

# *Valuation of Lottery Prize Payments for Estate Tax Purposes: An Analysis*

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## Valuation of Lottery Prize Payments for Estate Tax Purposes: An Analysis

By Ted D. Englebrecht and Mary M. Anderson

JUNE 2007 - The valuation of future lottery prize payments that flow through an estate has resulted in diametrically opposed decisions at the different appellate levels. The most recent opinion of *Donovan v. United States* (95 AFTR 2d 2005-2131, April 26, 2005) supports the IRS's contention that these winnings should be valued as an annuity in accordance with IRC sections 2039 and 7520. This district court ruling in the First Circuit aligns with the decision of the Fifth Circuit in *Cook v. Comm'r* [349 F.3d 850 (92 AFTR 2d 2003-7027) 5th Cir. 2003].

This stance, however, is at odds with two separate appellate decisions, in the Second Circuit case of *Gribauskas v. Comm'r* [116 T.C. 142 (2001), 2001 WL 227025, reconsidered and rev's, 342 F.3d 85 (92 AFT 2d 2003-5914)(2nd Cir. 2003)] and the Ninth Circuit case of *Shackleford v. United States* [262 F.3d 1028 (88 AFTR 2d 2001-5658)(9th Cir. 2001)]. These rulings support an estate tax valuation of lottery winnings per IRC section 2033. Thus, on one hand, the IRS and the Tax Court consistently value lottery winnings in an estate tax context as the present value of an annuity, using the actuarial formula in the regulations. On the other hand, several appellate jurisdictions support the taxpayers' contention that the proper valuation is the fair market value method.

What is at issue in this growing controversy are the marketability and assignability restrictions of lottery payouts. Under the actuarial formula, these characteristics are irrelevant. Using the fair market value methodology, the restrictions are crucial and, as expected, the resulting valuations can affect estates in very different ways.

What follows is a review of the statutory, administrative, and judicial interpretations involving valuation of lottery payments for estate tax purposes, along with an analysis of the critical elements in this interpretive controversy, and several recommendations on how to alleviate this growing estate tax issue.

### Lottery Prizes

In the mid-1970s, gambling was relatively rare in the United States. Nevada was the destination for gamblers; a few states provided lotteries and parimutuel gambling, such as horse racing, dog racing, and jai-alai. Today, however, some form of gambling is allowed in 47 states and Washington, D.C. Revenues in 1997 were estimated at over \$50 billion and rapidly increasing. This amount represents more than 10% of the monies available to Americans for leisure goods, services, and activities. To judge the impact of this immense industry, note that this amount does not include hotels, food, transportation, or other expenditures associated with gambling activities.

While the federal government is not heavily involved in the gaming industry, state governments participate by regulating and taxing commercial enterprises or sponsoring state lotteries [National Gambling Impact Study Commission, National Gambling Impact Study Commission Final Report (1999), [govinfo.library.unt.edu/ngisc](http://govinfo.library.unt.edu/ngisc) (as of March 16, 2006)]. In 2003, \$49.1 billion was spent on state lotteries alone. As of March 2006, when North Carolina introduced its lottery, 42 state governments and Washington, D.C., offered government-sponsored lotteries ([www.naspl.org/](http://www.naspl.org/)). State-sponsored lotteries operate as

quasimonopolies within their jurisdictions. With the state government's backing, this most common form of gambling provides little risk of default by the sponsoring entity (K.C.E. Grogan, "Lucky for Life: A More Realistic and Reasonable Estate Tax Valuation for Nontransferable Lottery Winnings," *Washington Law Review*, November 2004).

When someone wins a large lottery prize, the state lottery commission generally provides the winner the ability to receive the amount in a series of payments over a stipulated number of years or in a single lump-sum payment. Currently, only Arizona, Colorado, Ohio, and Oregon offer lump-sum payouts to new winners (R. Sanford, "Are You Ready?," [www.dafusa.com/Pages/gamblinglotteryready.html](http://www.dafusa.com/Pages/gamblinglotteryready.html), 2005). These states indicate that the majority of elderly winners choose a lump sum, while a majority of younger winners choose installment payments. The factoring of structured settlement awards from litigation is a thriving industry. But many states make lottery prize payments inalienable without a court order. Thus, the untimely death of a lottery winner during this stream of payments creates several estate tax dilemmas. First, with a substantial estate asset being illiquid because of the future receipt of the payout, the ability to timely pay any resultant estate tax due may be problematic. In addition, statutory guidance on the proper valuation of the structured payments is ambiguous.

