Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1225

Date: 15-Jan-08
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Womack - Lottery Winners Again Fail In Attempt To Treat Sale Of Lottery Payments As Long Term Capital Gain**

"When I see a bird that walks like a duck and swims like a duck
and quacks like a duck,
I call that bird a duck."

In the context of the sale of lottery winnings, this old phrase might be modified by the IRS to:

"When I see a lottery payment that would have been ordinary income
if you waited for it,
or that would have been ordinary income
had you originally selected a lump sum payout,
then it's ordinary income when you receive a lump sum for the sale of it."

"In defining "capital asset," Congress did not intend for taxpayers to circumvent ordinary income tax treatment by packaging ordinary income payments and selling them to a third party."

Jeff Baskies tells **LISI** members that in a December 2007 Ruling, the 11th U.S. Circuit Court Of Appeals Affirmed the application of the "Substitute For Ordinary Income" Doctrine to the tax treatment of the disposition of lottery winnings

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EXECUTIVE SUMMARY:

At the heart of the December 19, 2007 11th Circuit decision in Womack Vs. Commissioner of IRS (affirming the Tax Court and 4 other US Circuit Courts) is the notion that lottery winners have several ways to receive their winnings, but *all* of them are going to be treated as the receipt of ordinary income.

As we all knew already, if a state offers a lump sum payout or a 20 year payout (for example), either choice by a lottery winner will cause the recipient to pay tax at ordinary rates. What this decision affirms is that for those lottery winners who chose (or in some cases, who had no choice but to accept) a 20 year payout and then have sold the future payments for a lump sum, that subsequent sale will be treated the same way – as a receipt of ordinary income.

In what proved to be a clear and concise application of the "Substitute for Ordinary Income Doctrine" (a judicial doctrine that is *not* in the Code), the

11th Circuit nailed 59 lottery winners in Florida who banded together to seek a determination that their sale of the future payments on their lottery winnings should be taxed as long term capital gains.

Stating the case, Jude Beverly Martin, speaking for the panel began:

"This is an appeal by Florida State Lottery winners from the United States Tax Court's decision that proceeds from the sale of the rights to future installment payments from lottery winnings ("Lottery Rights") are taxable as ordinary income, rather than at the lower tax rate applied to the sale of a long term capital asset. The Tax Court specifically held that Lottery Rights are not capital assets as defined in 26 U.S.C. § 1221 ("Section 1221"), under the judicially established substitute for ordinary income doctrine. We affirm."

FACTS:

At the core of the case was an appeal by Roland and Marie Womack and Anastasios and Maria Spiridakos for themselves and on behalf of 59 other Florida lottery ("Lotto") winners who agreed to be bound by this decision, all of whom sold their Lotto winnings for lump sum payouts.

Many (if not all) of the Lotto winners won prior to the enactment of a law permitting Lotto recipients to choose a lump sum payout, so they were "forced" to receive their Lotto payouts in 20 equal, annual, non-assignable installments.

In 1999, Florida amended Section 24.1152, F.S. to permit assignment of Lotto winnings for existing winners with court approval.

According to the decision, the Womack and Spridakos families each obtained court approval and sold the balance of their payments to a firm called Singer Asset Finance Company of Boca Raton, Fl.

Each of them reported the funds they received from the sale as proceeds from the sale of a long term capital asset and thus paid tax as a long term capital gain.

The IRS issued a notice of deficiency to each family, explaining that they should have reported the receipt as ordinary income and paid at the higher rates.

Each taxpayer filed a petition in the Tax Court, which consolidated the two cases and then held for the IRS on November 7, 2006.

COMMENT

WHAT IS A CAPITAL ASSET?

"The question before us is whether Lottery Rights are "capital assets" as defined by Section 1221 of the Internal Revenue Code, 26 U.S.C. § 1221."

We all know that income derived from the sale of a capital asset held for longer than 12 months is taxed as capital gain.

Currently there is a rate differential of approximately 20% favoring capital

gains treatment - the maximum ordinary income rate being 35% and the capital gain rate being 15% - but the *actual* difference may vary depending upon the size of the sale, the taxpayer's other income, the impact on deductions, etc....

For 2000 (the year in question in the holding), the differential in rates was 39.6% for ordinary income and 20% for capital gains.

In finding the future Lotto payments *outside* the definition of a "capital asset", the court noted certain criteria in distinguishing.

1. The court noted that in general, selling a capital asset involved capturing increased value from an underlying investment, such as when a taxpayer buys shares of stock for X and sells them for Y (which is greater than X). A sale of Lotto rights involved *neither* an investment of capital *nor* a gain in the capital's value.

