American Journal of Business and Society
Vol. 1, No. 3, 2016, pp. 77-82
http://www.aiscience.org/journal/ajbs

AIS | American Institute of Science

Dreaming an Impossible Dream: A Case for Treating Lottery/Gambling Winnings as Capital Gain

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Abstract

Aim: To provide a discussion regarding how Tax Practitioners try to find the least burdensome tax rates for clients. Whenever possible, capital gains treatment rather ordinary income treatment is sought since it has a lower rate. Lottery winners are advised to re-consider selling their annuities because they are giving up their chance to acquire lineage wealth. When they sell their annuities, they receive no tax benefit and may have tax trouble later on. *Method:* In short, exploring case law, this article takes the reader through the arguments that are made in support of treating lottery/gambling winnings as capital gain. *Result:* An argument can be made for treating lottery winnings/gambling winnings as capital gain based on case law. *Conclusion:* The tax payer's arguments for treating lottery/gambling winnings as capital gain would likely not be upheld by the tax courts for public and fiscal policy reasons.

Keywords

Capital Gain, Case Study Method, Capital Asset, Stripping Assets

Received: May 25, 2016 / Accepted: June 2, 2016 / Published online: June 20, 2016

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1. Introduction

The government's awesome taxing power and the all-inclusiveness of gross income is inescapable for most people. According to Sidhu (2015), there has been an expansion of Congressional taxing power. Everything is taxed in our society. Blochliger and Nettley (2015) describe tax power as the extent that sub-central governments (SCGs) throughout the world set tax rates. Tax practitioners try to find the least burdensome tax rates for a client. Whenever possible, capital gains treatment, rather than ordinary income treatment is sought, it has a lower rate. Part I of this article explains the overall approach to the subject using the case study method. Part II discusses the probable service arguments against treating lottery/gambling winnings as capital gain. Part III explores a rebuttal to the service arguments. The article will conclude with a discussion of stripping assets and how it relates to this tax issue. Finally, the article explores the dilemma for a client and tax practitioner as the client struggles to understand the complexity of the tax code. It would be an uphill battle for the taxpayer to win in tax court but the arguments can still be made in an effort to change existing laws.

2. Method

In tackling issues this complicated it is helpful to formulate an inclusive approach that helps to organize the material. The client comes in to provide the factual context in the client interview. Here, the case study method is employed to mirror an actual real world client and problem. The reader can see the frustrations that clients are faced with when the law is unsettled in a given area. Tax professionals often struggle

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with how to explain the complexities of the tax law without offering any guarantees. A case is a written description in chronological order of the problem. There are no conclusions or analysis in the story. It is just the facts. The facts will be presented to the reader through the eyes of the client who experiences this tax problem. The case study method is a useful tool because it allows the writer to distinguish between pertinent and peripheral facts. It also helps with issue identification. Lastly, the case study helps the writer to present strategies to solve the problem. The case study also shows the reader the problem from another perspective. The reader can better understand what the client is faced with. This can lead to giving more comprehensive advice to the client who is unsure what to do. It must be clear to the client that it is his choice alone to make. The tax attorney cannot make the decision for him.

2.1. Initial Client Interview

Attorney: Good to see you. How is the family? Is your wife Rose still with Kraft?

Client: As you know, I won the lottery. The money is paid to me in yearly installments of two hundred fifty thousand dollars for twenty years. I was approached by XYZ

Corporation because it wants to purchase my right to receive the annual lottery payments.

I would get a lump sum payment in exchange. I want to know if I can claim capital gains treatment on my tax return. I'm dying and I want the money in a lump sum. I'm just afraid that the tax liability will diminish most of it.

Attorney: Congratulations. I'm not aware of anyone successfully asserting that kind of claim. I will have to research it and get back to you. When do you have to let XYZ

Corporation know? Do you have to sell all of your shares?

Client: The offer expires in 60 days. I can sell as much as I want. I need to sell all of my shares, though.

