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The Sale of Lottery and Other Income Rights: Ordinary Income or Capital Gain?

Martin H. Zern
THE SALE OF LOTTERY AND OTHER INCOME RIGHTS: ORDINARY INCOME OR CAPITAL GAIN?

by

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I. INTRODUCTION

Those who are conversant with our tax laws understand that much of the complexity of the Internal Revenue Code ("Code") is attributable to the historical disparity between the tax rates applicable to ordinary income as contrasted with the lower rates applicable to long-term capital gains ("capital gains"). As most taxpayers are aware, particularly investors, capital gains of individuals receive preferential treatment. Ordinary income is taxed under a progressive rate structure ranging from 10% to 35%. Through 2007, capital gains generally were taxed at a flat rate of 15%, reduced to 5% to the extent the capital gain fell within the 15% or 10% marginal tax bracket for ordinary income.1 The 5%/15% rate was due to expire at the end of 2007, after which it was to increase to 10%/20%.2 However, on May 18, 2006, the President signed into law The Tax Increase and Prevention Reconciliation Act of 2005 ("TIPRA"). TIPRA extended the 15% rate through 2010. For those in the 15% and 10% marginal brackets, it should be noted that the capital gains tax rate for 2008 through 2010 is lowered to zero. All the capital gain rates are, of course, subject to legislative change. Although at one time corporations received the benefit of a lower tax rate on capital gains, presently there is no rate differential.3

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* Professor, Lubin School of Business, Pace University, New York

In order to qualify for the reduced capital gains tax rate, the property sold must be held for more than one year (i.e., if the property sold was held for one year or less, the gain is taxed at the rates applicable to ordinary income). In addition to the requirement that it be held for more than one year in order to qualify for the reduced capital gain rate, the property sold must be a capital asset. The term "capital asset" is defined in the Code as "property held by the taxpayer (whether or not connected with his trade or business)," unless specifically excluded.4 Thus, if the property interest is not affirmatively excluded, by definition it would seem to be characterized as a capital asset.5

II BACKGROUND

The term "property" has been broadly defined as an aggregate of rights that are guaranteed and protected by the government.6 A decision of the United States Supreme Court in 1960, Commissioner v. Gillette Motor Transport, Inc., informs us that not everything that can be called property qualifies as a capital asset even though it does not fall within the statutory exclusions.7 The Supreme Court observed that it has long held that the term capital asset should be narrowly construed to reflect Congressional intent to allow a reduced tax rate only for appreciation on property accrued over a substantial period of time. However, in a subsequent decision in 1988, Arkansas Best Corp. v. Commissioner, the Supreme Court took a different tack, suggesting instead that the definition of a capital asset should be broadly construed to omit only those items specifically excluded in the Code definitional provision.8

The problem with an overly broad definition of the term capital asset is that the sale of some property rights could be
taxed as capital gains in situations that Congress did not intend to receive preferential treatment. For example, although not specifically excluded as a capital asset, the sale of one’s property right to be paid for services rendered should not qualify as a capital gain. To get around this problem, the courts have created the “substitute-for-ordinary-income” doctrine, which provides that a lump sum payment for what would be ordinary income in the future may not be taxed as a capital gain.\(^9\)

The seminal substitute-for-ordinary-income case dates back to a decision of the Supreme Court in 1941, Hort v. Commissioner.\(^9\) The Supreme Court held that a lease cancellation fee received by a landlord was ordinary income since it was a substitute for future rental payments – which would have been ordinary income when collected – rather than a capital gain as the landlord had argued. The Supreme Court bolstered the substitute-for-ordinary-income doctrine in a later decision in 1958, Commissioner v. P.G. Lake, Inc., where a corporation assigned an oil payment right payable out of a working interest in two leases.\(^11\) The assignment was reported as a capital gain. The Supreme Court held that the consideration received for the assignment was ordinary income under the substitute-for-ordinary-income doctrine.

The doctrine has come to the fore in recent years with the advent of state and regional lotteries paying out large sums. Some winners have attempted to reduce the tax bite by selling their right to future installment payments – which admittedly would be ordinary income had they been collected – for the present value of the payments and claiming the proceeds of the sale qualified as a capital gain. A 2006 case illustrates an attempt to tax lottery winnings at capital gain rates and sets forth an approach to determining whether the sale of future income rights should be taxed as ordinary income or as a capital gain.

III. LATTERA

A. Facts

In February of 2006, the Third Circuit decided Lattera v. Commissioner,\(^12\) which reviewed a decision of the United States Tax Court in favor of the government. In 1991, George and Angeline Lattera won $9,595,326 on a one-dollar lottery ticket. The mandated payout was in 26 annual installments of $369,051, and there was no right to a lump sum payout. In 1999, the Latteras sold their remaining 17 installment rights (for which sale they had obtained court approval) to Singer Asset Finance Co., LLC for a lump sum amount of $3,372,342. The Latteras reported this sum as the proceeds of the sale of a capital asset that had been held for more than one year, which had a zero adjusted basis. Accordingly, the taxpayers paid a tax at the lower capital gains rate on the full sales proceeds. The IRS, however, determined that the sales price was ordinary income and assessed a deficiency of $660,784.

