REPRESENTING LOTTERY (AND OTHER) WINNERS

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Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
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Past Chair, Houston Bar Association Elder Law Committee, 1991-1992
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SELECTED LAW RELATED PUBLICATIONS AND SPEECHES:

Author/Speaker for the Planned Giving Council of Houston Quarterly Meeting, Testamentary Charitable Planning, January 1989
Author/Speaker for South Texas College of Law Wills and Probate Institute, Staying Out of Trouble with the Generation-Skipping Transfer Tax, September 1990
Author/Speaker for the Elder Law Committee Elder Law Seminar, Non-Probate Assets: The Missing Piece of the Estate Planning Puzzle, April 1992
Author/Speaker for the Planned Giving Council of Houston's 1992 Annual Conference, The Very Basics of Planned Giving, November 1992
Author/Speaker for the State Bar of Texas Advanced Estate Planning and Probate Course, The ABC's Through XYZ's of GST's, Including the Proposed Regulations, June 1993
Author/Speaker for South Texas College of Law Wills and Probate Institute, Estate Administration Checklist, September 1994
Author/Speaker for the State Bar of Texas Advanced Estate Planning and Probate Course, Multiple-Party Accounts: Multiple Risks for Estate Planning Attorneys and Their Clients, June 1995
Author/Speaker for Women Attorneys in Tax and Probate, A Potpourri of Disclaimer Issues, July 1995
Author/Speaker for the Southwestern Legal Foundation Wills and Probate Institute, Tax Considerations in Probate and Trust Litigation, May 1998
Author/Panelist for the State Bar of Texas Conference, Strategies for Building a Successful Estate Planning Practice, December 1998
Author/Speaker for the State Bar of Texas Advanced Drafting: Estate Planning Course, Naming a Trust as the Beneficiary of Qualified Plans and IRAs, November 1999
Author/Speaker for the Houston Estate and Financial Forum, The New Minimum Required Distribution Rules, March 2001
Author/Speaker for the Texas Society of Certified Public Accountants, The Finalized Minimum Required Distribution Rules for Defined Contribution Plans and IRAs, August 21-22, 2003

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I. INTRODUCTION.

A. Definition of Lottery. "Lottery: A tax on people who are bad at math."

B. History of and Facts about the Lottery.

1. First Commercial Lottery. The first commercial lottery took place in the French town of L'Ecluse in 1420. The proceeds of the town lottery were used to help pay for improvements to the town moat.

2. North American Lottery Facts.

a. Lotteries have existed in North America since the 1600s.

b. The General Court of England authorized the first government sponsored lottery in the United States in 1744.

c. Benjamin Franklin sponsored a lottery to help Philadelphia buy cannons to defend itself during the Revolutionary War (one wonders whether the General Court of England was "kicking itself" at that point).

d. In colonial times, lotteries served two important functions:

(1) Raising capital for developing sorely needed infrastructure (roads, forts, schools).

(2) Allowing private citizens to dispose of large valuable assets when times were hard and currency was scarce (a lot of land was sold this way).

e. In the 1800s, private lotteries fell into disfavor due to fraudulent practices.

3. Some Recent Facts/Statistics About the Lottery.

a. U.S. Lotteries. Currently, at least 37 states and the District of Columbia sponsor lotteries.

b. Popular Numbers. The most popular lottery numbers in the U.S. are 7 and 13. Allegedly, in Missouri the most popular lottery numbers are 9 and 5 (9 to 5). The combination "7-1-1" is the most popular combination of numbers. In November 2001, shortly after an American Airlines jet liner crashed in Rockaway, Jew Jersey, the New Jersey Lottery Commission paid out over $1 million to thousands of players who correctly selected randomly drawn numbers 5-8-7 (the flight number of the unlucky jet).

c. Big Dollars in Lottery Business. Experts estimated that in the year 1995 alone, over $34,500,000,000 was "invested" in state lotteries (imagine the total amount invested in all games of chance, including at casinos and in all other gambling enterprises, etc.).

d. Unclaimed Prizes. Every year, in every state lottery, many prizes become officially "unclaimed prizes". For example, in January 2000, a player from San Diego lost $25 million by failing to turn in his/her ticket. Other significant unclaimed prizes in California include $20 million in 1997 and $15 million in 1999.

e. Popularity of Texas Lottery. The 1999 Demographic Study of Texas Lottery Players indicates that approximately 62% of adult Texans play Lotto Texas each year, spending an average of $192 per year on tickets. Further information regarding the Texas Lottery can be obtained by reviewing the annually prepared demographic studies.

f. Lottery Dollars for Texas. As of April 2004, the total amount of Texas lottery revenue transferred to the Texas Foundation School Fund exceeded $6.1 billion. In addition, more than $11.3 billion in funds has been transferred to the State of Texas as a result of the Texas lottery.

C. "Sudden Wealth". Sudden wealth can come from a variety of sources.

1. Sale of a business/Initial Public Offering (IPO).

2. Settlement or judgment in a lawsuit.

3. Receipt of large employee benefits (including a lump sum distribution on retirement, highly appreciated employer stock, valuable stock options, bonuses, etc.).

4. Sale of a successful invention, book, film.

5. Large contract signing bonuses or product endorsement contracts (e.g., LaBron James).

6. A large inheritance.

7. A divorce settlement (although this can produce "sudden poverty" as often as "sudden wealth").

8. Winning the lottery (or other game of chance).

D. Winning the Lottery is Different. Experiencing sudden wealth as a result of winning the lottery is often different from receiving other forms of sudden wealth.

1. No Existing Advisors. Lottery winners frequently have no prior, ongoing relationship with or ready access to legal, tax, financial and other professional advisors.

2. No Prior Planning. While creating a Lottery Trust or FLP in advance of the drawing to hold the lottery ticket is a great idea, who is actually going to spend the time and money to do that before a ticket becomes a winning ticket?

3. Sharing of Winnings Expected. Friends and family members may expect lottery winners to share their good fortune with them (since they did not do anything to earn it/deserve it).

4. "Sudden Wealth Syndrome". While many people think "If I only win the lottery, all of my problems will go away," winning the lottery can bring on a new set of problems and exacerbate (not alleviate) some existing

problems. Lottery winners may experience a wide variety of emotions due to winning: euphoria, guilt, anxiety, alienation, paranoia, mania, depression, fear, uncertainty, etc., and may need some counseling. Psychologists call this complex of emotions "Sudden Wealth Syndrome." There are many articles, from the scholarly to the silly, discussing "Sudden Wealth Syndrome." *See*, e.g., Gallo, *The Psychological Impact of Sudden Wealth*, http://www.fpanet.org/journal/articles/2001; *Rich Man's Burden*, http://www.economist.com/surveys (June 14, 2001); *Sudden Wealth Syndrome*, http://www.mmcinstitute.com/sws; and (my personal favorite – a satirical description of a "rehabilitation program" for people having a difficult time adjusting to their sudden wealth) *Who Wants To Be A Millionaire? (Sudden Wealth Syndrome Satire)*, from the July 2000 article by Steven Pritzker and Gary Greenberg originally printed in Psychology Today, http://www.findarticles.com. Here are some excerpts from the Pritzker/Greenberg article:

> "An early sign of Sudden Wealth Syndrome is an unhealthy attachment to aspects of your premillionaire lives. We'll help you gain closure by staging a mock funeral in which you'll lovingly bury representative objects such as Ramen noodles, the license plate from your Chevette, and that three-gallon jug of Price Club shampoo."
>
> "You've probably noticed how much smarter, sexier and more fun you've become since cashing in those stock options [or since collecting that lottery prize]. How do you know whether people like you for yourself or for your money? You can't. That's why you'll have to start hanging around with other rich people."

E. <u>Practical Problems in Advising Lottery Winners</u>.

1. <u>Lack of Basic Tax Knowledge</u>. Most lottery winners have no knowledge/understanding of gift tax laws (winners want to make many large gifts) and other tax laws, such as the estate tax – a <u>lot</u> of education is required (starting at <u>a</u> <u>very</u> <u>basic</u> <u>level</u>).

2. <u>Unsophisticated, Wary</u>. Many lottery winners have not previously worked with professional advisors and do not know who to trust. They will be bombarded with advice (and deals) from everyone.

3. <u>No Money for Fees Before Prize is Claimed</u>. A great deal of legal, tax and other planning must be done and documentation must be prepared for lottery winners before they have any money to pay for such work.

II. <u>MARITAL PROPERTY/CREDITOR PROTECTION/LITIGATION ISSUES</u>.

A. <u>Marital Property Considerations</u>.

1. <u>CP → Ticket = CP Winnings</u>. Lottery winnings derived from community property are community property. Tex. Fam. Code §§ 3.001-3.003.