### Statutory Background

Lottery winnings are not specifically mentioned in the statutes, but two Tax Code sections bring these payments into the estate: IRC sections 2033 and 2039. A transfer tax (i.e., the estate tax) is imposed on the taxable estate of every decedent who is either a citizen or resident of the United States in accordance with IRC section 2001(a). Computing this taxable estate begins by including all real, personal, tangible, and intangible property of the decedent, wherever situated [IRC section 2031(a)]. IRC section 2051 delineates the allowable reductions of the gross estate. Where the value of the decedent's estate is substantial (in excess of \$2 million for 2006–2008), the estate is required to file Form 706 and to pay federal estate taxes. Generally, the value of property to be included in the gross estate is the fair market value of the item at the time of the decedent's death or (if elected) at the alternate valuation date six months after the decedent's death. The fair market value is defined by regulations as "the price at which the property would change hands between a willing buyer and a willing seller under no compulsion to buy or sell and both having knowledge of the relevant facts" [Treasury Regulations section 20.2031-1(b)].

Under IRC section 2039, property includes any annuity or other payment receivable by a beneficiary under any contract or agreement dated after March 3, 1931 [Treasury Regulations section 20.2038-1(b)(1)(i)]. Annuities are financial products that periodically pay the obligee a specific amount for a determined period of time (or until death). Typical uses for structured payouts include individual retirement accounts, pension plans, commercial annuities, and litigation awards. For annuities payable after death to an estate, a surviving spouse, or another beneficiary upon the annuitant's death, the present value of the future payments is includable property in the estate. Because future lottery winnings represent rights to receive annual fixed-dollar amounts for a defined period of time, similar to annuities, IRC section 2039 could serve to bring these payments into the estate.

Present value computations entail subjective measurements and estimates. As a result, IRC section 7520 seeks to minimize valuation discrepancies that might occur when the interest rates prevailing in the economy differ substantially from the fixed interest rate assumptions in IRS tables (G. Hayes and E. Krzanowski, "When IRS Actuarial Tables Don't Apply in Valuing Interest," *Estate Planning Journal*, February 2005). IRC section 7520 mandates the use of IRS-issued actuarial tables provided in Publication 1457. The tables are based on monthly floating interest rates and mortality assumptions; they are used to value interests in property, including annuities, life estates, remainder interests, and

reversions mandated for transfers after April 30, 1989.

IRC sections 2033 and 2039 provide indirect guidance to estates that include future lottery payments. The gross estate includes any future lottery payments as well as any lottery prize proceeds the winner has already received but has not yet spent.

### **Administrative Stance**

By classifying lottery payments as annuities under IRC section 2039, the IRS considers the future lottery payouts includible in an estate using the IRC section 7520 actuarial methodology. The IRS has promulgated regulations for IRC section 7520 and issued several technical advice memoranda to provide on-point guidance when valuing unpaid lottery payments for estate tax purposes.

**Regulations.** Treasury Regulations section 20.2031-7(d)(1) provides that the fair market value of an annuity includible in the gross estate is its present value determined by use of the section 7520 mandated actuarial factors (assuming the valuation date for the estate is after April 30, 1989).

Under Treasury Regulations section 20.7520-1, the present value of an annuity is generally determined by use of the interest rate component pursuant to IRC section 7520. The present value is computed using the method described in Treasury Regulations section 20.2031-7.

In addition, Treasury Regulations section 20.7520-3(b), effective for estates of decedents dying after December 13, 1995, provides exceptions to the use of standard actuarial factors. It notes that a standard IRC section 7520 annuity, income, or remainder factor may not be used to value a “restricted beneficial interest.” A restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is “subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances.” Of the appealed cases, only *Donovan* (95 AFTR 2d 2005-2131, April 26, 2005) is relevant.

**Technical Advice Memorandum 9616004.** This memorandum was issued in response to a request by the estate of an individual who had died testate and was survived by his mother. A few years before his death, the decedent had won the lottery in a state where assignment of the lottery payments was prohibited without appropriate judicial order. At the time of death, the decedent was entitled to receive additional annual lottery payments, which were transferred to his mother pursuant to his will.