B. Court Discussion

The IRS and the taxpayers agreed that, under established case law, the lottery windfall was gambling winnings and that all installment payments, past and future, should be treated as ordinary income.\(^13\) Nevertheless, the taxpayers asserted that when they sold off their rights to the 17 remaining installments, the sale resulted in a capital gain.

The Third Circuit observed that although the issue presented was one of first impression in its Circuit, it was not a new question since both the Tax Court and the Ninth Circuit have
considered it. In Maginnis v. Commissioner, a 2004 decision, the Ninth Circuit stated that “Fundamental principles of case law lead us to conclude that [the] assignment of [a] lottery right produces ordinary income.” Referring to some law review articles, however, the Third Circuit noted that the decision of the Ninth Circuit has been criticized. Apparently considering the criticism to have merit, the Third Circuit proposed a different approach.

The taxpayers in Laterra argued that the substitute-for-ordinary income doctrine espoused in Hort-Lake and a conforming line of cases was effectively limited by the subsequent decision in Arkansas Best. The Third Circuit observed, however, that the Tax Court on several occasions has held that the Hort-Lake line of cases was not affected by Arkansas Best, and that the Ninth Circuit had agreed. Nevertheless, the Third Circuit observed that there is “tension in the doctrine” since conceptually any capital asset is a substitute for ordinary income. Citing a commentator, the Court stated that “[a] fundamental principle of economics is that the value of an asset is equal to the present discounted value of all the expected net receipts of that asset over its life.” Referring to another commentator, the Court continued “[u]nless restrained, the substitute-for-ordinary income theory thus threatens even the most familiar capital gain transactions.”

Although the Third Circuit agreed with the Ninth Circuit’s decision in Maginnis, it noted that it did not simply agree with its reasoning. It observed that there is a “seamless spectrum” between the Hort-Lake line of cases and conventional capital gain transactions. The Court therefore opted for a case-by-case analysis and set out a method of analysis.

1. Substitute-for-ordinary-income analysis:

The Court listed certain types of assets generally viewed to be capital assets, such as stocks, bonds, options and personal-use assets that ordinarily will qualify for capital gain treatment. It then noted that there are rights known to be ordinary income rights, such as rental income and interest, that will taxed as ordinary income. The Court set these two categories at the opposite ends of the spectrum and then adopted a “family resemblance” test to determine whether a transaction falls at one end or the other end of the spectrum, or somewhere in between.

For transactions in between that do not bear a family resemblance to either end of the spectrum, such as contract and payment rights, the Court adopted a two factor test: (a) type of carve out and (b) character of assets.

(a) Type of Carve-Out: The Court noted that there are two ways two carve out interests in property: “horizontally” and “vertically.” In a horizontal carve out, a part of an interest is disposed of and a part retained. This is what happened in certain lottery cases: the lottery winners sold “some” of their rights to future payments. Likewise, in the Hort and Lake cases, respectively, a term of years was carved out from a fee simple, and a three-year payment right was carved out from the entire interest in an oil lease. A vertical carve out involves the disposition of a person’s entire interest. For instance, in Maginnis, the lottery winner sold all of his rights to future lottery installments.

The weight of authority suggests that amounts received in a horizontal carve out result in ordinary income. But different treatment has resulted where there is a vertical carve out. In Dresser Industries, the taxpayer had transferred the entire
interest in some of its rights (a “vertical slice”) rather than an interest in the totality of its rights (a “horizontal slice”). Nevertheless, Maginnis suggests that the substitute for ordinary income doctrine may still be applicable where a taxpayer sells his or her entire property rights retaining nothing. Because a vertical carve out could result in either ordinary income or capital gains, the Court moved on to a further analysis in order to make its determination.

(b) Character of the Asset: In Dresser Industries, the Fifth Circuit noted that there is a vast difference between the sale of future rights to earn income and the sale of future rights to earned income. The sale was of patent rights, which is the sale of the right to earn income and not the right to earned income to be paid in the future. Accordingly, the Fifth Circuit disregarded the fact that the patent would have generated ordinary income had it not been sold, and held that capital gain treatment was applicable.

The Third Circuit approved the approach of the Fifth Circuit stating that the sale of an asset reflecting the right to earn income merits capital gain treatment. In fact, it observed that it had previously made this distinction in Tunnell v. United States. In that case, a taxpayer withdrawing from a law firm assigned his rights in the firm for a certain sum. The court held the sales price was taxable as a capital gain except that to the extent the sales price reflected the sale of accounts receivable it was taxable as ordinary income. In contrast, the court observed that a termination fee paid with respect to an employment contract is taxable entirely as ordinary income. The termination fee is earned in the sense that the employee no longer is required to perform any future services.