2. <u>Assignment of Texas Lottery Winnings Requires Spousal Consent</u>. Note the Texas lottery rule regarding the requirement of informing the Court of the existence or non existence of a spouse in the event a lottery winner seeks to make a voluntary assignment of a lottery prize. *See* Tex. Gov't Code Ann. § 466.410(c). If the lottery winner is married, the spouse must consent to the assignment. Id.

3. <u>Pre-Divorce Considerations</u>. A married claimant should consider whether to collect the prize as an individual or as an entity. *See* VII.A.1.

B. <u>Creditor Protection Considerations</u>.

1. <u>Marital Property Partition</u>. If one spouse has above average liability exposure, consider partitioning community property lottery winnings into the separate property of each spouse.

2. <u>Other Creditor Protection Planning</u>. All of the other usual creditor protection planning techniques, such as creation of some form of limited liability entity or purchase of exempt assets, can be used to shelter assets before a problem arises.

C. <u>Litigation Issues</u>.

1. <u>Breach of Agreement to Split Lottery Winnings</u>. Players of the lottery often agree, either expressly or implicitly, to combine their resources to purchase lottery tickets and to share the winnings among themselves. Problems emerge when one party possessing a winning ticket refuses to share the winnings with the other participants as (allegedly) agreed.

2. <u>Proof of Agreement is Difficult</u>. Usually there is no written agreement regarding the sharing of lottery winnings. Proving an oral agreement is very difficult – the evidence is mostly unreliable.

3. <u>Court Enforcement of Agreement not Guaranteed</u>. Some states will not enforce such an agreement, even if proved. This may be due to that state's public policy against gambling (people frequently cross state lines to buy lottery tickets in neighboring states where lotteries are legal) or some other public policy reason.

4. <u>Articles re: Sharing Lottery Prizes</u>. Two excellent articles discuss many of the cases that have arisen due to an alleged broken promise to share lottery winnings. *See* Thompson, *Contracts to Split Lottery Prizes: What Happens When The Ticket Is A Winner?*, 18

Am. J. Trial Advoc. 201 (1994); Note, *Judicial Enforcement of Agreements to Share Lottery Tickets*, 44 Duke L. J. 1000 (1995).

5. Argument Against Judicial Enforcement. The author of the Duke Law Journal note proposes that courts should refuse to entertain these suits in the first place or, if they do entertain them, they should refuse to enforce any such agreements unless they are in writing. He likens these agreements to unenforceable gift promises and social engagements. The author states that taking this approach will save judicial resources and, possibly, prevent the destruction of personal relationships. 44 Duke L. J. 1000, at 1001-1003.

III. APPLICABLE RULES AND PROCEDURES OF THE TEXAS LOTTERY, IN PARTICULAR.

A. Legal Framework.

1. Texas Constitution. Prior to November 4, 1980, all forms of gambling were illegal in Texas.

a. Bingo Games. On November 4, 1980, the Texas Constitution was amended to allow bingo games to be legally conducted by qualified religious and other non profit organizations. Texas Constitution, Art. 3., Sec. 47 (a), (b) and (c).

b. Charitable Raffles. The Texas Constitution was amended again in November 7, 1989, to allow charitable raffles to be conducted by qualified religious and other non profit organizations. Texas Constitution, Art. 3, Sec. 47 (a) and (d).

c. Texas Lottery. On November 5, 1991, the Texas Constitution was further amended to allow the State of Texas to sponsor and operate lotteries. Texas Constitution, Art. 3, Sec. 47 (a) and (e).

2. Texas Government Code.

a. The State Lottery Act. Chapter 466 of the Texas Government Code, denominated "the State Lottery Act," contains rules applicable to lotteries in Texas. The State Lottery Act was initially passed by the 72nd Legislature in 1991, as part of Vernon's Annotated Civil Statutes (art. 179(g)), but was subsequently revised as necessary to make it part of the Government Code (in keeping with the state's codification program) by the 73rd Legislature, effective August 30, 1993.

b. The Texas Lottery Commission. Chapter 467 of the Texas Government Code is entitled "Texas Lottery Commission." This Chapter contains definitions and duties of the persons involved in the Texas Lottery Commission and other relevant administrative rules.

c. Website. The Texas Lottery has a website containing a lot of useful information, including forms and rules: http://www.txlottery.org.

d. Sunset. The Texas Lottery Rules are scheduled for "sunset" as of September 1, 2005. Tex. Gov't Code Ann. § 466.003.

3. Texas Administrative Code. Additional Texas law regarding the administration of lotteries and other games of chance in Texas can be found in Chapters 401, 402 and 403 of Title 16 of the Texas Administrative Code. Chapter 401 is entitled "Administration of State Lottery Act." Chapter 402 has to do with "Bingo Regulation" and Chapter 403 contains further administrative rules.

4. Texas Lottery Revenue. The state lottery account is a special account in the general revenue fund. Money in the lottery account may only be used to pay lottery prizes, to pay the costs of operating and administering the lottery, and to establish a reserve to pay future lottery prizes. The balance in the account after payment of the items noted above is transferred to the Texas Foundation School Fund. Tex. Gov't Code Ann. § 466.355. Unclaimed prize money in Texas may be appropriated by the legislature for other purposes, such as to or for the benefit of the Texas Department of Health and Human Services. *See* Tex. Gov't Code Ann. § 466.408.

B. Particular Rules Relating to the Texas Lottery.

1. The State Lottery Act. The State Lottery Act (codified in Chapter 466 of the Texas Government Code) currently comprises ten lettered parts (A through J), many of which relate to matters, such as the licensing of sales agents, minority business contracts, advertising of games, involvement of other State agencies, "Amber Alert" provisions, etc., that are not directly relevant to this outline.

2. Rules Relating to the "Integrity" of the Lottery. The Texas Lottery Commission has authority and control over all lottery games conducted in Texas and is charged with promoting and ensuring the "integrity, security, honesty, and fairness" of the lottery. Tex. Gov't Code Ann. § 466.014. Here is a sampling of some of the rules that relate to preservation of the integrity and security of the Texas lottery.

a. Persons Not Eligible to Play.

(1) Texas Lottery Commission employees and their relatives may not play the lottery. Tex. Gov't Code Ann. § 466.254.

(2) Vendors who supply goods or services to the Texas lottery and their relatives may not play the lottery. Tex. Gov't Code Ann. § 466.254.

(3) Minors (persons under age 18) may not purchase lottery tickets in Texas. Tex. Gov't Code Ann. § 466.3051 (a) and (b). Note, however, that adults may make a gift of a lottery ticket to a minor. Tex. Gov't Code Ann. § 466.3051(c).

b. Unauthorized Sales/Purchases.

(1) Unauthorized persons may not sell lottery tickets. Tex. Gov't Code Ann. § 466.303.

(2) Lottery tickets may not be purchased on credit or with the proceeds of an AFDC check or food stamps. Tex. Gov't Code Ann. §§ 466.305, 466.3052 and 466.3053.

(3) A person who purchases tickets on behalf of a group (e.g., an office pool) commits a crime if the person uses any part of the funds contributed for another purpose or to pay himself/herself a fee for acting on behalf of the group. Tex. Gov't Code Ann. § 466.3054.

c. Forgery/Fraud/Crimes.

(1) A person commits a felony if he/she intentionally or knowingly alters or forges a lottery ticket. Tex. Gov't Code Ann. § 466.306.

(2) A person who fraudulently claims (or attempts to claim) a lottery prize commits a felony offense (the degree of felony depends on the amount of the prize involved). Tex. Gov't Code Ann. § 466.308.

(3) A person commits a felony offense if he/she induces another person to assign or transfer a right to claim a prize, offers for sale the right to claim a prize, or offers, for compensation, to claim the prize of another person. Tex. Gov't Code Ann. § 466.310.

(4) Crimes involving the lottery are vigorously investigated and punished. Tex. Gov't Code Ann., Subchapter G.

d. Annual Reports.

(1) The Texas Lottery Commission must annually provide a comprehensive financial report to the governor and legislature. Tex. Gov't Code Ann. § 466.016.

(2) The Texas Comptroller, who must report to the governor, is charged with annually reviewing the management and operation of the lottery. Tex. Gov't Code Ann. § 466.0161.

(3) Annual audits of all aspects of Texas lottery operation are conducted by independent CPAs. Tex. Gov't Code Ann. § 466.017.

e. Public Matters.

(1) Specific information regarding each lottery game must be made public. Tex. Gov't Code Ann. § 466.025.

(2) If a lottery game involves a drawing, the drawing must be open to the public and witnessed by an independent CPA. Tex. Gov't Code Ann. § 466.401.

(3) Virtually all information regarding a prize winner is available to the public under the Open Records Act. 16 Tex. Admin. Code § 403.101. *See also* III.B.6.a.(1), infra.

