So your client just won the lottery …

By Dan W. Holbrook

"The odds of winning the lottery are essentially the same whether or not you buy a ticket." — Conrad Teitell

Congratulations! Your client just beat the odds, won the Tennessee lottery, and picked you, out of all the lawyers in the state, to advise her. Now what? Your analysis should begin with four questions.

1. Who should own the ticket? This may seem simple, but here is where you are most likely to earn your fee, unless the winner has already filed her claim.

Your client may well desire to share her good fortune with others, especially spouse or children, by listing co-owners to claim the prize.[1] Can she? Interestingly, Tennessee's lottery web page, www.tnlottery.com, answers the question about whether a group of people can share a prize as follows: "Yes, lottery prizes can be shared. Winners can decide how to share a prize before they claim it. The lottery will only issue one prize check." Moreover, IRS Form 5754, Statement by Person(s) Receiving Gambling Winnings, allows one person to name himself as agent for others who are sharing in the winnings, by listing all the other winners and their respective amounts won. These inducements to divide the pie seem to contradict *Tenn. Code Ann.* §4-51-123(c)(1): "No prize, any portion of a prize, or any right of any person to a prize awarded shall be assignable." Tennessee's web page makes sense if the word "awarded" in the Tennessee Code is intended to apply after every use of the word "prize" — in which case the statute reads, in effect, that any prize can be assigned at any time until it is awarded by the Tennessee Education Lottery Corporation (TELC), but not afterward. If so, this may be a trap for the unwary, since federal tax law trumps state law on the tax consequences of assignment.

If Mom learns she holds a winning ticket, and then assigns interests in the ticket to her children before claiming the prize, she has made taxable gifts on the one hand and failed to assign the income tax liability on the other hand, a double whammy. If Mom assigns interests in the ticket *before* it becomes a winning ticket, the lottery proceeds are excluded from gift tax and taxed for income tax purposes to the multiple owners according to their percentage interests. A pre-winning agreement, even if oral, is the key to successful sharing of ownership.[2] The problem, of course, is proof. Although the absence of a written agreement is not necessarily fatal, the taxpayer has an extremely high burden of proof as to a pre-existing agreement in the family context. While clients cannot invent facts, human drama suggests that actual events are often ambiguous, and it is the attorney's job to determine whether the actual facts admit of any prior understandings or agreements that may help reduce the income, gift, or estate tax exposures. Any such understandings, if not already reduced to writing, should be documented by the attorney. The *Winkler* case cited in footnote 2 is a model taxpayer victory, where the Tax Court upheld the existence of a family partnership based on an analysis of the facts and the broad definition of partnership. Of course, if your client bases her tax reporting on a memorialized pre-winning agreement, you, the attorney, must be sure to explain the potential adverse gift and income tax consequences if the IRS successfully attacks its validity.

In most cases there will not be any pre-winning agreement, but it may still be desirable to form an entity to claim the prize. One alternative is a partnership, with the client contributing the winning ticket for a 99+% interest, and family members contributing nominal amounts for initial interests. The partnership would obtain a tax identification number from the IRS[3] and then claim the prize. Subsequently the winner can make gifts of interests in the partnership to other partners, without violating the Tennessee Code's apparent restriction on transferability

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of the prize. Another alternative is a revocable trust. The grantor contributes the winning ticket to the trust, and then the trustee obtains a federal tax identification number for the trust and claims the prize on behalf of the trust. Since the grantor can amend the trust, she can add spouse or others as beneficiaries during life or at her death for estate planning purposes, subject to the various income, gift, and estate tax rules. Tennessee law specifically contemplates the use of trusts in *Tenn. Code Ann.* §4-51-123(c)(1), which states: "Any prize or any portion of a prize remaining unpaid at the death of a prize winner shall be paid to the estate of the deceased prize winner or to the trustee of a trust established by the deceased prize winner as settlor if a copy of the trust document or instrument has been filed with the corporation along with a notarized letter of direction from the settlor and no written notice of revocation has been received by the corporation prior to the settlor's death."

2. Can (or should) your client take a lump sum? *Tenn. Code Ann.* §4-51-108(a) authorizes the board of the TELC to issue regulations, policies, and procedures regarding prizes, including options for lump sum payments or installments over a number of years. Based on the experience in other states, and on the recent decision of TELC to join Powerball, it is safe to assume such regulations will offer some grand prize winners a choice between lump sum or annual installments. The choice between lump sum or annuity may depend on many factors, including the client's age, experience, family situation, income tax brackets, exposure to death taxes, ability to handle large sums of money, etc.

One huge income tax problem is the constructive receipt doctrine, under which a lottery winner given a choice between a lump sum or an annuity must report the entire value of the lump sum in federal gross income in the year of the election, even if the annuity option is chosen.[4] Prior to 1998, most state lotteries avoided constructive receipt by requiring the buyer to make the choice at the time the ticket is purchased, a time when the buyer has probably not been adequately informed of the tax implications of her choice. Internal Revenue Code §451(h), enacted in 1998, overrides the federal constructive receipt doctrine for a "qualified prize" (one of the requirements of which is that the annuity term be at least 10 years) by giving the winner 60 days in which to seek counsel and make an informed choice, but only if the state law conforms to §451(h). Unfortunately, the Tennessee enabling legislation did not specifically meet the requirements of §451(h) for a "qualified prize." Thus there are two ways the TELC can help the taxpayer avoid constructive receipt. We must hope that the regulations, which have not yet been adopted, either meet the requirements for a qualified prize or else adopt the pre-1998 method. Otherwise, every winner should choose lump sum since it will all be taxed immediately anyway.

