

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:IT&A:05-PLR-110663-99

Date:

May 5, 2000

State Lottery =

State =

Act =

X =

Date a =

Date b =

Dear . . . :

This responds to your request for a private letter ruling, dated June 9, 1999, submitted on behalf of the State Lottery. Specifically, you have asked for a ruling that:

The assignment of all or part of future lottery payments by a "Lotto" jackpot prize winner pursuant to the procedures established by the State statute, as amended by the [Act], will not cause other cash basis lottery prize winners who are entitled to receive their prizes in the form of an annuity and who do not assign their rights to such payments to realize income for federal income tax purposes in advance of the receipt of such payments from the State Lottery.

FACTS:

The State Constitution authorizes the establishment of a state lottery. Enabling legislation created State Lottery as a separate agency of the State. State "Lotto" is one

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of several lottery games administered by State Lottery. Lotto contestants select six numbers from a field of forty-nine numbers at the time they purchase lottery tickets. Lottery drawings are held once a week, with six numbers selected, and prizes are awarded to contestants who correctly match three, four, five, or six of the selected numbers. The amount of the prizes depends upon the total amount wagered on the particular drawing, amounts rolled over from previous drawings in the particular prize category (i.e., because there were no matching combinations in the prior drawing), and the number of winning tickets in each category. Under the State Lottery rules, the first prize ("jackpot") in a Lotto drawing is awarded to any player who matches all six numbers on one ticket.

The State Lottery has implemented the provisions of § 451(h) of the Internal Revenue Code. This provision allows states to offer prize winners the option of receiving in a single cash payment any lottery prize that otherwise is payable over at least ten years, provided the option is exercised within sixty days of the date of the taxpayer's entitlement to the prize. Section 451(h) also provides that the availability of this option will not affect the taxation of those prize winners who do not choose the single payment option. In accordance with § 451(h), the State Lottery rules provide that "Lotto" jackpot winners have the option of receiving their share of the jackpot pool either as a single cash payment or in thirty (30) annual payments.

State law requires the X to invest moneys available for payment of prizes on a deferred basis in accordance with a trust agreement between the State Lottery and the X. The trust agreement requires investment in U.S. Treasury Bonds that will mature in each of the years for which an annual payment must be made. The securities are purchased in the name of the State and are not set aside for any specific winner.

Prior to the effective date of the amendment contained in the Act (the "Amendment"), the State statute provided that a prize winner's right to a prize was not assignable other than to the estate of a deceased prize winner or to a person designated pursuant to an appropriate judicial order.

The Amendment, which was signed into law on Date a, expressly permits the voluntary assignment of the right to receive future annual prize payments, in whole or in part, if the assignment is made pursuant to an appropriate court order, and provides specific procedures for obtaining that order. Specifically, under the Amendment, a written notice (a petition) of the proposed assignment and any court hearing must be provided in advance to the State Lottery. The State Lottery may intervene in the judicial proceeding, and the court receiving the petition is authorized to issue an order approving the assignment provided all of the following conditions are met: (1) the assignment is in writing and is subject to by its terms to State law; (2) the discount rate being used does not exceed State's usury limit for loans; (3) the assignor provides a sworn written declaration that he/she had an opportunity to consult with independent legal counsel, has received independent tax and financial advice, is of sound mind and

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not acting under duress, understands that he/she will not receive payments or portions thereof during the assignment period and that the State Lottery will have no liability to make the assigned payments to him/her, has been provided a disclosure statement setting forth the payments being assigned, the purchase price being paid, the discount rate, and any origination or closing fees, and was advised in writing that he/she had the right to cancel the contract within 3 business days; and (4) the State Lottery received the required notice. The court order must provide that delinquent child support obligations of, or debts owed to a state agency by the assigning prize winner as of the date of the court order shall be offset first against remaining payments to the winner and then against payments to the assignee. The Amendment also authorizes the State Lottery to establish a reasonable fee to defray administrative expenses associated with effecting assignments.

The effective date of the Amendment is the earlier of date b, or the receipt of the ruling requested from the Internal Revenue Service (Service). The Amendment provides that if at any time the Service or a court of competent jurisdiction issues a determination letter, revenue ruling, other public ruling of the Service, or published decision to any state lottery or prize winner of any state lottery declaring that voluntary assignment under the State statute will affect the federal income tax treatment of prize winners who do not assign their prizes, a court may not issue an order authorizing a voluntary assignment after the date any such ruling, letter, or published decision is filed.

The State Lottery has represented that several private companies operate in other states with voluntary assignment provisions similar to the Amendment. These private companies contract to purchase a winner's future installment payments in exchange for a discounted, fixed sum. This has already occurred in State after the Amendment became effective. Experiences in other states with similar statutes in effect indicate that pricing is negotiated on a case-by-case basis and that, as a result, discount rates vary widely.