2. Citing to United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963), the Court held that a sale of Lotto payments involved a right to income *already* earned, as distinguished from a right to earn income in the *future*. Dresser involved a grant of an exclusive license to use and develop an oil well surveying patent. The court concluded in Dresser that such a transaction warranted capital gains treatment as it involved a right to use an asset that might earn income in the *future*, as opposed to a transfer of a defined amount of income the receipt of which is just *delayed* by time.

3. The Court held that a capital asset is one with the *potential* to earn future income; whereas, the holder of a right to Lotto payments *is* entitled to the income by virtue of merely owning the right to the future payments. Thus, instead of having a right to use an asset to develop an uncertain future income (a capital asset as the court described it), the Lotto winners held an entitlement to a defined amount of income *without risk or effort*.

THE "SUBSTITUTE FOR ORDINARY INCOME" DOCTRINE:

There was no dispute about the holding period for the Lotto winners, but only a dispute over whether the sale of the future winnings should be treated as ordinary income or capital gains. The Opinion noted that the Tax Court and 4 other Circuit courts all held that the disposition of lottery winnings created ordinary income.[i]

However, the Opinion noted they did not all do so on the same basis. While the prior decisions all reviewed the same legal question, and while each Circuit court concluded that the sale of future lottery payments was a substitute for ordinary income, the Opinion noted they came to the conclusion in different ways.

Thus, the 11th Circuit tried to synthesize the opinions in an orderly fashion by applying the "substitute for ordinary income" doctrine. That doctrine provides that when you receive a lump sum payment as a substitute for future ordinary income payments (payments that would otherwise be received in the future and taxed as ordinary income), then the lump sum will be taxable as ordinary income – not as capital gains.

Explaining the origin of the doctrine and its purpose, the Court held:

"(The doctrine) prevents taxpayers from circumventing ordinary income tax rates by selling rights to future ordinary income payments in exchange for a lump sum." See Lake, 356 U.S. at 265, 78 S. Ct. at 694.

The doctrine is attributed to four seminal Supreme Court cases: Hort v. Commissioner, Commissioner v. P.G. Lake, Inc., Commissioner v. Gillette Motor Transport, Inc., and United States v. Midland-Ross Corp. The taxpayer in Hort, 313 U.S. 28, 29, 61 S. Ct. 757, 757, 85 L. Ed. 1168 (1941), a building owner, received a lump sum in exchange for canceling a lease on the property. The sum was taxable as ordinary income because it was "essentially a substitute" for the 8 rental payments, themselves obviously ordinary income. Id. at 31, 61 S. Ct. at 758.

The Court then looked to the other opinions and held:

"The Ninth Circuit used a case-by-case analysis, but focused on two factors in particular: that the taxpayer "(1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2) the sale of his right did not reflect an accretion in value over cost to any underlying asset [he] held." Maginnis, 356 F.3d at 1183. Though the Maginnis court noted that these factors would not be dispositive in all cases, the Third Circuit in Lattera, 437 F.3d at 404-09, found the factors problematic, and instead formulated its own approach, which it termed the "family resemblance" test. Within the confines of this test, the Third Circuit analyzed the nature of the sale and the character of the asset, specifically, whether the payment was for the future right to earn income or for the future right to earned income. Id. at 409. The Second and Tenth Circuits did not explicitly adopt the Maginnis reasoning or the Lattera test, but held that "whatever the [substitute for ordinary income] doctrine's outer limits, this case falls squarely within them." Prebola, 482 F.3d at 612; see Watkins, 447 F.3d at 1273 ("[W]e need not formulate any specific test regarding the appropriate limits of the doctrine's application."); Wolman v. Comm'r, 180 Fed. Appx. 830, 831 (10th Cir. 2006) ("For the same reasons stated in Watkins, we reject the Wolmans' argument and hold that the lump sum payments were taxable as ordinary income.").

After analyzing these other opinions, the 11th Circuit in Womack agreed that selling Lotto payments is a

"clear case of a substitute for ordinary income."

The Court focused on the realities of Lotto winners and the treatment of their payments. That's why the analogy to the old saying "if it walks like a duck" seems apt.

The Court noted that a Lotto winner who does not sell the rights to the payments must report each annual payment as ordinary income. And a Lotto winner who opts for a lump sum payment at the outset must report the entire payment as ordinary income when the lump sum is received.