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3. What will be the income tax burden? On any lottery prize over $5,000, the TELC must withhold 25 percent[5] and file IRS Form W-2G to report the taxes paid. Winners of large prizes may be dismayed the following April 15 to learn they owe even more, from being taxed at rates higher than withheld. Clients can deduct gambling losses, including not only the price of the winning ticket but also other gambling expenses, provided they are properly substantiated.

Beyond that, consider charitable gifts to reduce the taxes owed. Big winners who take a lump sum and who have charitable inclinations should consider a grantor-type Charitable Lead Annuity Trust (CLAT), which provides an up-front charitable income tax deduction. The trust pays amounts to charity for a term of years, and the balance to family members at the end of the term. Although the client would pay income tax on the income earned by the trust during its term, without receiving any cash flow during those years, the trust can be invested largely in tax-exempt bonds or growth stocks. Depending on the return of the trust during its term, the family may receive a significant distribution at the end, largely free of gift or estate tax.

Finally, beneficiaries of the estate of a deceased lottery winner who had elected annuity payments instead of a lump sum can take an income tax deduction under Internal Revenue Code §691(c) for federal estate taxes

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attributable to the value of that income in the decedent's estate.

4. How can the client reduce gift and estate taxes? Our firm's experience is that lottery winners begin making gifts almost before they have the money in hand, and then want to "shoot the messenger" when confronted with cold, hard tax laws. At the very least, a gift plan for utilizing the gift tax annual exclusions should be discussed and worked out with the client, and the client should be made aware of all the necessary procedures for reporting and documentation.

At the client's death, her estate includes all assets paid to her that she has not spent or given away, plus the lump sum value of any remaining annuity payments. Several planning ideas can reduce or eliminate the death taxes.

First, be sure the client has a will or a revocable trust as a testamentary instrument. Second, take advantage of the usual estate planning tools, such as the marital or charitable deductions. Third, if your client took your advice and created a partnership to own the ticket, convert it into a limited partnership and take advantage of potential valuation discounts on the partnership interests, both for annual gifting and for valuation in the taxable estate at death. Fourth, take advantage of Internal Revenue Code §6161, which allows a 10-year payout of federal estate taxes, plus interest. Of course, this may not help estate beneficiaries as much as one might think if the remaining annuity payout term is much longer than 10 years. In one notorious case in Texas, the estate tax payments during the 10 years were greater than the actual annuity payments from the lottery being paid over 25 years, so that for 10 years the decedent's sole beneficiary was being forced to deplete her own estate to make the tax payments, and she could enjoy the lottery only after the 10 years ended. Texas regulations were amended on account of her predicament to allow her to elect a lump sum.[6] Fifth, consider whether the Tennessee state law making the lottery prize non-assignable depresses the lump sum fair market value of the remaining payments. Cases in the Second and Ninth Circuits have so held, although the Fifth Circuit and the Tax Court disagree.[7] Sixth, if interest rates rise after the date of death, use the alternate valuation date six months after death, which decreases the lump sum value of the remaining annuity payments. Seventh, if liquidity is an issue, consider having the client buy a life insurance policy and use the lottery annuity payments to pay premiums, preferably in a trust so the death benefit can be kept out of the client's taxable estate.

Most of all, the lottery winner needs trusted counsel, perhaps a team of advisors, and plenty of patience to resist short-term urges in favor of a long-term plan.

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1. Your client may even have a devious reason for wanting to assign the ticket, such as an outstanding debt to the state of Tennessee or to an individual on whose behalf the state of Tennessee acts to collect a debt, such as past due taxes, penalties and interest, judgment against her to the state of Tennessee, an outstanding child support obligation, or a past due education loan. On the flip side, she should be careful that any proposed assignee of an interest in the ticket not have such liabilities either.

2. See Rev. Rul. 55-638, 1955-2 C.B. 35, PLR 9217004, and *Winkler Est. v. Comr*, TCM 1997-4.

3. Federal Employer Identification Numbers (EINs) can now be obtained online at www.irs.gov.

4. A taxpayer constructively receives income before an actual receipt when the income is made available to her without substantial limitations or restrictions. Internal Revenue Regulations §1.451-2(a). If the lump sum offered by the TELC is less than the fair market value of the annuity option (which may well be the case), there is a sound argument that the winner electing the annuity should not constructively receive the lump sum payment, because she would be giving up

something substantial, i.e., the excess value. See by analogy Rev. Rul. 80-300, 1980-2 C.B. 165. The result may also depend on whether the TELC default is an annuity unless the winner chooses a lump sum, which is typically the case with large lottery prizes, or the other way around, with the former less likely to involve constructive receipt than the latter.

5. Under Internal Revenue Code §3402(q), the amount required to be withheld is the third lowest tax rate for a single individual under Code §1(c), which is 25 percent for 2004. The maximum rate for all categories of taxpayer in 2004 is 35 percent.

6. "Commission Moves to Aid Estate to Handle Large Inheritance Tax Bill," *San Antonio Express-News*, Aug. 29, 1996, at 20A.

7. *Shackleford v. U.S.*, 262 F.3rd 1028 (9th Cir., 2001), *Gribauskas v. Comm.*, 116 T.C. 142 (2001), rev'd 342 F.3rd 85 (2nd Cir., 2003), and *Cook v. Comm.*, ___ F.3rd ___ (5th Cir., 2003).



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