3. Important Definitions. Important definitions can be found in both the Texas Government Code and the Texas Administrative Code. Here are the definitions of some key terms, all which can refer to one and the same person at different points in the lottery process – note the subtle but significant distinctions:

a. Player. A "Player" is a person who contributes any part of the consideration for a lottery ticket. Tex. Gov't Code Ann. § 466.002(8).

b. Ticket Bearer. A "Ticket Bearer" is the person who has signed the lottery game ticket or who has possession of an unsigned lottery game ticket. 16 Tex. Admin. Code § 401.301(55).

c. Claimant. A "Claimant" is a player who has submitted a valid claim for payment within the required time frame. 16 Tex. Admin. Code § 401.301(5).

d. Prize Winner. A "Prize Winner" is the person who presented a valid ticket, claimed a lottery prize and was and is recognized by the Texas Lottery as the person entitled to receive the lottery prize payments and who is not an assignee of the lottery prize. 16 Tex. Admin. Code § 401.309(a).

4. Drawings/Odds.

a. Scheduled Lotto Drawings. Drawings for Lotto Texas are held each week on Wednesday and Saturday evenings at 9:59 p.m. CST. 16 Tex. Admin. Code § 401.305(g)(1).

b. Jackpot. To win the jackpot (first prize) a player must have a ticket with all six numbers (from 1 through 54) for a single play that match all six numbers selected in that particular drawing. 16 Tex. Admin. Code § 401.305(e)(1).

c. Odds. The odds of winning the jackpot (first prize) were approximately 1:26 million before the expansion of game numbers beyond 50; now the odds are approximately 1:47 million for a large prize. 16 Tex. Admin. Code § 401.305(e)(1).

d. Players Have Sole Responsibility for Ticket Numbers. Players cannot sue vendors or the Texas Lottery Commission due to alleged errors in the numbers reflected on their tickets. *Kinnard v. Circle K Stores, Inc.*, 966 SW2d 613, rehearing overruled (App. 4 Dist. 1998). The burden is on lottery players to verify the accuracy of the numbers on their tickets. *Stewart v. Texas Lottery Commission*, 975 SW2d 732 (App. 13 Dist. 1998). *See also* 16 Tex. Admin. Code § 401.305(f)(3).

5. Claiming of Prizes.

a. Player → Winner. By purchasing a lottery ticket, a player agrees to be bound by all Texas Lottery rules, and acknowledges that he/she must follow certain claims procedures and pass certain validation tests before becoming a "winner". Tex. Gov't Code Ann.

§ 466.252 and 16 Tex. Admin. Code §§ 401.304(e)(5) and 401.302(1).

b. Claimant Representations. A claimant represents that the ticket he/she is presenting for validation was lawfully obtained and was not stolen, forged or altered in any way. Tex. Gov't Code Ann. § 466.256.

c. Prizes < $600. Prizes less than $600 in amount may be paid by an authorized Texas lottery retailer.

d. Prizes ≥ $600 and < $1 Million. Prizes in an amount of $600 or more but less than $1 million may be claimed at a local Texas Lottery Commission Center or at the main Texas Lottery Commission Center in Austin.

e. Prizes ≥ $1 Million. A lottery prize in the amount of $1 million or more and all prizes payable in annuity form can only be paid by the Director of the Texas Lottery Commission at the main Texas Lottery Commission Claim Center in Austin.

f. Multiple Winners of One Drawing vs. One Winner Per Ticket. For any particular drawing, more than one ticket might be a "winning ticket" and each of the winning ticket holders will share equally in the prize for that drawing. Tex. Gov't Code Ann. § 466.404. However, the Texas Lottery Commission firmly adheres to the rule that there can be ONLY ONE WINNER PER TICKET!!! 16 Tex. Admin. Code §§ 401.302(f)(8) and 401.304(e)(6). If more than one person has an "ownership" interest in a single winning ticket, then that ownership interest should be documented in writing and some form of "entity" (e.g., a trust, partnership, corporation) comprised of all individuals who have an "ownership" interest in that single winning ticket should claim the prize as "the winner".

g. Claim Period. With a few exceptions (primarily for persons on active military duty), all prizes must be claimed within 180 days after the winner is selected. Tex. Gov't Code Ann. § 466.408.

h. When Cash Option Elected. A player must elect "cash option" or not at the time of purchasing his/her ticket. 16 Tex. Admin. Code § 401.305(e)(3)(A)(ii).

i. Lottery Prize Paid in Installments. If a prize winner did not elect cash option, his/her share of the jackpot amount will be paid in 25 installments, consisting of an initial payment, followed by 24 annual installments thereafter. The payment of each annual installment will be made on the 15th day of the particular month in which the ticket was originally selected as the winning ticket. 16 Tex. Admin. Code § 401.305(e)(3)(A)(i).

j. Installments Worth ≤ $2 Million. If the net present cash value of the 25 payments is $2 million or less, then the prize winner will be cashed out (i.e., will receive a lump sum) instead of receiving installment payments (even if he/she did not elect "cash option"). 16 Tex. Admin. Code § 401.305(e)(3)(A)(i).

k. To Claim Jackpot: Go To Austin. The first prize (jackpot) must be claimed at the Austin claim center. 16 Tex. Admin. Code § 401.305(e)(3)(A)(iii).

l. Deductions from Prizes for Certain Liabilities. If an *individual* who has been determined to be a prize winner happens to be delinquent in the payment of various types of state taxes (such as taxes due the Texas Workforce Commission or child support or certain types of student loans), the total amount due will be deducted from his/her prize before payment. Tex. Gov't Code Ann. §§ 466.407 and 466.4075.

6. Claims Procedure and Forms.

a. Claim Form. All claimants must complete a claim form and supply certain information as part of the claims process, including, but not limited to, name, address, date of birth, social security number/ taxpayer identification number, work and home telephone numbers, whether the individual is a U.S. citizen or resident alien, and, if claiming the prize as an "entity", the type of entity (trust, corporation, partnership) and the name and title of the individual with "Signatory Authority" for the entity, and where and how (including as a gift) the winning ticket was acquired.

(1) Privacy Issues. Virtually all information regarding a prize winner is available to the public under the Open Records Act. 16 Tex. Admin. Code § 403.101. The only exceptions are the winner's street address and telephone number, pursuant to Tex. Gov't Code Ann. § 466.022(b)(3), and the winner's social security number or federal employer identification number ("EIN") (pursuant to internal rules of the Texas Lottery Commission). *See* 16 Tex. Admin. Code § 403.101. NOTE: If an "entity" is the winner, all entity documentation will be available to public inspection.

b. Eligibility Affidavit. In addition, each claimant must execute an Affidavit to the effect that he/she is not ineligible to receive a lottery prize. If an ineligible person purchases a ticket or claims or attempts to claim a prize, the amount is treated as an unclaimed prize. Tex. Gov't Code Ann. § 466.409.

c. Ticket Signing Issues.

(1) More than One Person has Signed the Ticket. If more than one person has signed the back of the lottery ticket, all persons who have signed the ticket, in addition to the one actual "claimant", must travel to Austin to participate in the claims procedure and, as part of the claims procedure, the "excess" signers must execute an Affidavit (the "Claimant Designation Form") indicating that their signature on the ticket was a

mistake and designating the actual single claimant of the lottery prize.

(2) Individual has Signed the Ticket but Entity is the Winner.

(a) If That Individual Can Sign for Entity. If an individual has signed the back of the ticket but an entity is claiming the prize as the winner, if that particular individual is the person with "signatory authority" for the entity, that person may add additional wording after his/her name, indicating that he/she is signing on behalf of the entity as the winner, and reflecting his/her title/capacity. For example, if John Jones is the Ticket Bearer and has already signed his name on the back of the ticket but the claimant of the prize will be the Jones Partnership, assuming that the Jones Partnership Agreement designates John Jones as its Managing Partner and specifically designates John Jones as the person with signatory authority to sign all lottery paperwork on behalf of the partnership, then John may add wording after his name, as follows: "John Jones, Managing Partner of the Jones Partnership". This is called "signature completion".