Therefore, the Court opined, when a Lotto winner accepts the payments in installments but then sells the right to the future installment payments, the lump sum received in that transaction must also be treated as ordinary income as it's

just a *substitute* for the *other* forms of Lotto payments which are clearly taxed as such.

Applying the language of "capital assets" and the "substitute for ordinary income" doctrine, the court found that "when a lottery winner sells the right to his winnings, he replaces future ordinary income. In defining "capital asset," Congress did not intend for taxpayers to circumvent ordinary income tax treatment by packaging ordinary income payments and selling them to a third party."

BRIEF REVIEW OF TAXPAYER ARGUMENTS

The Taxpayers made several interesting arguments, none of which prevailed, obviously.

Their first argument was that Arkansas Best restricted the substitute for ordinary income doctrine.[ii] The 11th Circuit Opinion distinguished the taxpayers proposed narrow reading of that opinion. The Court agreed that Arkansas Best stood for the proposition that the substitute for ordinary income doctrine has to have outer limits. But the 11th Circuit simply disagreed with the Taxpayers as to the Lotto winnings being inside or outside those limits.

Second, the taxpayers argued the Lotto payments were "property" within the meaning of Section 1221. "As Taxpayers note, Arkansas Best makes clear that if a given asset is not listed within Section 1221's exclusions, it *is* a capital asset unless it is *not* considered "property." The Court concluded that the Lotto payments *were* "property" for purposes of many general definitions, but they were *not* "property" as Congress intended the term to be used for purposes of Section 1221.

Next, the taxpayers urged the court to treat the Lotto payments as property because they were "Accounts Receivable" as defined in the UCC.[iii] Again, the Court acknowledged the argument, but noted that the IRC does not define "accounts receivable" and the interpretation of "property" for purposes of Section 1221 would not be made on such narrow terms. The substitute for ordinary income tax doctrine was meant to be applied more broadly, the court found.

"We acknowledge the merits of Taxpayers' statutory interpretation argument. But in order to effect congressional intent, courts applying the substitute for ordinary income doctrine sometimes reach a different result than they would applying bare interpretive canons without context. See In re Griffith, 206 F.3d 1389, 1393 (11th Cir. 2000) (explaining that canons of construction "'are no more than rules of thumb that help courts determine the meaning of legislation.'") (quoting Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253, 112 S. Ct. 1146, 1149, 117 L. Ed. 2d 391 (1992)). The substitute for ordinary income doctrine prioritizes substance over form to eliminate capital gains treatment in situations involving claims for ordinary income. See Lake, 356 U.S. at 266, 78 S. Ct. at 695 ("The substance of what was assigned was the right to receive future income."). Congress did not intend to tax lottery winnings as capital gains. Thus, whether or not Lottery Rights are "accounts receivable," they are not capital assets under Section 1221."

Finally, the court rather summarily dismissed the Taxpayers arguments that the Lotto winnings should be treated as debt instruments.

CONCLUSION:

The 11th Circuit's opinion is a clear rejection of the argument that Lotto winnings should be taxed as capital gains and a ringing endorsement for the broad power of the IRS to apply the substitute for ordinary income doctrine.

The Opinion straight-forwardly rejects the multiple taxpayer arguments for capital gain treatment, clearly articulates the substitute for ordinary income doctrine and tries to weave together the prior opinions from other Circuits on the issue.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Baskies

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CITES:

Roland Womack et ux. et al. v. Commissioner No. 07-11568

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[i] "The Tax Court and the four U.S. Circuit Courts to consider the question have concluded that Lottery Rights are not a capital asset within the definition set forth in Section 1221. E.g., Prebola v. Comm'r, 482 F.3d 610 (2d Cir. 2007); Watkins v. Comm'r, 447 F.3d 1269 (10th Cir. 2006); Lattera v. Comm'r, 437 F.3d 399 (3d Cir. 2006), cert. denied, 127 S. Ct. 1328 (2007); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Comm'r, 119 T.C. 1 (2002). These decisions are based on the so-called substitute for ordinary income doctrine, which provides that when a party receives a lump sum payment as "essentially a substitute for what would otherwise be received at a future time as ordinary income" that lump sum payment is taxable as ordinary income as well. Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 265, 78 S. Ct. 691, 694, 2 L. Ed. 2d 743 (1958)."

[ii] Arkansas Best Corp. v. Comm'r, 485 U.S. 212, 108 S. Ct. 971, 99 L. Ed. 2d 183 (1988).

[iii] U.C.C. § 9-102(a)(2).