Florida State Lottery Tax and Estate Planning Issues

> *While it is every person's dream to win the lottery, planning is usually the last thought on a winner's mind*

by Linda S. Griffin and Richard V. Harrison

Since the establishment of the Florida Lottery many individuals have, or will be, achieving their dream of financial success. Unfortunately, unlike the television and radio commercials where the winner is relaxing on a tropical island or driving a new car, because of poor or no advice, many individuals may face tax problems or their children may be faced with estate taxes with no cash to pay the estate taxes. The purpose of this article is to alert attorneys of the state law of the lottery and income and estate tax consequences should you or your client win the lottery. For purposes of this article, the applicable lottery game to be discussed is the Florida Lotto.[1]

Florida Law

The Florida Lottery is governed by F.S. Ch. 24 and the related administrative regulations.[2] A lottery winner must collect the award on or before the 180th day (not *six* months) after the applicable drawing,[3] complete winner game claim Form DOL 173-1, and present one form of picture identification with the winner's name and signature or two forms of valid identification if a picture is not presented.[4] Only one person or entity may claim the prize. Information to claim a prize can be received from the Florida Lottery, Public Information, Capitol Complex, Tallahassee, Florida, 32399-4016 or by calling 1-800-752-9352 or 1-904-487-7732. If more than one name appears on the back of a ticket, then payment is paid to the first name.[5]

If a trust, corporation, or other legal entity name is named on the lottery ticket, then payment is made to the legal entity, but only after the lottery has received a copy of the organizational documents setting forth the names and Social Security numbers of all shareholders, partners, beneficiaries, or other persons ultimately entitled to receive lottery winnings.[6] The winner must also complete an affidavit and present the document at the Florida Department of Lottery.[7] Except for the name and city of the winner's residence, this information is confidential.[8]

If a claim is filed, then debts owed to the state will be collected from the winnings. Such debts generally include, but are not limited to, judgments by the Florida Department of Revenue and child support payments.[9] The lottery can withhold the prize money from the claimant and transmit the money net of taxes to the Comptroller for payment.[10]

The lottery has the discretion to pay a winner annuity payments over 20 years rather than make a lump sum payment.[11] However, this author knows of no instance of the lottery paying a lottery prize of over $1 million in a lump sum or over a period of less than 20 years. While bills requiring lump sum payments have been introduced in the Florida Legislature, none have been enacted into law. Newspaper reports claim that lottery officials oppose the change, arguing that lump sum jackpots would be smaller than the amounts that can now be paid by investing sums of money over the 20-year payout period.[12] Other states that do offer lump sum payments indicate about 65 percent of elderly winners choose a lump sum, while a majority of younger winners are choosing installment payments.[13]

England has recently established a weekly national lottery which also uses six out of six numbers from one to 49 at a cost of one pound (about $1.60) and provides the jackpot winner a single lump sum payment together with counseling for the management and investment of the winnings.[14]

F.S. §24.120 provides for the creation of an administrative trust fund in the

State Treasury. Monies available for payment of prizes on a deferred basis are invested by the State Board of Administration in accordance with the terms of an approved trust agreement. The first payment is made by check or by wiring funds to the winner's bank account. The balance is then invested in U.S. Treasury "strips" with maturity dates ranging from one year later to 19 years later. The Department of the Lottery turns this balance of the grand prize money over to the State Board of Administration, which makes the future payouts to the winner.[15]

Income Tax Consequences

All lottery winnings are income subject to income tax.[16] Under the Internal Revenue Code,[17] withholding is mandated at 28 percent.[18]

As a taxpayer has no constructive receipt of winnings because no unrestricted right exists until the ticket is validated and paid by the State Lottery Commission,[19] winnings are taxable in the year received, not won. If a winner had the discretion to ask for and receive a lump sum, then the winner would be taxed on the entire amount in the first year even if the winner did not elect to receive the lump sum.[20]

Most of the case law regarding the income tax consequences of lottery winnings revolves around who owns the ticket and therefore who is taxable on those proceeds. Generally, the ownership of the ticket and the relationship with the lottery is one of contract[21] and the individual or entity "holding" the ticket, *i.e.*, having physical possession, is the one entitled to the money.[22]

Ownership, however, can be determined by an agreement between the parties prior to the winning number being announced. For example, in a Massachusetts case, *Welford v. Nobrega*, 586 N.E. 2d 970 (Mass. 1992),[23] a dispute over ownership occurred between Welford and Nobrega, the joint owners of a ticket, and the former spouse of Nobrega. The former spouse argued that all of the winnings belonged to her former spouse, Nobrega. Welford, however, funded part of the purchase price and orally agreed with Nobrega to share equally any winnings.[24] Welford, however, did not sign the ticket because of other financial problems. Like Florida, the Massachusetts Lottery allowed winnings to only one person. Nobrega and Welford established a trust with themselves as equal beneficiaries. The court found that Nobrega and Welford established themselves as co-owners *prior* to the purchase of the ticket.