(b) If That Individual Cannot Sign for Entity. If the particular individual who has signed the back of the ticket does not have signatory authority for the entity that is claiming the prize as the winner, then that individual must execute an Affidavit indicating that he/she signed the ticket by mistake and designating the actual prize claimant and further indicating who has signature authority for the claimant. The individual with signatory authority for the claimant must then sign the Prize Claim Form on behalf of the entity claiming the prize as the winner.

d. Requirements for Entity Claimant. If an entity is the claimant, the entity documentation must clearly reflect the legal name of the entity and the names of all legal and beneficial interest owners. The document must state that Texas law (including the Texas lottery rules) applies. The entity must be created on a date before the prize is claimed (it is acceptable to the Texas Lottery Commission for the entity documentation to be dated after the particular lottery drawing date). The document must clearly identify the person with legal authority to sign all lottery paperwork on behalf of the entity. All entities (even a self trusteed grantor trust) must obtain an EIN prior to claiming the prize. Copies of entity filings with the Secretary of State's Office must be supplied to the Texas Lottery Commission. The original entity documents must be brought to Austin and three copies must be supplied to the Texas Lottery Commission. The Texas Lottery Commission will require *each individual involved in the entity* to complete a claim form providing all of the same information that an individual claimant would supply, including his/her name, address, telephone number, and social security number (although, as noted above, the street addresses, telephone numbers and social security numbers are kept private). Each individual involved in the entity must also execute the Eligibility Affidavit. If an individual involved in the entity owes child support or any of the other state liabilities that would be deducted from the prize money if the individual were claiming the prize as an individual, the Texas Lottery Commission will ask the individual for permission to deduct such liabilities before paying the prize to the entity.

7. Payment of Prize Money to Minors. As noted, minors cannot legally purchase lottery tickets in Texas; however, they can receive a lottery ticket *as a gift* from an adult. Tex. Gov't Code Ann. § 466.3051. If a minor is entitled to prize money on a winning lottery ticket, the prize money is paid as follows.

a. Prize < $600. A prize less than $600 in amount may be paid to an adult member of the minor's family or to the minor's guardian. Tex. Gov't Code Ann. § 466.405(a).

b. Prize ≥ $600. A prize worth $600 or more may be placed on deposit in any bank to the credit of an adult member of the minor's family or to the minor's guardian as custodian for the minor. Tex. Gov't Code Ann. § 466.405(b).

c. Cash Equivalent Only for Non-Cash Prizes. If a minor wins a prize other than money (e.g., a truck in the Trucks 'n Bucks II game), then the cash equivalent of the prize will be paid to the appropriate adult member of the minor's family or to the minor's guardian as custodian. Tex. Govt. Code Ann. § 466.405(c).

d. Adult Payee is Custodian for Minor. An adult who receives payment of a lottery prize on behalf of a minor has the powers and duties of a custodian under Chapter 141 of the Texas Property Code (the Texas Uniform Transfers to Minors Act). Tex. Gov't Code Ann. § 466.405(d).

8. Assignments.

a. Illegal Assignments. It is illegal in Texas to assign or transfer or to try to induce another person to assign or transfer the right to claim a lottery prize. In other words, once a lottery ticket has been selected as the winning ticket (but before the ticket bearer/claimant has completed the claims process to become the officially recognized "prize winner") it is *illegal* to assign the ticket to someone else. Tex. Gov't Code Ann. § 466.310. *See also* Tex. Gov't Code Ann. § 466.406(a). It is all right to make a *gift* of a lottery ticket to someone, either before the ticket has been selected as a winning ticket or after the claimant has become a winner (although all assignments made by a prize winner – versus a player – require an appropriate

Court Order – see next section). Be aware, however, that such gratuitous assignments are gifts and, depending on the amount of the gift at the time of the transfer, the assignor could have gift tax consequences. *See* Part V. infra.

b. Lawful Assignments.

(1) Voluntary Assignment by Winner per Court Order. A person who has already been declared to be a "prize winner" may lawfully assign all but the final two installment payments of a prize payable in installment form. Tex. Gov't Code Ann. § 466.410. This rule allowing assignment of lottery prizes by winners, effective September 1, 1999, is a change from former Texas law, which prohibited the assignment of lottery prizes payable in installment form. The assignment can only be accomplished by obtaining a Court Order from the District Court of Travis County, Texas, directing that the assignment be made and meeting all of the requirements for a voluntary assignment set forth in Subsection (b) of Section 466.410 of the Texas Government Code. One particular requirement that must be met in order for an assignment to be valid is that the assignor must provide sworn testimony to the Court regarding the existence or non-existence of a spouse, and if the assignor is married, his/her spouse must consent to the assignment. Tex. Gov't Code Ann. § 466.410(c).

(2) Involuntary "Assignments" per Court Order. A prize to which a winner is otherwise entitled may be paid, in whole or in part, to someone else pursuant to an "appropriate judicial order" when there is an underlying controversy, such as a divorce or allegations of fraud relating to the lottery ticket. Tex. Gov't Code Ann. § 466.406(c). The Texas Lottery Commission takes a strict position on involuntary assignments, limiting it to those cases where a Court Order is required to resolve an underlying controversy between the prize winner and "a third party". This type of Order need not be obtained from a district court in Travis County, Texas (as is necessary for "voluntary assignments") , as long as it is an "appropriate judicial order". For example, if a married individual claimed a lottery prize payable in installments *as an individual*, assuming that the prize is community property, a Divorce Decree or other appropriate Order issued by a court of competent jurisdiction incident to the divorce could direct the Texas Lottery Commission to divide each annual installment payment post-divorce into shares per the Order, so that separate payments can thereafter be made to the original winner and to his/her former spouse. *See* Tex. Gov't Code Ann. § 466.406(c) and 16 Tex. Admin. Code § 401.309.

(3) Assignment Fee. Note that the Texas Lottery Commission charges an administrative fee for each assignment. Tex. Admin. Code § 401.309(e)(2).

9. Death of an Individual Prize Winner Entitled to a Prize Payable in Installments.

a. Continued Payment to Prize Winner's "Estate". If a lottery prize payable in installments was claimed by an individual (vs. an "entity") as the winner and the winner dies before having received all installments, the installment payments continue to be paid annually to the deceased prize winner's "estate". Tex. Gov't Code Ann. § 466.406(b). This means that a single payment will be made to the "estate" each year and it will be up to the Executor or Administrator to (i) keep the estate open until all installments have been received and (ii) distribute the appropriate shares of each installment payment received to the deceased lottery winner's beneficiaries or heirs. *See also* 16 Tex. Admin. Code § 401.309(b)(1).

b. "Cash Out" of Installment Payments Due Estate. The Executor or Administrator of a deceased prize winner's estate may obtain an "appropriate judicial order" from the "proper Probate Court", joined in by all estate beneficiaries or heirs, directing the Texas Lottery Commission to make a lump sum payment to the estate of the value of all remaining lottery installments. Tex. Admin. Code § 401.310(a). Such an Order must contain, among other required provisions, a statement that the cash out is necessary to pay federal estate and Texas inheritance taxes due by the estate. *See* 16 Tex. Admin. Code § 401.309(b)(6). The lump sum payment is paid into the registry of the Court. 16 Tex. Admin. Code § 401.309(b)(5). The amount paid to the estate is the lesser of the Texas Lottery Commission's book value (the daily recalculated amortized cost of investments under the interest method) or fair market value (the value of investments at any point in time determined by the market place), further reduced by applicable taxes and all administrative costs incurred by the Commission. 16 Tex. Admin. Code § 401.310(a).

IV. INCOME TAX ISSUES APPLICABLE TO LOTTERY WINNERS.

A. Taxability/Inclusion in Income.

1. Winnings Included in Gross Income. Winnings and prizes derived from lotteries, raffles and other gambling activities/games are included in gross income. IRC §§ 61 and 74(a). The exclusions from gross income for gifts (IRC § 102(a)) and interest on state and local bonds (IRC § 103(a)) are not applicable to lottery prizes, even if a government entity paying the prize in installments purchases a bond or annuity to use in making payments to the winner. *See* Rev. Rul. 78-140, 1978-1 CB 27 and *Duberstein*, 363 U.S. 278 (1960).

2. Sale/Assignment of Winnings: Proceeds are Ordinary Income. Many lottery winners, including winners of Lotto Texas after the change in Texas's lottery assignment rule in 1999, choose to sell or assign most or part of their winnings being paid in installment form (per Texas law, the last two installments cannot be assigned). What are the income tax consequences of such assignments? The proceeds from the sale or assignment of lottery installment payments are taxed as ordinary income, not capital gain (just like the installment payments themselves would have been). TAM 199945008. The full amount is taxable in the year of receipt.

B. Constructive Receipt Doctrine.

1. When Included. Most individuals are on a calendar year and report income on a cash basis. In such cases, an item of gross income is includable in income for the tax year in which actually or constructively received by the taxpayer. IRC § 451(a); Treas. Regs. §§ 1.451-1(a) and 1.446-1(c)(1)(i).

2. Amount Included: Cash Option vs. Annuity.

a. Option Given *After* Winning. If a lottery player is given the option of choosing between a lump-sum distribution (cash option) or installment payments (i.e., an annuity) after his/her ticket has been selected as the winning ticket, then the full value of his/her winnings will be taxable in gross income in the year he/she becomes entitled to the prize, even if he/she selects the annuity form of payment. PLR 8552022 (9/25/1985).

b. Option Selected *Before* Winning. If, on the other hand, a lottery contestant has to choose between a lump sum payment or an annuity at the time of purchase (i.e., *prior* to his/her ticket being selected as the winning ticket), selection of installment payments will not result in the full amount of the prize being subject to income tax in the year the option is exercised. PLR 8552022 (9/25/1985). NOTE: Lotto Texas is structured this way.