The decedent’s estate contended that the IRC section 7520 annuity factor and, thereby, the interest rate applicable on the valuation date, should not be used to determine the present value of the lottery payments for estate tax purposes. The estate argued that, because the recipient of lottery proceeds could not assign the payments without court approval, the annuity constituted a restricted beneficial interest under the regulations. Thus, the annuity could not be valued under the tables. The estate argued that a valuation based on a discount rate derived from the sale of long term bonds, adjusted to take into account the state’s assignment approval requirement, would better reflect the fair market value of the annuity.

The IRS disagreed with the estate’s analysis that the restriction on transfer constitutes the kind of restriction referenced in the regulations that would justify departure from the use of the actuarial tables. Moreover, TAM 9616004 mandated that the decedent’s estate use the IRC section 7520 annuity factor to determine the present value of the lottery winnings payable to the decedent’s beneficiary, despite the restriction on assigning the payments under state law. The IRS thought that lottery payments are not a restricted beneficial interest under Treasury Regulations section 20-7520-3(b)(1)(ii) because the

assignment restriction does not alter the recipient's right to receive all lottery payments, but only affects the right to assign the right to receive the payments.

**Technical Advice Memoranda 199909001.** This memorandum dealt with two relatives who won a state lottery and had the winnings paid to a partnership. After winning, one of the relatives executed a revocable living trust, naming herself as beneficiary during her life and her nieces and nephews as beneficiaries upon her death. Before her death, she transferred her interests in the partnership to the trust. She died after only one of the 20 annual payments was paid to the partnership. Applicable state law provided that lottery prizes were not assignable except pursuant to an appropriate judicial order.

In valuing her interest in the partnership held in the revocable living trust, her estate claimed several discounts to the lottery payments and her interest in the partnership. First, the estate discounted the payments to present value using a discount rate based on the AAA-rated general-obligation bond yield rather than using the section 7520 interest rate applicable on the valuation date. The estate also discounted each payment by 39.6% for federal income taxes, 25% for lack of marketability, and 20% for lack of control. The executor then allocated the discounted value to the partnership interest.

The IRS concluded that none of the exceptions to using the standard actuarial factors applied in this case. TAM 199909001 noted that the state law restricting transfer did not affect the right of the partnership to receive any and all of the lottery winnings. As a result, the present value of the right to receive the remaining lottery payments had to be computed using the standard IRC section 7520 annuity factor as of the valuation date. Consequently, in valuing the lottery winnings payable to the partnership, the executor was allowed neither the discount for lack of marketability nor a reduction for income taxes payable on receipt of the winnings.

### **IRS Publication 1457**

IRS Publication 1457 provides actuarial factors for an annuity payable for a term of years (Table B) and adjustment factors for period payments (Table K). Multiplying the annuity factor from Table B by the aggregate amount payable annually and by the applicable adjustment factor from Table K for payments made at the end of the specified period will result in the actuarial valuation amount.

**Example.** At the time of the decedent's death, the survivor is entitled to receive an annuity of \$20,000 a year for 10 years, payable in equal monthly installments at the end of each period. Assume the IRC section 7520 rate for the month of death is 9.6%. Under Table B in Publication 1457, the annuity factor at 9.6% for 10 years is 6.2516. Under Table K, the adjustment factor for payments made at the end of each monthly period at the rate of 9.6% is 1.0433. The annual annuity amount, \$20,000, is multiplied by each factor to yield a present value of the annuity, at the date of the decedent's death, of \$130,445.88 ( $\$20,000 \times 6.2516 \times 1.0433$ ).

### **Judicial Interpretations**

The Tax Court has consistently supported the IRS in using IRC section 7520 to value lottery winnings includable in an estate. The U.S. District Court, Eastern District of California, as the court of original jurisdiction in *Shackleford*, found that the taxpayer overcame the presumption of correctness by providing evidence that the IRC section 7520 valuation was unrealistic and unreasonable under the facts and circumstances of the case (262 F.3d 1028; 88 AFTR 2d 2001-5658; 9th Cir. 2001). In addition, several appellate courts (Second and Ninth Circuits) have discounted the valuation of lottery winnings because of their lack of marketability or assignability. Because the IRS tables fail to consider lack of marketability, the Second and Ninth Circuits have held that the valuation tables produce an

unrealistic valuation result. This is similar to the adjustments made when valuing property at its fair market value. Conversely, the Fifth Circuit and the U.S. District Court, District of Massachusetts, have held that a marketability discount is not appropriate for unalienable lottery winnings and that the valuation tables are controlling.