Attorney: I shall send written memorandum analyzing the legal arguments. Please make an appointment with my secretary for a follow up visit in about a week. Are there any other questions?

Client: Thank you and I look forward to hearing from you.

2.2. Legal Facts Solicited from the Interview

XYZ Corporation purchases the right to receive to receive annual lottery payments from a lottery winner for a lump sum payment. The transfer of the right to receive the lottery payments is a sale for state law purposes. The lottery winner may have the right to receive two hundred and fifty thousand dollars per year for twenty years. The winner could sell all his payments, or could sell a portion of his payments for all or a part of the twenty-year term. Regardless of the portion the winner sells, the winner wants to report the gain on the sale as a capital gain.

3. Creation of Memorandum for Client and its Application to the Model Rules

This memorandum analyzes whether a sale of lottery/gambling winnings results in capital gain rather than in ordinary income. The purpose of this memorandum is to explain to the client the legal arguments in support and against this position. A practitioner may not recommend an unsupportable or frivolous position to a client. A practitioner must keep the client informed as much as possible. The attorney performs his due diligence by creating this memorandum of law. This firm wants to be sure it can support this position in the event of a challenge by the Internal Revenue Service ("the Service").

3.1. Questions Presented

The issues are: (1) whether there is gain or loss if the right to receive lottery payments is sold to a third party and (2) whether the character of that gain or loss is ordinary or capital.

3.2. Short Answer

Case law exists for treating the payments a lottery prize winner receives in exchange for his rights to future annual lottery payments as gain from the sale of a capital asset, that is, capital gain. This memorandum analyzes relevant case law to investigate whether the position is supportable. Despite the existence of case law in support of characterizing the gain from the sale of the lottery winnings as a capital gain, the Service could successfully assert that the gain is ordinary in character. The taxpayer really has no basis in the amount realized which is the proceeds from the lump sum payment.

4. Service Arguments: Ordinary Income

The Service will likely argue that gain from the sale of lottery winnings results in capital gain. First, in order to obtain capital gain, a taxpayer must sell or exchange property that constitutes a capital asset. The right to the proceeds from the sale of lottery winnings may not constitute property within the meaning of Section 1221 of the Internal Revenue Code of 1986, as amended (the "Code"). Second, if the right to lottery

winnings is property, the right still may not be a capital asset. Third, the gain from the sale of lottery winnings is ordinary income if the lump-sum payment for the lottery winnings is a substitute for the right to receive ordinary income in the future.

4.1. Lottery Winnings May Not Constitute Property

As stated above, an asset must be property in order to qualify as a capital asset (Commissioner v. Ferrer, 1962). Neither the Code nor the regulations defines the term property, and the distinction between what is and what is not property is not always clear. Property includes obligations, rights, and other intangibles, as well as physical things. "Property is a word with broad meaning and when used without qualification, may reasonably be construed to include obligations, rights, and other intangibles, as well as physical things" (Citizens State Bank, 1940). Property within the tax laws should not be given a narrow meaning. Notwithstanding the broad definition of property for tax purposes, a contract right that is merely a right to receive income is not property and, therefore, is not a capital asset. In Buena Vista Farms (1977), the taxpayer sold part of its right to the water on its land to adjacent land owners and reported the amount it received from the sale as long-term capital gain from water rights. *Buena Vista* argued that the rights constituted property that did not fall within any of the exclusionary provisions of Section 1221, and thus constituted a capital asset. The Tax Court found petitioner's argument unpersuasive; stating: "It fails to distinguish between the conversion of capital investment and the sale of a right to earned income…The mere fact that what was sold by petitioner was a contract right does not establish that what was sold was a capital asset. The Tax Court held that upon the sale of a portion of its contractual right, petitioner merely received a substance for what would otherwise constitute ordinary income and, therefore, the proceeds from the sale of the right represented ordinary income. The law is fairly unclear as to when a contract right is property. On one hand, cases such as (Dresser Industries, 1963) held that intangibles can qualify as property even if all income that is earned by such intangibles is ordinary if the party is holding/using the contract. On the other hand, cases such as Buena Vista Farms attempt to differentiate among intangibles based upon whether or not the intangible represents a contractual right to receive already earned income. Although the right to receive payments pursuant to a winning lottery ticket does not accrue until dates certain, the Service could assert that, because it requires no other act by the lottery winner following the surrender of the ticket to the state lottery authority, the lottery winnings represent a right to receive already earned income and not property. If the right to the lottery winnings does not constitute property within the meaning of Section 1221 of the code, then the sale of the lottery winnings will not be characterized as a sale of a capital asset.