3. "Qualified Prize" Option.

a. Sixty Day Special Period. A lottery winner may be able to make an election (subject to the particular state's lottery rules) between receiving his/her winnings as a lump sum distribution or as an annuity, within 60 days after winning and avoid application of the constructive receipt doctrine if an annuity form is elected. IRC § 451(h).

b. Effective Date. This special rule applies to individuals who won the lottery after October 21, 1998 (and the particular state's law must be specifically amended to authorize this).

(1) Definitions.

(a) A "Qualified Prize" is any prize or award which (i) is awarded as 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 services, and (iii) is payable over a period of at least 10 years. IRC § 451(h)(2)(B).

(b) 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 became entitled to the qualified prize. IRC § 451(h)(2)(A).

(2) Rule. For a cash-basis taxpayer, a qualified prize option shall be disregarded in determining the taxable year for which any portion of the qualified prize is properly includable in gross income of the taxpayer. IRC § 451(h)(1).

(3) Reason for Rule. The Qualified Prize rule allows lottery (and other) winners time to consult with family members, attorneys, CPAs, financial planners and other advisors to determine which option is best for them.

(4) Transitional Rule. A transitional rule was available for certain lottery winners who won before October 21, 1998. If a state lottery specifically amended its rules to so provide, a previous lottery winner receiving installment payments had the option between July 1, 1999, and December 31, 2000, to elect to receive a lump sum payment equal to the present value of the remaining annuity payments. *See* Sec. 5301(b)(2) of P.L.105-277 (the Tax and Trade Relief Extension Act of 1998). Merely having this option under these rules did *not* trigger application of the constructive receipt doctrine.

(5) Effective Date Problem for Certain Winners. Section 451(h) inadvertently created a class of prize winners who could not obtain its benefits: winners who won after October 21, 1998 and before July 1, 1999. *See* further discussion of this problem in the excellent article by Farhad Aghdami, *The Morning After: Tax Planning for Lottery Winners*, 90 J TAX 228 (April 1999).

4. Other Constructive Receipt Issues.

a. Timing of Receipt. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Treas. Reg. § 1.451-2(a).

(1) Substantial Limitation. If a taxpayer wins the lottery in late December but does not travel to the required place to fill out all the paperwork until January, in which year are the lottery winnings includable in his/her gross income? In *Paul*, TC Memo

1992-582 (9/29/1992), the Tax Court held that the winnings were taxable in the year in which payment was actually received because, although the winner *could* have made the trip during the last two days of the year and demanded his/her winnings "on the spot", such a requirement was a "substantial limitation" and negated application of the constructive receipt doctrine.

(2) Delay in Receipt. What if a taxpayer unduly delays claiming his/her winnings? If a taxpayer wins the lottery in September 2003, and delays claiming the prize until January 2004, the Service would probably include the winnings in 2003 income unless a "substantial" limitation or restriction caused the delay in collection.

b. Availability of State Law Assignment Option≠Taxable Income. Merely because a particular state allows lottery winners who are receiving installment payments to sell or assign their winnings to third parties does not result in current taxable income to cash basis taxpayers who choose not to make an assignment. PLR 200031031. The main reason why the constructive receipt doctrine fails to apply in this situation is that there is no clear cash equivalent due to the wide disparity in discount rates applied to determine the lump sum amount payable to purchase the future installment payments.

C. Economic Benefit Doctrine. Income is taxable under Section 61 of the Internal Revenue Code even though it is not actually or constructively received in the form of cash if it amounts to an identifiable property interest over which the taxpayer's rights have vested. *See*, e.g., *Sproull v. Comr.*, 16 TC 244 (1951), aff'd 194 F.2d 541 (6th Cir. 1952). A lottery winner receives a taxable economic benefit when 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. *See* Rev. Rul 68-99, 1968-1 CB 193; PLR 8552022; *Pulsifer*, 65 TC 245 (1975); Rev. Rul. 67-203, 1967-1 CB 105. Even in states where the lottery commission purchases an annuity to pay the lottery winner, various lottery rules usually prevent application of the economic benefit doctrine in those cases so that the lottery winner is not taxed on the full value of all annuity payments, only on each payment as received. *See* PLR 8552022 (9/25/1985); Tex. Gov't Code Ann. § 466.403; Va. Code Ann Sec. 58.1-4013(B); 20 Ill. Ann. Stat. ¶ 1605/27.

D. Withholding.

1. Federal Income Tax Withholding. The Internal Revenue Code provides that every person, including a federal, state or other government/ subdivision, making any payment of winnings which are subject to withholding shall deduct and withhold from such payment a tax in the amount of 25% of the payment. IRC § 3402(q)(1).

2. State Withholding. In some states, lottery winnings may be subject to state income tax withholding, too. *See*, e.g., Georgia and Virginia.

3. Additional Income Tax Due. Lottery winners must be prepared to pay additional federal income taxes by the following April 15 (due to the difference between the top federal income tax rate and the 25% withheld). Additional state income taxes may be due also, depending on state income tax laws.

E. Gambling Loss Deduction.

1. Winnings = Gambling Gains. Lottery winnings are gains from gambling. IRC §§ 61 and 74(a); TAM 9808002.

2. Gambling Losses Netted Against Gambling Gains. Losses from wagering transactions are allowed only to the extent of gains from such transactions. IRC § 165(d). Accordingly, gambling losses may not offset other income or be used as an NOL carryback or carryover. *See*, e.g., FSA 1999-519.

a. "No Purchase Necessary" Sweepstakes Prize Winnings Cannot be Offset by Gambling Losses. A recent technical advice memorandum concluded that a "no purchase necessary" sweepstakes sponsored by a corporation did not constitute a "wagering transaction," so that the taxpayer who won the sweepstakes could not use his/her gambling losses to offset the winnings from the sweepstakes. TAM 200417004 (4/22/04).

b. IRS Definition of "Wagering Transaction". Neither the Internal Revenue Code nor the Treasury Regulations define the term "wagering transaction." According to the IRS, for a transaction to be a wager, three elements must be present: (1) prize, (2) chance, and (3) consideration. The IRS found only the first two elements here. TAM 200417004 (4/22/04). The taxpayer contended that even a relatively small consideration (e.g., $1 to buy a lottery ticket) creates a wager. However, in this case, where the taxpayer's only consideration was postage and envelopes relating to submission of his/her contest entries, the consideration was deemed to be too negligible/insignificant to constitute sufficient consideration for a wagering transaction.

3. Gambling as a Trade or Business.

a. Use of Gambling Loss Deduction. If a taxpayer's gambling activity constitutes a trade or business, substantiated gambling losses are deducted (to the extent of gambling gains) in arriving at the taxpayer's adjusted gross income. *Comr. v. Groetzinger*, 480 U.S. 23 (1987).

b. Miscellaneous Itemized Deduction. If the gambling activity does not constitute a trade or business, the taxpayer must deduct such losses – which are disallowed to the extent they exceed wagering gains for the year – as miscellaneous itemized deductions. IRC §67(b)(3).

c. Trade or Business Definition. What amount of gambling rises to the level of a "trade or business"? If the taxpayer's gambling is actively pursued, full time, in good faith, and with regularity for the production of income or as a livelihood, it is considered a business. *Groetzinger,* 480 U.S. 23 (1987).

4. Character of Future Lottery Installment Payments. Do installment payments of a lottery prize retain their character as gambling gains when paid in a year subsequent to the original winning year? Yes. Thus, if a taxpayer has new gambling losses in those subsequent years, he/she can reduce the installment payment (his/her gambling gain) by these losses in reporting net gambling income for the year. TAM 9808002 (2/20/1998).

F. Assignment of Income Doctrine. If a lottery ticket is "assigned" before it becomes a winning ticket, the assignment is effective for income tax purposes. Rev. Rul 55-638, 1955-2 CB 35; *Braunstein* TC Memo 1962-210 (8/31/1962). If the ticket is assigned after it has been selected as a winning ticket, the winnings are still taxed to the original ticket holder under the assignment of income doctrine (the assignor could also be making a gift depending on the facts of the assignment – *see* Part V, infra). PLR 9315008 (1/13/1993); PLR 8433014 (5/8/1984). NOTE: Under the Texas lottery rules, it is illegal for a "claimant", an individual holding a purported winning lottery ticket, to assign or transfer that ticket before the claimant has become a "winner" (although it is lawful for a "player" to assign or transfer a ticket before it becomes a winning ticket – i.e., before the drawing). Tex. Gov't Code Ann. §§ 466.310 and 466.406(a). It is very difficult to prove a pre-existing agreement to share a lottery ticket absent a written document entered into before the ticket becomes a winning ticket, unless there are extremely good facts. *See, e.g., Winkler,* infra, at V.C.3. See also the litigation cases discussed in the two articles cited at II.C.4.