### ***United States v. Estate of Shackelford***

In 1987, Thomas J. Shackelford, a retired U.S. Air Force officer, won a California lottery jackpot of more than \$10.16 million. According to California law, Shackelford could not collect his prize in a lump sum, and at the time, California prohibited any assignment of lottery payments. He was to receive his winnings in 20 annual payments of \$508,000.

Shackelford died in 1990 and had received only three payments. The compound value of the 17 remaining payments was \$8,636,000 at the time of death. Originally, when Shackelford's estate filed Form 706, the present value of these payments was reported at nearly \$4 million. After paying the estate tax, however, the estate claimed the value of the payments was zero and filed for a refund. The IRS disagreed and insisted that the \$4 million valuation was correct. The estate sued the IRS, and the case went to court.

The U.S. District Court, Eastern District of California, ruled that a taxpayer's estate did not have to use IRS valuation tables to calculate the value of lottery annuity payments. Specifically, it thought that the use of IRC section 7520 tables would result in unrealistic and unreasonable values because of restrictions on the assignment of payments under state law. The lack of liquidity also was not taken into account and no discount was taken. The court did not allow a zero valuation in light of "gray market" transactions. It noted that at least 10 California lottery winners had tried to transfer all or part of their winnings in 1990, even though assignments of prizes are constrained by state law. In each case, the amount the winner received for the payments was substantially discounted to take into account the validity of the transactions. Therefore, it allowed the Shackelford estate to apply an alternative valuation method for its tax return. The court ruled that the payments had a value of \$2,012,500 based on expert testimony (84 AFTR 2d 99-5802).

The IRS appealed to the Ninth Circuit Court of Appeals [(262 F.3d 1028; 88 AFTR 2d 2001-5658 (9th Cir. 2001)]. In his decision, the judge explained that the right to transfer is an important property right, and that the transfer restrictions on the remaining lottery payments, accordingly, reduced their fair market value. The judge also noted that, conversely, when the results would favor the IRS, the IRS had argued that departure from the tables was warranted (*Estate of Lin v. Comm'r*, 438 F.2d 56, and *Frok V. Comm'r*, 100 T.C. 1). In upholding the district court's decision, the Ninth Circuit enunciated a new standard: If the taxpayer proves that a more realistic and reasonable valuation method exists that more closely approximates fair market value, courts are free to employ it. The key to the district court's and the Ninth Circuit's decisions to depart from the tables was the ability of the taxpayer's expert to locate arm's-length attempted transactions of lottery prizes. Had a discount for lack of marketability been taken without such data, the courts would probably not have agreed that a more realistic and reasonable valuation method existed.

### ***Estate of Cook v. Comm'r***

Gladys Cook had a longstanding informal agreement with her sister-in-law, Myrtle Newby, by which they jointly purchased Texas lottery tickets and shared the winnings. On July 8, 1995, Cook won a \$17 million lottery prize, payable in 20 annual installments. The initial payment of \$848,648 was made on July 10, 1995, and the remaining payments of \$853,000 would be made over the next 19 years. The

assignment of the payments is prohibited without court order, according to Texas law, under which the prize cannot be collected in a lump sum [349 F.3d 850; 92 AFTR 2d 2003-7027 (5th Cir. 2003)].

Following their first annual prize disbursement, Cook and Newby converted their informal partnership to a formal limited partnership. Both of them assigned their interests in the lottery winnings to the partnership and each received a 45% limited partnership interest and a 2% general partnership interest. Cook died on November 6, 1995, when the valuation of the partnership's assets for estate tax purposes was cash in the amount of \$391,717 and the right to receive 19 annual lottery payments of \$853,000 each.

Cook's executor hired a valuation expert, who valued the partnership's right to lottery payments at \$4,575,000 using a discounted cash flow method and including a discount for nonmarketability. Because of the prohibition on transfer of the lottery prize, no market for the right to lottery payments existed. The expert valued the estate's interest in the partnership at \$1,529,749.

The IRS assessed a deficiency based on the value of the partnership interest and rejected the estate's expert valuation. The IRS valued the partnership's right to the lottery payments, using IRC section 7520 and the accompanying tables, at \$8,557,850. The IRS then valued the estate's partnership interest, discounted for the lack of control restriction in the partnership agreement, and lack of a ready market, at \$3,222,919, yielding a tax deficiency of \$873,554.

