter Exchange Transactions. The Form 1099-B listed proceeds from the sale of "Stocks, bonds, etc." Clopton maintained that the sale of his interest in the trust resulted in a capital gain, not ordinary income.

In *Lattera* [T.C. Memo 2004-216], the taxpayers won approximately \$9.5 million in the Pennsylvania Lottery. The prize was only available in 26 annual payments. After collecting payments for nine years, the taxpayers sold the remaining 17 payments to a finance company for a lump sum payment. The finance company issued a 1099-B and listed proceeds from the sale of "Stocks, bonds, etc." The taxpayers reported the proceeds as a long-term capital gain. At trial, the taxpayers maintained that their lottery ticket was a capital asset and the proceeds from the sale were a capital gain from the sale of that ticket.

In *Watkins* [T.C. Memo 2004-244], the taxpayer won approximately \$12.4 million payable in annual installments over the next 25 years. After five years, the taxpayer sold his interest in the future payments to a finance company for a lump sum payment. *Watkins* reported the sale as the sale of a capital asset with a basis of zero. The taxpayer relied on the Ninth Circuit opinion in *Maginnis* to establish that the proceeds were actually from the sale of a capital asset. In that opinion, the court stated that two requirements for a capital gain were (1) an underlying investment of capital and (2) an accretion in value over cost of any underlying asset. *Watkins* argued that (1) his purchase of the ticket for \$1 was the underlying investment and (2) the fact that the lottery payments

increased over time based on a market rate of interest proved an accretion in value.

The IRS's and Courts' Responses

The IRS response to taxpayer arguments remains unchanged. In each case the IRS relies on the well-established "substitution for ordinary income" doctrine. In a line of U.S. Supreme Court cases, beginning with *Hort* [313 U.S. 28 (1941)], the Supreme Court has held that a lump sum amount that's received instead of a series of future payments, which would be ordinary income, doesn't convert ordinary income into capital gain. *Hort* dealt with a lease cancellation payment that the court found simply substituted for future monthly lease payments that would have been ordinary income.

The Ninth Circuit in *Maginnis* cited the U.S. Supreme Court case *Gillette Motor Transport, Inc.* [364 U.S. 130 (1960)] for the proposition that "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." The Ninth Circuit stated that *Maginnis* made no initial capital investment. Noting that the IRC treats lottery winnings the same as any other gambling winning, the court stated that "the purchase of a lottery ticket is no more an underlying investment of capital than is a dollar bet on the spin of a roulette wheel." Since *Maginnis* had no cost or initial investment, "the money he received for the sale of his right cannot plausibly be seen as reflecting an increase of value above the cost of

any underlying capital asset."

The Tax Court consistently cites their reasoning in *Davis* [119 T.C. 1 (2002)] in their three 2004 cases. *Davis* begins by refuting the taxpayer assertion that a right to future income is a property right that complies with §1221. The court describes the taxpayer reliance on *Arkansas Best* [485 U.S. 212 (1988)] to classify an asset as a capital asset (unless the asset falls in one of the several exceptions) as misplaced. It points out that in the *Arkansas Best* opinion the Supreme Court specifically reaffirmed their decision in *Hort* and its progeny. Since the lottery property right isn't a capital asset, there's no capital gain.

Out of Luck

Taxpayers have tried numerous creative arguments to establish that the sale of a right to future income is a property right eligible for capital gain treatment. So far, all of their arguments have failed. The IRS and the courts see no initial investment or increase in value over time. The IRS always relies on the "substitution for ordinary income" argument. Anytime a lump sum payment substitutes for what would have been ordinary income, the lump sum payment retains the ordinary income character. ■

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