If a winner gifts prize monies away *after* receiving the winnings, then a gift tax may be payable under §2501 of the Code unless the gift tax annual exclusion or other exclusions should apply.[25] What may not be so clear is the situation in *Welford*, when the ticket is *later* put into a trust or other entity.

In *Droge v. Commissioner*, 35 B.T.A. 829 (1937),[26] a husband and wife each bought two tickets in an Irish sweepstakes and orally agreed that if any one ticket won, then the proceeds would be shared equally. When the husband received the proceeds, he immediately gave one half of the proceeds to his wife. The issue on the question was who bears the tax liability. The court, after questioning the husband and wife and finding them credible, found that one half of the proceeds were taxable to the wife and one half of the proceeds were taxable to the husband. Subsequent cases have confirmed the result that should there be evidence of joint ownership prior to winning, then the income can be taxable in proportion to the ownership.[27]

The more evidence can be demonstrated that intent to have joint ownership existed *prior* to purchasing the ticket, the better the argument for joint ownership. One approach to resolve the ownership issue would be for the taxpayer to create a "stand-by" trust prior to purchasing a ticket to ensure proper tax treatment. The trustee of the trust would be the actual purchaser and signer of the ticket.

Taxpayers have also attempted to avoid income taxes by assigning or selling the lottery proceeds. It is well settled under *Lucas v. Earl,* 281 U.S. 111 (1930), that an assignment of income is not valid to transfer taxability of income. Furthermore, under Florida law, the right to a prize "shall not be assignable."[28] Winnings, however, can be paid "to a person designated pursuant to an appropriate judicial order."[29] While no Florida cases on the assignment of lottery proceeds could be located by this author, other states have generally interpreted such assignment statutes strictly. For example, in *Lotto Jackpot Won By Marianov*, 625 A.2d 637 (Pa. 1993),[30] the Pennsylvania Supreme Court determined that although a "sale" of a remaining right in lottery proceeds was approved by a judicial order of a court, the judicial order was not an "appropriate judicial order" under the statute.[31] The court determined an "appropriate judicial order" to be an order granted in another proceeding, such as a garnishment, attachment, execution or equitable distribution.[32]

The same result has been found in an attempted assignment to a finance company[33] and an attempted exemption in a bankruptcy proceeding.[34] The result in these cases and the statute effectively prohibit present value sales.[35]

Since the winner's first payment may be made within 180 days of winning, and the lottery makes its annual payments four times during a year, a bunching of income in the first year could occur. Care should therefore be taken as to when the first payment is received.

Estate Tax Consequences

Lottery proceeds are payable pursuant to a contract for a period of time (20 years), so the present value of the lottery proceeds[36] is includable in a taxpayer's estate under §2039 of the Code. The present value can be greater than the cash actually available in the estate to pay the estate taxes (and generation-skipping taxes, if any).

For example, assume a Florida resident, Dolores, wins a $20 million Lotto Grand Prize which pays $1 million over 20 years. After receiving the first 10 years of payments, Dolores dies unmarried. The present value of the annuity payment of $1 million per year for 10 years is includable in Dolores' gross estate. The sole beneficiary and personal representative of the estate is an adult child, Linda.

When the present value of the annuity is added to Dolores' other assets, an estate tax of $4,500 is due. The estate has $1 million liquid cash, which it pays to the Internal Revenue Service and the Florida Department of Revenue. Section 6161 of the Code provides that the Service can extend the time for payment of the balance of estate tax for reasonable cause. Reasonable cause can, for example, arise when a substantial part of an estate's assets is composed of rights to receive payments in the future, and those assets provide insufficient present cash with which to pay the estate tax and the estate cannot borrow

against these assets, except on terms which would inflict loss upon the estate.[37] Thus, an extension agreement is entered into between Linda, the Service, and the Florida Department of Revenue.[38]

In the first year of the agreement, lottery proceeds of $1 million are payable to the estate. Assuming an effective income tax rate of 40 percent, $400,000 is paid directly to the Service for income taxes, leaving a $600,000 balance payable to the Service and Florida Department of Revenue. The amount of $350,000 is applied to the first year's interest (10 percent rate), leaving $250,000 to reduce the unpaid balance of the estate tax from $3,500,000 to $3,250,000.