The estate procured a second expert valuation and petitioned the Tax Court for a redetermination of the deficiency. The estate contended that the IRS erred in using the annuity tables to value the lottery prize held by the partnership, and thereby assigned an unreasonable value to the lottery prize. The Tax Court relied on its decision in *Estate of Gribauskas v. Comm'r* [116 TC 142 (2001)] to value the lottery payments using the annuity tables.

The Fifth Circuit affirmed the Tax Court's holding that the lottery prize, an unsecured right to a series of fixed payments for a certain term with virtually no risk of default, fell within the definition of a private annuity and thus should be valued under the IRC section 7520 tables. The appellate court further concluded that nonmarketability did not render the valuation of the prize unreasonable under the section 7520 tables because it is assumed in the annuity tables.

### ***Estate of Gribauskas v. Comm'r***

In late 1992, Paul Gribauskas and his wife won a \$15,807,307 Connecticut lottery prize, payable in 20 annual installments of \$790,365. Following disbursement of the first installment, Gribauskas and his wife divorced. Thereafter, each was entitled to receive \$395,183 annually. Gribauskas died intestate on June 4, 1994, with 18 installments remaining to be paid. His estate filed an estate tax return on September 11, 1995. The value of the remaining prize installments was discounted on the return to account for prohibitions imposed on lottery winnings by Connecticut, which severely restricted the ability of winners to exchange their contractual rights to future payments for a lump sum [116 T.C. 142 (2001), 2001 WL 227025, reconsidered and rev's, 342 F.3d 85, 92 AFT 2d 2003-5914 (2nd Cir. 2003)]. Nevertheless, both parties recognized that a market for such unassignable winnings did exist at the time, but at a significant discount.

Gribauskas's estate, after factoring in this risk-based market discount, valued the lottery prize at \$2,603,661 on its tax return. The IRS disagreed with the estate's method of valuation and valued the remaining payments, pursuant to the IRC section 7520 tables, at \$3,528,058. Correspondingly, the estate was assessed a \$403,167 tax deficiency. The estate contested this valuation in the Tax Court. In

support of its petition, the estate argued that the section 7520 tables should not govern valuation because they yielded an “unrealistic and unreasonable” result that did not accurately account for marketability restrictions. The Tax Court held that the IRC section 7520 tables provided the proper method for valuing the winnings, which should not receive a marketability discount. The Tax Court emphasized that the valuation tables serve the important function of increasing consistency and efficiency, and that courts have narrowly construed any exceptions to their use.

On appeal, the Second Circuit reversed the Tax Court’s decision. The Second Circuit held that the pre-*Shackleford* cases, in which courts allowed departures from the tables, involved situations where there was an inconsistency between the tables’ factual assumptions and the facts of the case. The Second Circuit held that the same reasoning that required departures from the tables in those pre-*Shackleford* cases, however, also required departures from the tables in cases involving a substantial error in the tables’ ultimate valuation result. The court noted that the party seeking to depart from the tables has the considerable burden of proving that the tables’ value is unrealistic and unreasonable, and it concluded that this burden was met in *Gribauskas*.

Thus, both the Ninth and Second Circuits departed from the strict use of the valuation tables because the tables produced an unrealistic and unreasonable result by failing to consider the lack of marketability of nontransferable lottery winnings. In contrast, the Fifth Circuit held in *Cook* that a marketability discount was inappropriate.

### ***Estate of Donovan, Jr., v. United States***

John Donovan, Jr., won the Massachusetts lottery on January 4, 1999. The prize was to be paid in 20 annual installments of \$100,000, and could not be assigned. Donovan died in July 1999 after having received only the first annual payment. The remaining 19 payments were valued at \$367,482 on the decedent’s estate tax return. On audit, the IRS calculated the value of the payments at \$1.09 million using the IRC section 7520 annuity tables. This resulted in an additional \$173,611 of tax liability, which was paid by the estate. The estate later filed suit for a refund, arguing that the nonmarketability of the lottery payments had to be considered for valuation purposes.

Before addressing the issue of valuation, the U.S. District Court for the District of Massachusetts thought that the threshold question was whether the lottery prize constituted an annuity (*Estate of Donovan v. U.S.*, 2005-1 USTC par. 60,500). The court rejected the estate’s position that the restriction on the marketability of the prize made the lottery payments exempt from the annuity tables. Specifically, it noted that the prohibition on assignment was not a restriction that placed limitations on the estate’s right to receive the remaining installments in full.