LAW AND ANALYSIS:

Lottery winners generally use the cash receipts and disbursements method of accounting. Taxation of the value of an annuitized lottery prize in the year the prize is won requires application of one of three tax doctrines: constructive receipt, economic benefit, or cash equivalence.¹

A. Constructive Receipt

¹ Although there are distinct criteria for application of each of the doctrines, they are often referred to collectively as constructive receipt. Nevertheless, each of these three theories of income inclusion will be considered separately in this ruling.

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Section 451 of the Internal Revenue Code provides that the amount of any item of gross income shall be included in a taxpayer's gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. According to § 1.451-1(a) of the Income Tax Regulations, under the cash receipts and disbursements method of accounting, such amounts are includible in gross income when actually or constructively received.

Section 1.451-2(a) of the regulations provides that income, which is not actually reduced to a taxpayer's possession is constructively received by the taxpayer in the taxable year during which it is credited to the taxpayer's account set apart for the taxpayer, or otherwise made available so that the taxpayer may draw on it at any time, or so that the taxpayer could have drawn on it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The courts have determined that the following conditions are necessary to tax an amount under the doctrine of constructive receipt: (1) the amount must be due; (2) the amount must be appropriated on the books of the obligor; (3) the obligor must be willing to pay; (4) the obligor must be solvent and able to pay; and (5) the obligee must have knowledge of the foregoing facts. In essence, the obligee's demand for payment must be the only thing that would be necessary for payment.

The value of an annuitized lottery prize under the State Lottery would not be taxable by reason of the constructive receipt doctrine. Prior to the effective date of the Amendment, the value of an annuitized lottery prize was not taxable by reason of constructive receipt in the year the prize was won. The winner had no current right to receive the prize. Constructive receipt requires that an amount credited to an individual's account be subject to unqualified demand. Robinson v. Commissioner, 44 T.C. 20 (1965); Basila v. Commissioner, 36 T.C. 111 (1961) acq., 1962-1 C.B. 3; Oates v. Commissioner, 18 T.C. 570 (1952), aff'd, 207 F.2d 711 (7th Cir. 1953); Veit v. Commissioner, 8 T.C. 809 (1947), acq., 1947-2 C.B. 4. The Amendment does not alter the time in which the Lottery makes prize payments. A lottery winner's power to assign his or her rights to a lottery prize does not accelerate the time in which the Lottery is required to make prize payments. Accordingly, a lottery winner is not taxable on the value of an annuitized prize in the year it is won under the doctrine of constructive receipt by virtue of the Amendment.

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B . Economic Benefit

The doctrine of economic benefit requires a determination that the actual receipt of property or the right to receive property in the future confers a current economic benefit on the recipient. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for a taxpayer's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 195 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174 (Situation 4).

In Sproull, the court applied the economic benefit doctrine to tax amounts an employer paid to an interest bearing trust as compensation for an employee's past services. No one other than the employee had any interest in or control over the monies in the trust. The employee was required to take no further action to earn or establish his rights to the amounts in trust. The trustee's duties were limited to holding, investing, and paying the amounts in trust to the employee or his estate in the event of his prior death in the two taxable years following the creation of the trust. The Tax Court held that "there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit." Sproull, 16 T.C. at 248.

In Pulsifer v. Commissioner, 64 T.C. 245 (1975), a minor was held taxable on winnings from the Irish Sweepstakes in the year the winnings were deposited in an interest bearing bank account for the minor's benefit. The funds, including interest, were to be held in the account until the minor reached age 21 or the minor's legal representative applied for release of the funds on the minor's behalf.

The absence of a right to assign an individual's interest in amounts held in a fund or trust for the exclusive benefit of the individual does not preclude taxation under the doctrine of economic benefit. However, it may affect the value of such interest. United States v. Drescher, 179 F.2d 863 (2d Cir. 1950). In circumstances where an employer provided additional compensation to an employee in the form of a paid-up single premium non-assignable annuity contract that had no cash surrender value, the employee was taxed on the value of the annuity contract in the year received. Brodie v. Commissioner, 1 T.C. 275 (1942).

If the State Lottery purchased an annuity and irrevocably named a lottery winner as the beneficiary of the annuity, the lottery winner could be taxed in the current taxable year on the value of the annuity under the economic benefit doctrine. Lotteries that purchase annuity contracts to fund prize payments avoid application of the economic benefit doctrine by naming the lottery rather than the winner as the owner and beneficiary of the annuity. The lotteries use the payments received under the annuity contracts to fund payments to the lottery winners. Similarly, lotteries that invest in Treasury securities or strips of Treasury securities do not set aside securities beyond the reach of creditors for the exclusive benefit of a lottery winner. Proceeds of maturing securities are used to fund the annual payments to a prize winner.