This example demonstrates that by the end of the 10th year of the agreement, little or no money is left for the beneficiary. Any professional fees or administrative expenses are not included in this computation. Fortunately, planning can ameliorate this result.

In a recent private letter ruling,[39] the Service addressed several issues relating to a trust created for a lottery. A husband and wife were joint owners of a winning lottery ticket paying an amount over 20 years. They created a trust of which they were the co-trustees and their separate revocable trusts were beneficiaries. As trustees, they were required to distribute one half of the lottery annuity payments to each of their revocable trusts.

Each spouse's revocable trust provided that during each spouse's lifetime, the income would be payable quarterly and the principal would be payable as needed. Upon the death of either spouse, and after payment of debts, expenses, and taxes, the deceased spouse's trust provided that the balance would be held in trust with all income payable to the surviving spouse. The executor was given the power to make a QTIP election under §2056(b)(7) of the Code. The surviving spouse was also given a power to appoint the principal to decedent's issue. All unappointed trust assets would be divided into generation-skipping exempt and nonexempt trusts.

The Service determined that since each spouse could revoke 50 percent of the lottery trust, the lottery trust would be a grantor trust under §676 of the Code. Fifty percent of the income and deductions would be reportable to each taxpayer on their Form 1040. A Form 1041 would not have to be filed.[40] As a grantor trust, the trust would not be subject to income tax at the accelerated rates on trust taxable income (39.6 percent rate on amounts over $7,500).

The Service confirmed that any lottery payments paid after death to the lottery trust would be income in respect of the decedent (IRD) under §691(a) of the Code. Therefore, under §1014(c) of the Code, the property's basis would not be stepped up. Under §691(c) of the Code, the entity required to pay tax on the IRD could deduct a proportionate share of estate tax attributable to the IRD. The ruling further held that the payments received by the trust did *not* constitute a transfer within §691(a)(2) of the Code.

The Service also confirmed that §2039 of the Code would govern the estate tax consequences. Therefore, the present value of the lottery payments would be valued under that section of the Code.

In addition, the Service blessed the marital trust as a QTIP trust under §2056(b)(7)(C) of the Code because the surviving spouse had the right to receive payments before his or her death. Further, because the lottery trust was required to distribute all income for any annual period to each spouse's trust by the close of such period and each spouse's trust was required to distribute all of the income currently to the surviving spouse, the income was considered to be payable annually to the surviving spouse for purposes of §2056(b)(7)(B)(ii) of the Code. Therefore, if a proper election was then made, a marital deduction would be allowed for all or such portion of the trust subject to the election.

Finally, the Service ruled that the formula allocating the generation-skipping transfer tax exemption would provide for a trust with an inclusion ratio of zero, provided that the property distributed was properly valued and distributed, and did not exceed the available exemption. The ruling also confirmed that the executor could make a reverse QTIP election in order for the decedent spouse to utilize fully the $1 million exemption.

While this private letter ruling may be considered a "blueprint" for a winning married couple's estate planning, other plans can be implemented to provide for payment of estate taxes. A trustee of an irrevocable trust could purchase life insurance to ameliorate the harsh tax consequences. A charitable trust[41] and/or other grantor annuity trusts[42] should also be considered.

While it is every person's dream to win the lottery, and as a practical matter, planning is usually the last thought on a winner's mind, the prudent winner will proceed directly to his or her tax advisor's office prior to flying to Tallahassee.❑