The court believed that factoring nonmarketability into the valuation of a lottery prize was inappropriate because, as *Cook* noted, nonmarketability was an assumption underlying the annuity tables. In addition, the inability to assign winnings did not affect the value of the property interest held at death, which represented an enforceable right to receive annual payments in a specified amount from a reliable party (Massachusetts). The limitations on transferring the property interest did not, reasoned the court, reduce its worth to the estate in a manner not already accounted for by the annuity tables. In short, it was unreasonable to apply a nonmarketability discount. The court believed that the approach taken in *Gribauskas and Shackleford*, where nonmarketability was factored into the valuation of lottery winnings, was flawed by failing to give proper regard to the usefulness of the annuity tables.

### **Marketability**

Kenneth Freeman won the Massachusetts lottery in 1989 and died in 1999 after receiving 10 of 20 annual payments of \$209,220. Subsequent to an audit of the tax return, the estate decided that the IRC section 7520 annuity tables were not appropriate and filed an informal refund claim based upon a fair market valuation methodology factoring in nonmarketability. The IRS denied this claim on November 21, 2002, and the estate filed suit in the U.S. District Court, District of New Hampshire.

Although this suit has yet to be heard, it is noteworthy that the IRS's motion for summary judgment has been denied (97 AFTR 2d 2006-332, 12/19/2005). The IRS asked for reconsideration, which was also denied (97 AFTR 2d 2006-824, 1/18/2006). In his opinion, the judge disagreed with the *Cook* and *Donovan* (notably, also in the First Circuit) courts' perspectives that nonmarketability is an underlying assumption of the annuity tables. He further stated that it would be more correct to infer that the tables assume marketability; however, as presented, the tables account for only two factors: assumed interest rate and the time period of the annuity. As such, the judge reasoned that the tables are less accurate in gauging fair market value when an annuity is nonmarketable, stressing: "The paramount goal of the Tax Code is, after all, to determine the fair market value of the asset in question."

For a summary of the judicial positions on the valuation of lottery payments, see the [Exhibit](#).

### **Additional Considerations**

**Income Tax Consequences.** In *Comm'r v. Groetzinger* [480 U.S. 23, 32 n.11, 107 S. Ct 980, 94 L. Ed 2d 25 (1987)], the Supreme Court eliminated any controversy concerning the income tax treatment of lottery winnings. The Court characterized lottery payments as gambling winnings, which is ordinary income. The income tax treatment of lump-sum proceeds received in exchange for assigning the rights to future lottery payments is, however, ambiguous. Taxpayers contending this exchange qualifies as a sale of a capital asset and capital gains treatment have been challenged by the IRS. In a reported decision, *Davis v. Comm'r* [119 T.C. 1 (2002)], and several memorandum decisions, most recently *Watkins v. Comm'r* (T.C. Memo 2004-244), the Tax Court has found for the IRS. Although the reasons differ, the Third Circuit, in *Lattera v. Comm'r* [437 F.3d 399 (3rd Cir. 2006)], the Ninth Circuit, in *United States v. Maginnis* [356 F.3d 1179, 1181 (9th Cir. 2004)], and the Tenth Circuit, in *Wolman v. Comm'r* (U.S. App. Lexis 12490, May 19, 2006), have affirmed the lower courts' decisions that the proceeds from the assignment of future lottery payments constitute ordinary income.

**Liquidity.** As previously discussed, a lottery winner's untimely death before the payout is complete may create a liquidity problem for an estate. Federal estate tax is payable on the entire lottery prize even though cash has not yet been received. Due no later than nine months after the taxpayer's death, the amount of the estate tax can be far greater than the estate's cash on hand. Delinquent taxes are subject to a monthly penalty of one-half of one percent per month, up to a maximum penalty of 25%. In addition, the IRS assesses interest on the delinquent tax and assessed penalties at the federal short-term rate plus three percentage points (Eldridge Blanton III, "Who Gets a Dead Man's Gold? The Dilemma of Lottery Winnings Payable to a Decedent's Estate," *University of Richmond Law Review*, April 1994).