G. Sale/Assignment of Lottery Prize to Third Party. Many states, including Texas, have amended their rules to allow lottery "winners" (vs. "claimants") to sell or assign their right to receive a future stream of installment payments in exchange for a lump sum. There are private companies that specialize in doing this.

V. GIFT TAX ISSUES APPLICABLE TO LOTTERY WINNERS.

A. Only One Winner Per Ticket. Only one winner per ticket can claim a lottery prize in Texas. *See* 16 Tex. Admin. Code §§ 401.302(f)(8) and 401.304(d)(4).

1. Transfers by Winners are Gifts. Once the winner is determined, all gratuitous transfers by that winner to others are subject to the (usual) gift tax rules. *See* IRC § 2501 et seq.

2. Lottery Winners Often Want to Make Gifts.

a. Gift Tax Rules are a Surprise. Lottery winners are not familiar with and do not understand (or like or accept) the gift tax rules.

b. Annual Exclusion Gifts Often Insufficient. The annual gift tax exclusion (per IRC § 2503(b)(i)) is useful but often not sufficient (at $11,000 per recipient per year) for estate planning purposes or to provide desired gifts (e.g., a new pick up truck).

c. Exclusion for Tuition and Medical Gifts. Lottery winners should be apprised of the availability of the tuition and medical care exclusions from the gift tax. IRC § 2503(e).

d. Spousal Gifts – but Watch Limit for Non U.S. Citizen Spouse. If the lottery prize happens to be the separate property of one of the spouses, consideration should be given to making gifts to the non wealthy spouse. There is no dollar limit on such gifts to spouses who are U.S. citizens – the full amount given qualifies for the gift tax marital deduction. IRC § 2523(a). If the donee spouse is not a U.S. citizen, however, the maximum deduction for a spousal gift is $100,000 per year. IRC § 2523(i).

e. Charitable Gifts. Of course, those lottery winners having charitable intent can make gifts during lifetime that qualify for the gift tax charitable deduction. IRC § 2522. Such gifts very likely will qualify for the income tax charitable deduction as well, with the percentage that is deductible depending on the factors listed in Section 170 of the Internal Revenue Code.

B. One "Winner" Comprised of Individuals. The winner can be an "entity" comprised of individuals, such as a partnership, trust, or corporation; however, in the case of family members, it is difficult to negate a gift (gratuitous transfer), especially if minors are alleged to be participants in the entity since minors cannot legally purchase lottery tickets. *See* Tex. Gov't Code Ann. § 466.3051 (a) and (b). Minors can receive a lottery ticket, or an interest in a lottery ticket, *as a gift,* however. *See* Tex. Gov't Code Ann. § 466.3051(c).

C. Avoidance of Gift as to "Ownership" of Lottery Prize.

1. Prior Agreement Necessary. An agreement among two or more individuals to share the proceeds of a winning ticket entered into prior to the ticket being selected as the winning ticket, if proven, will avoid gift treatment. The burden to prove an agreement not in writing is difficult, however.

2. Written Agreement. A written agreement pre-dating the purchase and drawing of a winning lottery

ticket is best. *See* TAM 9217004 (4/24/92), where an unmarried couple signed a written "Separate Ownership Agreement" in which they agreed to share any lottery winnings 50/50. Result: each was treated as the owner of 50% of the prize (no gift).

3. Oral Family Partnership. A family successfully established the existence of an oral partnership prior to the purchase and selection of a winning lottery ticket. *Estate of Winkler v. Comr.*, TC Memo 1997-4 (½/1997). As a result, the winning ticket was deemed to be owned by the family partnership and not merely by Mrs. Winkler, who had actually purchased that particular ticket.

a. Good Facts. The *Winkler* case contained unusually good facts: various family members regularly contributed dollar bills to a fund used to purchase lottery tickets, which were routinely purchased during trips to and from medical clinics [Mr. Winkler was in poor health, making frequent trips necessary], with the tickets then being placed in a glass bowl in the parents' home. The children, who lived near their parents, visited their parents' home every week and the mother (Mrs. Winkler) stated that she never bought any lottery tickets on her own (just for herself), but always on behalf of the family (partnership).

b. Written Agreement Commemorating Oral Agreement Entered into After Winning Ticket was Selected. It was not fatal to the finding of a partnership that the written agreement among the family members was signed after the lottery ticket became a winning ticket, because the existence of the partnership itself and ownership of the lottery ticket by the partnership was proved by the particular facts in the case.

c. Gift Tax Issues. The written partnership agreement provided for unequal interests in the partnership (25% each to Mr. and Mrs. Winkler and 10% to each of their 5 children). Under local (Illinois) law, each partner is presumed to have an equal interest in the partnership, absent a written agreement otherwise. Thus, each of the seven partners in *Winkler* would be deemed to own a 1/7 interest (14.29%) in the partnership. Because Mr. and Mrs. Winkler each reported a 25% interest in the partnership, neither of them were deemed to have made any gifts to their children (although the children may have made gifts to their parents – an issue not addressed in the case).

VI. ESTATE TAX ISSUES APPLICABLE TO LOTTERY WINNERS.

A. Estate Includability. A decedent's interest in lottery winnings is an asset includable in his/her gross estate for federal estate tax purposes. IRC §§ 2031, 2033 and 2039.

B. Estate Tax Value of Lottery Winnings.

1. Annuity Payments that Terminate on Death. If the lottery payments were being paid to the winner only for his/her life (in Texas, this would only be true for the 7 people still living who won the "Win for Life" game – an early lottery game that has been discontinued), with no amount being transferred or paid to others on or after the winner's death, then only the amounts actually received prior to death and still on hand (in whatever form) are includable in the lottery winner's estate.

2. Lump Sum Prizes ("Cash Option" Elected). The value of whatever remains of a lump sum lottery prize on the winner's date of death (along with the value of his/her other assets) is includable in his/her estate under the usual federal estate tax rules. IRC §§ 2031 and 2033. This amount would also be subject to state inheritance tax rules.

a. Deduction for Income Taxes Due on Lump Sum. In the case where the lottery winner dies before all income taxes have been paid on the lump sum prize, the outstanding income tax liability may be deducted in the federal estate tax return filed for the deceased winner's estate. IRC § 2053. Most states sponsoring lotteries only withhold 25% of the prize money for federal income tax purposes (pursuant to IRC § 3402(q)(i)), so additional income taxes would usually be due by the following April 15.

b. Compare: No Deduction for Future Income Taxes on Installment Payments. Compare this to the lack of estate tax deductibility for the discounted present value of future income taxes arising from installment payments of a lottery prize that will be paid after the decedent's death.

3. Installment (Annuity) Payment of Prizes. The present value of the unpaid annuity/installment payments that will be paid after the deceased winner's death is included in the lottery winner's estate for federal estate tax purposes. IRC § 2039; Treas. Reg. § 20.2031-7(d)(1); TAM 9616004 (4/19/96). Some states (such as Texas – which follows the federal estate tax scheme) also impose an estate or inheritance tax on the transfer of unpaid future installments of a decedent's lottery prize.

a. IRS Valuation Position. The IRS position is that, in valuing the remaining (future) installment payments, the standard Section 7520 rate for private annuities must be used. See discussion in *Cook v. Comr.*, 349 F.3d 850 (5th Cir. 2003).

(1) The value is determined by reference to 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 following the procedure in Treas. Reg. § 20.2031-7(d)(iv).

(2) One commentator criticizes the IRS for treating the annuity as being analogous to lottery winnings payable in installment form and states that the IRS "refuses to recognize the inherent differences involved and chooses to ignore the total absence of statutory authority for inclusion of lottery proceeds in the annuity classification." *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 at 457 (1994).

b. "Restricted Beneficial Interests". If an annuity is subject to any "restriction" that affects its value, then the standard Section 7520 rate may not have to be used to determine its value. Treas. Reg. § 20.7520-3(b)(1)(ii). Taxpayers have argued that lottery rules which prohibit or limit assignability of future lottery payments cause those payments to be "restricted beneficial interests", and, therefore, the Section 7520 rate need not be used in valuing the future payments for estate tax purposes.

c. Recent Estate Cases Involving Discounting the Value of Future Lottery Payments in the Deceased Winner's Estate.