4.2. No Realization of Appreciation in Value

The Supreme Court in (Commissioner v. Gillette Motor, 1960) stated: "While a capital asset is defined…as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusion qualifies as a capital asset." The Supreme Court upheld a narrow interpretation of the term capital asset in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value that accrues over a substantial period of time, and thus to ameliorate the hardship of taxation of entire gain in one year. As the right to the lottery winnings does not involve the realization of appreciation in value that accrues over a period of time, it may not meet the definition of capital asset despite the fact that it falls outside the statutory exclusions.

4.3. Language of the Statute

The Service will argue that lottery proceeds are not property. They fall within the categories below. There is no mention of lottery payments in any section. This is not: stock, property used in a trade or business, a copyright, accounts receivable, a publication or a commodity. It can be argued, however, that the lottery stream of payments are a financial instrument and so they might fit into a category. It is not clear from the categories below that lottery payments or annuities, for that matter, are not capital assets. Section 1221 Capital Asset Defined (a) IN GENERAL-For purposes of this subtitle, the term "capital asset" means property, the taxpayer holds (whether or not connected with his trade or business) but does not include:

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on one hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by-(A) a taxpayer whose personal efforts created such property, (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or

exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in paragraph (A) or (B);

(4) accounts notes receivables acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public; and which is held by-(A) a taxpayer who so received such publication, or (B) a taxpayer in whose hands the basis of such publication, or (B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from the sale or exchange, in whole or in part by reference to

(6) any commodities derivative financial instrument held by a commodities derivatives dealer unless-(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a

(7) dealer, and (B) such instrument is clearly identified in such dealer's records as (8) being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); basis of such publication in the hands of the taxpayer described in subparagraph (A); any commodities derivative financial instrument held by a commodities derivatives dealer unless-(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and (B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

4.4. Arguments for Capital Gains Treatment

Gain from the sale or exchange of a capital asset that a taxpayer holds for more than one year is capital gain. The maximum tax rate applicable to net long term capital gains recognized by individuals is twenty-eight percent. On the other hand, the maximum marginal tax rate after the 2001 Act, applicable to ordinary income is about thirty-nine percent. As a consequence, a lottery winner recognizes significant federal income tax advantage if the gain from the sale constitutes a long-term capital gain.

4.5. Capital Gain

Three points support the treatment of a sale of lottery winnings as a sale of a capital asset: (1) the language of Section 1221 of the Code, (2) the court's dicta in (Silver v. Commissioner, 1960), (sale of Irish sweepstakes winnings produces capital gain), and (3) the argument by analogy that the sale of lottery winnings should receive treatment as a debt instrument. These rules applicable to annuities do not negate these arguments because a lottery winning is not an annuity for federal income tax purposes. A lottery player, unlike the annuitant, has no guaranty that he will win and thus receive a stream of payments. The annuitant can transfer the right upon death. The lottery winner does not have a contractual right to receive the payments and will continue to receive the stream of payments for as long as he lives and may not transfer the right.