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The Amendment would not result in the application of the economic benefit doctrine. Following the effective date of the Amendment, a winner would have very limited rights to amounts he or she has not received. Unlike the taxpayers in the cases described above, State law would not provide for an irrevocable set aside of funds for the benefit of a particular lottery prize winner. The State statute and rules, both prior to and subsequent to the effective date of the Amendment, do not provide for crediting to a prize winner's account any amount greater than the required annual payment due and payable to the prize winner that year. The prize winner has no right under State law to obtain a greater sum in any year from State. Accordingly, the present value of annuitized prizes would not be taxable by reason of economic benefit subsequent to the effective date of the Amendment.

C. Cash Equivalency

Amounts that are not taxable under constructive receipt or economic benefit may nonetheless be includible in gross income under the doctrine of cash equivalency. Under this doctrine, a taxpayer is treated as having income when he or she receives property that is the "equivalent of cash." Decisions in cases involving cash equivalency have been based on the facts and circumstances of the particular cases; neither the Code nor the regulations define cash equivalency. In situations where a contract provided for deferred payments and no notes or other evidences of indebtedness were given, the contract rights, which were not of a type commonly sold or given as part of the purchase price, were held not to be property and, therefore, not a cash equivalent. Estate of Ennis v. Commissioner, 23 T.C. 799 (1955); Ennis v. Commissioner, 17 T.C. 465 (1951); Johnson v. Commissioner, 14 T.C. 560 (1950).

In Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961), rev'g and rem'g 32 T.C. 853 (1959), on remand T.C. Memo 1961- 229, the court considered the taxation of contract rights to non- interest bearing deferred bonus royalty payments under an oil and gas lease. The rights to the deferred bonus payments were discounted to a bank for a nominal discount. The court stated that a promissory note, negotiable in form, is not necessarily a cash equivalent. Considerations such as the doubtful solvency of the maker might prevent the market's acceptance of a note. Current taxation of the contract rights as a cash equivalent was based on the solvent obligor's assignable unconditional promise to pay being of a kind not subject to set-offs and frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money. On remand, the Tax Court held the contract in Cowden to be a cash equivalent even though it did not make a finding that the contract was not subject to set-offs.

In Jones v. Commissioner, 524 F.2d 788 (9th Cir. 1975), the Ninth Circuit considered circumstances involving a cash basis taxpayer's sale of an apartment building. The taxpayer received a \$20,000 down payment and the buyer's promise in a standard form real estate contract to pay \$133,000, plus interest, over the following

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fifteen years. The contract -- which was the only evidence of the purchaser's indebtedness -- was of a type typically bought and sold in the area. The Tax Court determined the fair market value of the contract to be \$76,980. Based on the substantial discount from the \$133,000 face amount of the contract indicated by the lower fair market value, the Tax Court held that the fair market value of the contract was not includable in the amount realized because the contract was not a cash equivalent.

The Ninth Circuit reversed the Tax Court's decision in Jones. According to the appeals court, if the fair market value of a deferred payment obligation received in a sale or other exchange can be ascertained, that fair market value must be included as an *amount realized* under § 1001(b) of the Code. However, the Ninth Circuit's decision in Jones appears to stand only for the proposition that, for § 1001(b) purposes, the fair market value of property (other than money received) is includable as an amount realized from a sale or other disposition of property. If the fair market value of property received can be ascertained, the fair market value constitutes an amount realized. The Ninth Circuit did not hold that the fair market value of property received in an exchange is a cash equivalent. Section 1001(b) is not applicable in determining the income tax consequences of winning a lottery prize because the lottery prize is not received incident to the sale or other disposition of property.

It has not been established that the cash equivalency doctrine should be applied in this case to require immediate recognition of gross income. As discussed above, there are no prevailing market rate discounts applied to lottery prize payments paid in the form of an annuity. Rather, discounts will be negotiated on a case-by-case basis. Thus, it has not been established that prizes are frequently transferred to lenders or investors at a discount not substantially greater than the prevailing premium for the use of money.

CONCLUSION:

The assignment of all or part of future State Lottery payments by a "Lotto" jackpot prize winner pursuant to the procedures established by the State statute, as amended by the Amendment, will not cause other cash basis "Lotto" prize winners who are entitled to receive their prizes in the form of an annuity and who do not assign their rights to such payments to realize income for federal income tax purposes in advance of the receipt of such payments from the State Lottery.

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of the above transactions under other provisions of the Code and regulations that may be applicable. No opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction that are not specifically covered by the above ruling. A copy of this letter ruling should be attached to the appropriate federal income tax returns for the taxable years in which the transactions described herein are consummated.

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This letter ruling does not express an opinion of the above transactions where prizes are frequently transferred at a discount that is not substantially greater than the prevailing premium for the use of money.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
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By _____
Douglas A. Fahey
Acting Branch Chief, Branch 5