(1) *Shackleford*. In the Ninth Circuit case of *Shackleford v. U.S.*, 262 F. 3rd 1028 (9th Cir. 2001), the Court ruled that the decedent's estate could use a valuation method different from that prescribed by Treasury Regulations in view of the California Lottery's anti-assignment restriction on lottery payments. The Court found that the annuity tables did not take into account marketability factors and also that departure from the tables is permissible "where they do not produce a value that reasonably approximates the fair market value..." Thus, the estate met its burden of showing that an exception should apply.

(2) *Gribauskas*. In the Second Circuit case of *Gribauskas Estate v. Comr.*, 343 F 3rd 85 (2d Cir. 2003), the Court of Appeals cited the *Shackleford* case in support of its decision to allow the Gribauskas estate to use a valuation method other than the standard method prescribed in the regulations for valuing the decedent's interest in future lottery payments. The Second Circuit Court determined that the state law (Connecticut) prohibition on assigning the future lottery payments was a significant restriction that affected value, so that a discount was justified.

(3) *Cook*. A different result was reached by the Fifth Circuit in *Cook Estate v. Comr.,* 349 F. 3d 850 (5th Cir. 2003). The Fifth Circuit Court of Appeals disagreed with the Ninth Circuit in *Shackleford* and the Second Circuit in *Gribauskas*, finding their departure from longstanding valuation principles applicable to lottery installment payments unwarranted.

(a) Facts. Ms. Cook and her sister, Ms. Newby, had a longstanding informal agreement to share all winnings from jointly owned lottery tickets. Upon winning the lottery in 1995, the two sisters "assigned" the winning ticket to a jointly owned limited partnership that they had created, MG Partners, Limited. [COMMENT: with respect to the assignment of income doctrine and gift tax problems encountered by joint winners of a single lottery ticket, it is extremely hard to imagine that the sisters' informal oral agreement prior to winning contemplated a venture in the form of a limited partnership]. The FLP then claimed the lottery prize as the winner and held the right to receive the future lottery installment payments at the time of Ms. Cook's death in 1995. In 1995, Texas law prohibited the transfer of a lottery prize and, therefore, no market existed for the future lottery installment payments.

(b) Estate's Position. Ms. Cook's estate contended in the Tax Court that (i) the partnership interest, and not the stream of payments from the Texas Lottery, was the proper asset to be valued and (ii) the standard annuity tables should not be used to value the remaining installment payments. The estate used a discounted cash flow method of valuing the right to receive the future annual lottery payments that was based on lack of marketability.

(c) IRS's Position. The IRS valued the right to the lottery payments under IRC § 7520 and the accompanying regulations that govern the valuation of private annuities.

(d) Ruling. The Fifth Circuit Court of Appeals declined to apply any discounts in value due to lack of marketability where "the asset to be valued is the right, independent of market forces, to receive a certain amount of money annually for a certain term."

(e) Amendment to Texas Anti-Assignment Rule. Of course, as a result of amendments made to the Texas lottery rules in 1999, winners receiving their prize in installment form may now legally assign all but the last two installment payments. *See* Tex. Gov't Code Ann. § 466.410. This change in law probably eliminates at least that argument for deviating from the private annuity valuation method for valuing the future lottery installment payments receivable by a decedent's estate.

C. Use of Alternate Valuation in Annuity/Installment Payment Cases Due to Change in Section 7520 Rate. If the Section 7520 rate increases between the decedent's date of death and the alternate valuation date, it is permissible to value the remaining lottery payments on the decedent's date of death using the Section 7520 rate on the alternate valuation date (assuming election of alternate valuation is otherwise proper and applies to all estate assets per IRC § 2032(a)). *See* TAM 9637006 (9/13/1996).

D. Estate Tax Liquidity Problems where Lottery Winnings are Being Paid in Installments. The present value of future lottery payments is taxable in the decedent's estate, yet the estate may not have sufficient liquidity to pay the estate taxes.

1. Estate Planning Considerations. Advisors should recommend the usual estate planning techniques for illiquid estate situations: Use of ILITs, the marital deduction (if applicable) and the charitable deduction (if appropriate).

2. Example of Liquidity Problem: Interplay of Estate Tax and Income Tax. Assume that a person wins a $20 million lottery jackpot, to be paid at the rate of $1 million per year for 20 years. Assume that this occurred in 1996 when the highest marginal income tax rate was 39.5% and the highest estate tax rate was 55%, and that the winner died shortly after winning. Here is an example taken from an article written by John Berteau (used by permission) that appeared in the Spring 1996 issue of ACTEC Notes:

$20,000,000 Lotto Winner

Lottery winnings - $1,000,000 for 20 years	$20,000,000
$20,000,000 reduced to present value @ 8%	9,818,147
Estate tax due on $9,818,147 is $4,972,760, say (assumes no other assets subject to estate tax)	5,000,000
Annual lottery payment	1,000,000
Less IRD estate tax deduction	390,000
Federal taxable income	610,000
Income tax due – assessed @ 39% flat bracket	240,474
$1,000,000 less $240,474	759,526
Net available to pay estate tax each year	759,526
Amount of annual interest due on Estate tax (short term rate + 3%) = 9% $5,000,000 at 9% = $450,000 interest first year Payment $759,526 - $450,000 = $309,526	
Amount of principal reduction first year	309,526
Number of years to pay off $5,000,000 estate tax obligation at 9% with $759,526 annual payment	10
Number of years before beneficiaries get first inheritance	11
Funds currently available to pay attorneys for estate work and tax work:	nil
Disposition of beneficiaries who expected to inherit $20,000,000 from deceased lottery winner	testy

(Several steps of the actual calculations have been deleted or simplified in order to provide greater clarity.)

Berteau, *When Your Client Wins the Lottery – Tax and Estate Planning Issues*, 21 ACTEC Notes 308 (1996).

Another example (a true story) can be found in Professor Jerry W. Beyer's article about the case that led to the change in Texas law allowing estates to "cash out" future lottery payments to pay estate taxes. *See* Beyer and Petrini, *Lottery Players and Winners: Estate Planning for the Optimistic and the Lucky*, http://www.professorbeyer.com/Articles/Lottery. For yet another excellent article addressing this same problem and proposing certain solutions, 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).

3. Section 6161 Extension to Pay. If a lottery winner refused to do or was not able to do any planning for illiquidity prior to his/her death, the estate may need to seek annual extensions of time to pay estate taxes pursuant to Section 6161 of the Internal Revenue Code. The extension can be sought on the basis of reasonable cause or undue hardship, or both.

a. Reasonable Cause. "Reasonable cause" justifying an extension of time to pay estate taxes due is demonstrated when "[a]n estate is comprised [sic] 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 that would inflict loss upon the estate." Treas. Reg. § 20.6161-1(a)(1), Example (2). In addition, if an estate does not have sufficient funds to pay the entire estate tax due without borrowing at a rate of interest higher than that generally available, then reasonable cause for an extension exists. Treas. Reg. § 20.6161-1(a)(1), Example (4).

b. Undue Hardship. Undue hardship means more than an inconvenience to the estate. A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate. Treas. Reg. §20.6161-1(a)(2)(ii). A lack of readily available funds for the payment of estate tax when otherwise due is a factor indicating undue hardship. Treas. Reg. §20.6161-1(a)(2)(ii), Example (1). Further, if the assets in the gross estate that have to be liquidated to pay the estate tax can only be sold at a sacrifice price, then undue hardship exists. Treas. Reg. § 20.6161-1(a)(2)(ii), Example (2).

c. Idea: Filing Annual Amended Estate Tax Returns. One idea mentioned by the author of the University of Richmond Law Review Note is for the executor of the decedent's estate to keep the estate open for the duration of the lottery installment payout period and to file amended estate tax returns each year to reflect the actual amounts flowing to the estate (rather than filing just one original estate tax return reflecting a discounted present value rendered highly speculative by the illiquidity of the rights to those payments). *See, Who Gets a Dead Man's Gold*, 28 U. Richmond L. Rev., at 459. In addition to possibly reflecting more accurate numbers, following this approach might allow the estate to take a Section 2053 deduction for the income taxes paid with respect to each annual lottery payment received. However, this approach is very impractical and also without precedent: although the "open transaction" principle has been applied in the income tax area, it has not generally been permitted in the estate tax area.

4. Exercise of Lotto Texas "Cash Out" Option by Estate. The Executor or Administrator of the estate of a deceased Texas lottery winner who claimed a prize payable in installments as an individual can handle the liquidity problem by obtaining an order from the probate court directing the Texas Lottery Commission to "cash out" the estate (i.e., pay the estate the discounted present value of all future lottery payments). *See* 16 Tex. Admin. Code § 401.310(a).

5. IRD Deduction. Some relief from double taxation is provided to the recipients of the post-death lottery payments. To the extent that the amount being received by a beneficiary has attracted estate tax in the deceased lottery winner's estate, the beneficiary can take an income tax deduction for the estate taxes attributable to that amount. IRC § 691(c).