4.6. Lottery Winnings as Property

Gain or loss from the sale of an asset can be capital gain or loss only if such asset constitutes a capital asset for federal income tax purposes (Internal Revenue Service Tax Code Section 1221). Intangible rights, such as contractual rights, can qualify as property for federal income tax purposes. In (United States v. Dresser, 1977), the taxpayer held two patents to an oil exploration technique using nuclear technology. The taxpayer sold an exclusive license to a third party (who co-incidentally was the original patent holder) to exploit the technology. The taxpayer argued that the license effectuated a sale of the patents. The Service asserted that even if the transaction deprived the taxpayer of all ownership of the technology, the technology did not constitute a capital asset. In the Dresser case, the court distinguished the facts before it from the cases that hold a sale of a future right to income already earned is not the sale of a capital asset. It held that the technology rights were intangibles and "that all the income which could be earned (from the exploration of the patent) would be ordinary income is immaterial." The selling of patent rights constituted the sale of a capital asset. Lottery winnings represent a contractual right to receive distributions of cash from a state lottery authority (or other governmental authority). The fact that this contractual right is an intangible should not preclude it from qualifying as a capital asset within the meaning of Section 1221 of the Code. The right to receive the lottery winning may not constitute the right to receive already earned income because, like a bond or other debt instrument, the right to receive the payments does not occur until the time for receipt of the payment accrues. The right to receive the payments requires

time to vest in the lottery winner.

4.7. The Silver Case

Silver v. Commissioner, (1960), further supports the position that a lottery ticket should be considered a capital asset. In Silver, a neighbor purchased a winning Irish sweepstakes ticket in Silver's name. Silver received the ticket as a gift. Silver contended that the amount of the gift was not the $2.50 paid for the ticket, but the amount of winnings the winner realized from the ticket. In the Silver case the court rejected Silver's contention, "All that (Silver) received by way of gift was a ticket costing approximately $2.50…it thereupon became part of (Silver's) capital…the prize money was realized on a capital asset acquired by gift…" Although the issue in Silver was not whether gain the winner realizes upon a sale of a winning lottery ticket is capital gain, the court unequivocally stated that a winning lottery ticket is a capital asset. Although the statement is only dicta in the case, it does support the aforementioned interpretation of Section 1221 of the Code. A court's dicta in a particular case can indicate how the court plans to rule later, in a majority opinion, n this particular issue. The Silver case is still good law as it does receive positive treatment by other courts.

4.8. Analogy to a Debt Instrument

Except with respect to a dealer who holds a debt instrument as inventory, all income the taxpayer realizes with respect to a debt instrument will constitute ordinary interest income (either as interest through or as original issue discount) Internal Revenue Service Tax Code Section 163, 1272. Furthermore, when the taxpayer purchases an instrument, at a discount in the secondary market, and holds it to maturity (paid in full), the portion of the income resulting from the discount is ordinary income Internal Revenue Service Code Section 1276 (a) (1). On the other hand, if a taxpayer purchases a bond at a discount and then, either because of changes in interest rates or the credit profile of the issuer, the bond appreciates, any gain the taxpayer recognizes in such sale (other than market discounts which accrue) will be capital gain Internal Revenue Service Tax Code Section 1221. The gain from the sale of that asset is capital gain even if the asset is held to maturity.

4.9. Taxable as an Annuity

In general, any gain is ordinary income when a taxpayer realizes it from a taxable sale or exchange of an annuity contract. Lottery winnings resemble annuity payments in that fixed payments are made annually for a set period of time and the fixed payments do not differentiate between interest and principal. Lottery winnings differ from annuities in that the annuities did not invest a sum with an annuity provider or an insurance company as consideration for the guaranteed payout. The lottery ticket buyer pays the dollar in hopes of winning a stream of payments but there is no guarantee. If a lottery winning is under the definition of an annuity, then gain from the sale of a stream of lottery winnings is not taxable as capital gain. (Internal Revenue Tax Code Section 72). In a past decision, the Service addresses the federal income tax consequences of transferring, by gift, undivided fractional interest in a state lottery prize and it concludes that: (1) the taxpayer should include each lottery prize installment as income for the taxable year in which each installment is actually or contractually received, whichever is earlier, and (2) the lottery prize is not taxable as an annuity (Private Letter Ruling, 1990). In a Private Letter Ruling, the Service found that Section 61 applies to each lottery prize installment as income, including any portion that is distributable. The prize winner asked for the decision because he wanted to transfer by gift to three individuals an undivided 3.5 percent interest in the remaining lottery prize. Thus, the Service recognizes that notwithstanding certain superficial similarities between annuities and lottery winnings, that lottery winnings are not taxable as annuities for federal income tax purposes.