To deal with the problem of illiquidity where the annual lottery payments constitute a major portion of an estate, a lottery winner may consider making inter vivos gifts and testamentary bequests to a spouse. This can essentially eliminate all of a winner's gift and estate tax liability (to the extent of the winner's share of the lottery proceeds) by use of the unlimited marital deduction. Survivorship insurance may also be attractive if the taxing and liquidity dilemma causes a problem in the estate of the surviving spouse. For unmarried prize winners, purchasing an insurance policy to fund estate taxes, while expensive, may be appropriate. Inter vivos assignment through court order, in states that allow such

transfers, is another option. If the assignment is for a present interest, the annual gift tax exclusion would be available. When several beneficiaries are involved, the tax savings may be substantial.

An estate may request a postponement of paying estate taxes due to reasonable cause or undue hardship. Treasury Regulations section 20.6161-1(a)(1) explicitly mentions annuities as an asset that may qualify an estate for postponement due to reasonable cause. While the ability to borrow against such assets may ameliorate the cash flow problem, when such borrowing inflicts loss upon the estate, reasonable cause may be established. Reasonable cause provides a 12-month extension to pay these taxes. Undue hardship allows for payment periods up to 10 years; depending upon the remaining payout period for the lottery winnings, this may not be sufficient.

***Income in respect of a decedent.*** Because a lottery prize is received in exchange for the purchase of a lottery ticket and not as a gift (i.e., it is not excludible from income), winnings from lotteries are gambling winnings included in gross income under IRC section 61. In accordance with IRC section 74 (a), gross income includes amounts received as prizes and awards. When a lottery prize is payable in installments, amounts designated as interest to be paid on the unpaid annual installments of the prize are also included in gross income under IRC section 103(a).

If a lottery winner dies, the rights to the future payments become part of the winner's estate, and will be distributed to the beneficiaries. The state lottery will make the payment to the estate and, after distribution of the estate, directly to the heirs. Receipt of each payment constitutes income in respect of a decedent (IRD) per IRC section 691. As such, the payments, after reduction for the associated estate tax, are subject to income taxes upon the recipient. That is, the lottery income must be reported as gross income while a separate itemized deduction is allowed under IRC section 691(c) for the estate tax applicable to the amount of IRD reported. This requirement serves to compound the liquidity problem, as payment of income taxes further reduces the cash available to meet the estate tax obligation.

### **Assessment and Recommendations**

The court decisions discussed above present a problem that is both conceptual and pragmatic in nature. Conceptually, there appears to be significant confusion and disagreement concerning the valuation of lottery payments under IRC section 7520 as annuity payments when there are significant restrictions making the payment not assignable. Pragmatically, a taxable estate that includes future lottery payments may leave the estate with a tax liability and no available means to pay.

Courts have demonstrated a lack of consistency because there is a lack of authoritative guidance on the peculiarities of lottery payments. Because lottery payouts are never addressed directly, the statutory and administrative provisions on annuities are applied to lottery payments, seemingly by default. A fundamental difference, however, is that lottery winnings are generally not alienable or assignable, while an annuity generally is. Classifying future payouts as annuities, however, is not an issue the appellate courts have been presented. Because the right to future payouts is not marketable and transferable, the requirement that section 7520 tables be used to value lottery payments is questionable. The IRS stance on valuation is presumptive and can only be overcome by the taxpayer establishing that the table valuation is unrealistic and unreasonable.

Given the variety of findings at the appellate level, the judicial split over the proper valuation methodology for lottery payouts includible in an estate will eventually have to be resolved by the U.S. Supreme Court. To circumvent this eventuality, Congress should address the lack of statutory guidance. Meanwhile, taxpayers facing this valuation dilemma should file suit in the applicable district court. Generally, payment of the assessed tax deficiency is required before filing for a hearing. Additionally, a

defense presenting a supportable alternative valuation based on fair market valuation grounded in marketability similarities with other property may lead to a favorable finding. Merely attacking the unreliability and unreasonableness of an IRC section 7520 valuation is not enough.

There are several potential ways to solve illiquidity when lottery prize payments are estate property. Congress could enact a law recognizing the inequity of imposing estate taxes on income rights that yield cash over a period of many years. Allowing for the payment of estate taxes related to nontransferable streams of income to be paid upon receipt of the income would alleviate this predicament. Failing this, the IRS could promulgate a new regulation that takes the illiquidity of the lottery income rights into consideration. If state lotteries permitted a discounted lump-sum payout or eased the transferability of prizes, this would also address several of the issues.

Individual taxpayers must plan ahead. A professional tax planning advisor is crucial to maximize the marital deduction and annual gift tax exclusions. Life insurance, if cost effective, may solve the estate tax liquidity problem completely.

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