VII. VARIOUS PLANNING CONSIDERATIONS FOR LOTTERY WINNERS.

A. "Choice" of Winner. Consider who (or what) should claim the prize as the winner.

1. Pre-Divorce Considerations for Married Claimants Entitled to a Lottery Prize Payable in Installment Form.

a. Individual as Winner. If a married claimant domiciled in Texas claims a lottery prize payable in installment form as an individual and is later divorced, the Court Order incident to the divorce can be structured to comply with Texas lottery requirements so that future installment payments will be divided by the Texas Lottery, with each former spouse being paid his/her share directly. *See* Tex. Gov't Code Ann. § 466.406(c).

b. Entity as Winner. If the married claimant in this situation creates an entity (e.g., a trust or partnership) to claim the Lottery prize as the winner, payments subsequent to the divorce will still be made to the entity. Therefore, the entity documentation (trust or partnership agreement) will need to be amended or modified to provide for proper distributions from the entity in view of the divorce (i.e., the Texas Lottery Commission will continue making annual installment payments – a single payment – to the entity since the entity claimed the prize as the winner and the entity still exists and did not get a divorce).

2. Pre-Death Considerations for Claimants Entitled to a Lottery Prize Payable in Installment Form.

a. Individual as Winner. On the death of an individual winner, the remaining payments will continue to be paid to the individual's "estate" – meaning the estate must remain open until all payments are received. However, the estate may be able to obtain an Order, if necessary, cashing out the future installment payments to pay death taxes. *See* Tex. Gov't Code Ann. § 466.406(h) and Tex. Admin. Code § 401.310.

b. Entity as Winner. If an entity were to claim the prize as the winner, the entity would continue receiving the annual installment payments even after the lottery winner's death. Continuing to keep an entity in existence for 20 or more years is not unusual (vs. an estate). Proper documentation is essential if an "entity" will claim the prize as the winner and such documentation must provide for the continued existence of the entity at least until the last lottery installment payment is received.

B. Cash Option Election vs. Annuity. A "winner" must evaluate whether to elect cash option and receive a lump sum (if available) or receive the prize in the form of installment payments. (A "player", on the other hand, would always be best served by electing cash option when buying his/her ticket so that the choice is preserved – failure to elect cash option when buying a Texas Lotto ticket results in a prize payable in annual installment form).

1. Consider Liquidity Problems at Death. Cash option avoids liquidity problems at death. Therefore, if the winner is elderly, uninsurable or unmarried, electing cash option (if available) may be preferable.

2. Spendthrift Winner. Electing the cash option may be a bad choice for a spendthrift or person with no financial discipline.

3. Total Income Taxes Paid. Spreading a prize over several years versus taking a lump sum may result in lower overall income taxes being paid – it depends on both the income tax rates and the discount rates. If there is no discount applied to the amount, and if income tax rates do not increase in future years, installment payments could be the better choice from an income tax standpoint. For example, if winner A receives $1 million in gambling winnings in a lump sum in 2004, income tax at the rate of 35% would be paid to

the extent taxable income exceeds $319,100. If winner B receives $100,000 per year for 10 years (admittedly worth more than $1 million on a present value basis), absent changes in current income tax laws, winner B's winnings may only be subject to a 25% or 28% top income tax bracket each year.

4. Is Assignment Later an Option? If installment payments are elected, is there an option under the particular state lottery rules to assign or sell the stream of payments to a third party for a lump sum later?

C. CLT Technique. If the winner has any charitable intent and the lottery winnings are paid in a lump sum, consider creating and placing all or part of the winnings into a grantor charitable lead trust ("CLT") to obtain an income tax charitable deduction (subject to the 30% AGI limitation) for the present value of the charitable (lead) interest in the CLT. While income is taxable to the grantor each year, and the remainder interest passing to the non charitable beneficiaries (e.g., children) is a transfer subject to the gift tax rules, there is a 5 year carry forward of the income tax charitable deduction and, assuming a gift tax return is filed for the gift of the remainder interest (and any gift tax paid), and assuming the grantor outlives the term of the CLT, the assets remaining in the CLT upon termination (including any net appreciation in value) will pass income tax free (and outside the grantor's estate) to the remainder beneficiaries.

D. Other Estate Planning Ideas. Planners may want to explore the possibility of an irrevocable "sale" of the lottery winner's annuity using an installment sale, self-cancelling installment note (SCIN) or a private annuity (assuming the particular state's lottery rules would allow such a transfer).

E. Income Tax Liability Planning. Upon each receipt of funds, the winner should set aside the extra amount that will be needed to pay the balance of income taxes due the following April 15 (because only 25% federal income tax is withheld and no or insufficient state income tax may be withheld – for example, the Texas Lottery Commission does not withhold state income taxes even if the winner lives in a state that has a state income tax).

F. Creditor Protection Planning. If one spouse has above average liability exposure, consider doing a marital property agreement to partition the community lottery winnings into the separate property of each spouse. This also might be worth doing if the marriage is somewhat "shaky."

G. Other Protection Planning: Use of Trusts or Other Entity. Having a large lump sum claimed by an entity as the winner, especially a trust and, even better, a trust having a corporate (Co- or sole) Trustee, may protect the winner from the hair-brained schemes of and requests for cash from friends, relatives, charities and "on the edge" money managers because the winner can truthfully say, "Sorry, all my winnings are tied up in trust".

H. Use of (General) Partnership. A partnership is a good, simple way to document a group sharing arrangement. NOTE: There is a "weird" income tax reporting situation when a Lotto Texas prize is claimed by a partnership because the Texas Lottery Commission withholds federal income taxes at the partnership level. This can be explained in the partnership tax return and K-1's distributed to the partners.

VIII. PRACTICAL TIPS FOR LOTTERY WINNERS.

A. Immediately upon learning that ticket is a "winner" claimant should:

1. Either not sign back of ticket at all (until tax and legal advice has been obtained) OR sign his/her name only (since ticket is a "bearer" instrument), but leave room to add additional wording later.

2. Make a copy of potential winning ticket and place original ticket in safe deposit box or other safe place until ready to go to Austin to claim prize.

3. Not tell too many people about "winning" at that point.

4. Arrange for time off from work to attend meetings with advisors and make necessary arrangements.

B. Before deciding whether to elect lump sum (cash option) vs. annuity/installment form of winnings (if election is available due to specification at time of purchase) and before deciding who (or what) should claim the prize, claimant should:

1. Discuss income, gift and estate tax aspects with knowledgeable advisors.

2. Discuss marital property, creditor protection and "sharing arrangement issues" with knowledgeable advisors.

3. Consult with more than one type of advisor (attorney, CPA, financial planner, banker/trust officer, etc.).

C. Before going to Austin to claim lottery prize claimant should:

1. Make sure all pre-claim procedures have been completed (e.g., entity documentation has been submitted to and reviewed and approved by lottery attorneys, all necessary parties have executed entity documentation, required information, such as copies of Texas drivers licenses, Social Security cards, Assignment of EINs, etc., has been supplied to lottery, claims appointment has been scheduled with Austin Lottery Claims Center, etc.).

2. Obtain and then take with him/her to Austin all necessary information regarding wire transfer of prize funds to financial institution.

3. Transport original ticket safely (some claimants hire a professional security firm to assist them).

4. Make prior arrangement with all persons who must or should travel to Austin to participate in claims process.

5. Consider getting an unlisted telephone number.

6. Consider obtaining a P. O. Box for mail delivery (but <u>do</u> <u>not</u> use that address to claim the lottery prize because a P. O. Box is not a "street address" and, therefore, is not confidential).

7. Invite (and bring) "special guests" to lottery claim appointment and treat everyone to lunch after claiming prize.

8. Make a "wish list" and rank items in priority order (but do not begin spending yet).

D. After claiming lottery prize, winner should:

1. Purchase top 1 or 2 items from wish list, but allow for a "cooling off" period (and financial advice) before embarking on a major spending spree.

2. Consider consulting with a psychologist experienced with "Sudden Wealth Syndrome" to prepare for subsequent emotional let down, changes in relationships, anxiety due to new complexities, etc.

3. Set aside (in a separate "tax" account) funds necessary to pay additional income taxes that will be due on April 15 of following year.

4. Follow through with advice/action items recommended by professional advisors (e.g., completion of estate plan, entity funding, investment management, etc.) and pay them for their services (!).

5. Consider undertaking a systematic gift-giving program (if desire to make gifts).

6. Quit job, throw a big party, and/or delve into new ventures/hobbies!

IX. <u>CONCLUSION</u>.

Winning the lottery may be a "dream come true" for some people, but lottery winners who do not obtain professional tax and estate planning advice to help them through the new complexities brought on by their sudden wealth may find it to be a nightmare instead.