5. Sales of Partial Interest in Lottery Winnings

As described above, a lottery winner may sell less than his entire remaining lottery stream of payments. A lottery winner may sell: (1) only a portion of each payment, or (2) only certain payments, or (3) only a portion of certain of his payments. Even assuming that a sale of the entire interest constitutes a sale of a capital asset, an issue arises as to whether the retention of a portion of the payment stream prevents the transaction from constituting a sale or exchange. If a transaction does not result in a sale or exchange, the gain from the transaction cannot be capital under current law Internal Revenue Tax Code Section 1222. Under Section 1286(h)(3) of the Code, a person who strips a bond must allocate his basis between the stripped portions in proportion to the fair market value of such stripped portions. When the bond stripper sells one or more of the stripped portions, he recognizes gain or loss equal to the excess of the amount he realizes in the sale over his allocated basis Internal Revenue Service Tax Code Section 1001. Provided that the bond is a capital asset in the bond stripper's hands, any gain or loss she recognizes upon a disposition of the stripped portion is capital gain or loss Internal Revenue Service Code Section 1221. A bond for the purposes of Section 1286 of the Code means, "a bond, debenture, note, certificates or other evidence of indebtedness." Generally speaking, to strip a

bond means to separate a portion of the right to receive payments out from the remaining payment stream. A lottery winner who sells less than all of the remaining payments on his lottery winnings should not be precluded from asserting that case law exists for the proposition that gain from the transaction is capital gain because he may assert that the transaction is akin to a stripped bond. Consistent with case law the act itself of stripping the asset converts the asset into a capital asset since an ordinary asset is not large enough to be stripped. The right to receive a stream of payments from a lottery authority or other definition of a bond for purposes of Section 1286 of the Code both fall within the other evidence of indebtedness portion of the definition. The transaction pursuant to which the portion of the payments is sold should be considered a stripping transaction because it is a separation of certain of the payments from the remaining payments. Therefore, provided that the lottery winner is not a dealer in lottery winnings (or similar evidence of indebtedness), the arguments favoring capital gains treatment should be available to a person who sells less than his entire winning stream.

6. Conclusion

Taxpayers seek to pay the least amount of money in taxes. The capital gains rate is lower than most people's personal income tax bracket. People want capital gains treatment whenever possible. If this is viewed as a sale of a capital asset then the taxpayer is on solid ground. There are dire consequences to the taxpayer if it is not treated as a sale of capital asset. Interpretation and application of relevant case law suggests that there is a legitimate basis for treating the sale of gambling/lottery winnings as a sale of a capital asset entitled to capital gains treatment. Based upon the relative strength of the analyses in favor of a winning lottery ticket constituting property, that, when sold, generates capital gain, substantial authority exists for the position. The language of the (Silver, 1960) case, Section 1221 of the Code, and the analogy to a debt instrument provide a well-reasoned analysis of existing authorities to support such a conclusion. The law is unsettled in this area. There is no case on point. Applying the legal principles discussed in this article, the taxpayer will most likely face a challenge by the Service. The Service will assert that the gain is ordinary and penalties and interest will be levied against the taxpayer. This is the decision the taxpayer in the case study is faced with.

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[13] Section 1222 (3) of the Internal Revenue Service Tax Code.

[14] Section 1001 of the Internal Revenue Service Tax Code.

[15] Section 1286 (e) (1) and (e) (2) of the Internal Revenue Service Tax Code.

[16] Section 163, 1272 of the Internal Revenue Service Tax Code.

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