[1] Fla. Admin. Code Ann. Ch. 53-28 (1995).
[2] *Id.* Ch. 53.
[3] *Id.* 53 ER 95-27(1)(a).
[4] *Id.* 53 ER 95-27(6).
[5] *Id.* 53 ER 95-27(8)(a).
[6] *Id.* 53 ER 95-27(8)(j).
[7] The affidavit form can be obtained from the Department of the Lottery (1-904-487-7732). If a bank trust officer is signing on behalf of a bank trustee, then the lottery requires authorization for the individual to sign on behalf of the bank.
[8] Fla. Admin. Code Ann. §53-1.005(2)(I) (1995).
[9] *See* Fla. Stat. §24.115(4) (1993), and Fla. Admin. Code §53-1.018 (1995).
[10] Fla. Admin. Code Ann. §53-1.018(4)(a) (1995).
[11] *Id.* 53 ER 90-25(1). Fla. Stat. §24.105(10)(e) (1993). *See also Kentucky Lottery Corp. v. Casey*, 862 S.W. 2d 888 (Ky. 1993).
[12] Associated Press, *Lump-Sum Lottery Payments Win Endorsement From Panel*, Sarasota Herald Tribune, March 12, 1993.
[13] *Id.*
[14] Rupert Steiner, *Lottery Winners Throw Money About Carefully,* London Sunday Times, May 14, 1995.
[15] Conversation with State Board of Administration.
[16] I.R.C. §61 (1986). *See Donald Bodine,* ¶84,143 P-H Memo TC (1984), and *A.L. Voyer,* 4 B.T.A. 1192 (1926).
[17] All references are to the Internal Revenue Code of 1986.
[18] I.R.C. §3402(q). Notice 93-7, 1993-1 C.B. 297.
[19] Treas. Reg. §1.451-2(a).
[20] Treas. Reg. §1.451-1.
[21] *See Haynes v. Department of Lottery*, 630 So. 2d 1177 (Fla. 1st D.C.A.1994).
[22] *See Miller v. Department of Lottery*, 638 So. 2d 172 (Fla. 1st D.C.A. 1994).
[23] *See also Sexton v. Ohio State Lottery Com'n*, 566 N.E. 2d. 205 (Ohio Compl. 1989).
[24] *Welford v. Nobrega*, 586 N.E. 2d 970, at 973 (Mass. 1992).
[25] *See* I.R.C. §§2503(b)(c)(e), 2505, 2522, 2523 (1986).
[26] *See also Max Silver,* 42 B.T.A. 461 (1940), and *Samuel L. Huntington,* 35 B.T.A. 837 (1937). *But see Harry I. Riebe,* 41 B.T.A. 935 (1940), whereby court found all income tax-

able to husband because of lack of evidence of change in ownership.

[27] *See Braunstein*, ¶62,210 P-H Memo TC (1962); *Tavares v. Com.*, 60-1 U.S.T.C. ¶9297 (1960); *Dowling*, ¶59,169 P-H Memo TC (1959); and *Chelius*, ¶58,029 P-H Memo TC (1958). *See also* Priv. Ltr. Rul. 9217004. *But see Gene G. Tessers*, ¶66,172 P-H Memo TC (1966).

[28] FLA. STAT. §24.115(a) (1993).

[29] *Id.*

[30] *See also R & P Capital Resources v. State Lottery*, 37 Cal. Rptr. 2d 436 (Cal. App. 3d Dist. 1995). *In Re La. Lottery Grand Prize Drawing*, 643 So. 2d 843 (La. App. 4th Cir. 1994).

[31] *Lotto Jackpot Won By Marinov*, 625 A.2d 637, at 639 (Pa. 1993).

[32] *In Re Lotto Jackpot Prize*, 602 A.2d 402, 405 (Pa. Cmwlth. 1992).

[33] *See McCabe v. Director of New Jersey Lottery Com'n*, 363 A.2d 387 (New Jersey 1976).

[34] *See In Re Meyers*, 139 B.R. 858 (Bankr. N.D. Ohio 1992).

[35] *See also Kentucky Lottery Corp. v. Casey*, 862 S.W. 2d 888 (Ky. 1993).

[36] I.R.C. §2039 (1986), Treas. Reg. §20.7520-1, and Treas. Reg. §20.2031-7.

[37] Treas. Reg. §20.6161-1, Ex. 2.

[38] I.R.C. §6161 (1986). FLA. STAT. §198.15 (1993) provides a comparable extension of time for payment of tax if the payment for the federal estate tax is extended.

[39] Priv. Ltr. Rul. 9352015.

[40] Treas. Reg. §1.671-4(b)(2).

[41] I.R.C. §664 (1986).

[42] I.R.C. §2702 (1986).

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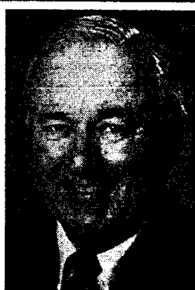

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This column is submitted on behalf of the Tax Section, Linda C. Hanna, chair, and Michael D. Miller and Joseph B. McFarland, editors.

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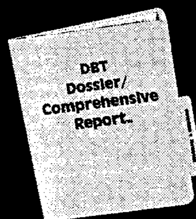

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