Another relevant case cited by the Third Circuit was Commissioner v. Ferrer, a Second Circuit decision. Jose Ferrer entered into a contract with respect to the novel Moulin Rouge. He received two relevant rights under the contract: (1) the exclusive right to produce a stage production and, if produced, (2) the right to share in the proceeds from any motion picture based on the book. He sold these rights, along with others, to a movie studio that planned to make the novel into a movie in which he would play the starring role. The Second Circuit held that the sale of right (1) was a right to earn income. Therefore, the gain on the sale of this right resulted in a capital gain. Once he had produced the play, however, he had the right to get further income under right (2) simply by virtue of holding that right. (In other words, by producing the play, he earned the right to share in any movie proceeds without having to do anything further.) Consequently, the court held that the sale of right (2) resulted in ordinary income.

C. Decision

The Third Circuit then applied the foregoing rules to the sale of the right to future lottery payments. The first thing considered was the “family resemblance test.” Was the asset (the lottery rights) similar to a clear-cut capital asset, such as stocks and bonds, or similar to an income item, such as rental or interest income? The Court found no controlling resemblance either way. Accordingly, it then proceeded to its second tier analysis, looking at the nature of the sale. If the sale is similar to a horizontal carve-out, ordinary income results. If the sale is similar to a vertical carve-out, then one must look at the character of the asset. If the sale results in a payment for a right to earn income, the result is a capital gain. If the sale results in a payment for income already earned, the proceeds of the sale will be ordinary income.

In Lattera, the taxpayers sold the right to all of their remaining lottery payments, which was similar to a vertical
carve-out. Consequently, the sale could be classified as either ordinary income or as a capital gain. The right to future lottery payments, however, did not require the Latteras to do anything further. By winning the lottery, they had earned the right to the future payments, provided they continued to own that right. Accordingly, the Court held that the proceeds from the sale of the future rights were taxable as ordinary income.28 The Court observed that the result comports with the Maginnis case. Further, it noted that the result ensures that the Latteras do not receive an advantage by selling their lottery rights over those who elect to take their lottery winnings in a lump sum.29

The Latteras raised another argument that the Court refused to consider. They asserted that the lottery ticket itself was a capital asset, and had they sold it, they would have been entitled to capital gain. The Court found that it did not have to address this issue since they did not sell the lottery ticket. They cashed in the ticket electing to take the winnings in installment payments. After collecting winnings for eight years, they sold their right to future installments for a lump sum. In conclusion, the Third Circuit affirmed the decision of the Tax Court.

IV CONCLUSION

The decision of the Third Circuit in Lattera develops a sophisticated method of analysis in order to determine whether the proceeds from the sale of the right to income should be taxed as ordinary income or as a preferential long-term capital gain. There is a broad spectrum between the sale of items that are clearly capital assets (e.g., securities) and the sale of items that are clearly substitutes for ordinary income (e.g., prepaid rent). If one falls between the ends of the spectrum, however, it must be determined whether some of the rights have been sold (a “vertical carve out”) or all of the rights have been sold (“a vertical carve out”). Ordinary income results in the former case. In the latter case, it still depends. If the sale is of the right to earn income, the sale is of a capital asset. If the sale is of the right to earned income, however, the sale results in ordinary income. The case involving Jose Ferrer illustrates the distinction. Applying these rules to the Lattera case, the Third Circuit correctly determined that the sale of the lottery rights resulted in ordinary income.

The reasoning in the Lattera case was followed in two cases decided subsequently in the Second and Eleventh Circuits; Prebola v. Commissioner30 and Womack v. Commissioner,31 both cases affirming Tax Court decisions supporting the position of the IRS. Accordingly, it appears that the possibility of obtaining capital gain treatment on the sale of future lottery winnings is pretty much nil.

ENDNOTES

1 For collectibles (e.g., art, antiques, coins, stamps, etc.) the tax rate can be as high as 28% (I.R.C. §1(h)). Also, there is a 25% rate applicable to gain on the sale of real estate that is attributable to prior depreciation deductions taken on the property (I.R.C. §1250).
2 The 10%/20% rate was the rate in 2003 prior to the reduction to the 5%/15% rate, which became effective for taxable years after 2003 (I.R.C. §1(h)).
3 Although there is no special tax rate for corporate capital gains, a corporation nevertheless might wish to generate capital gains if it has capital losses currently or carried forward. Corporations can only deduct capital losses to the extent of capital gains. Capital losses of a corporation that can’t be deducted can be carried back two years and offset against capital gains, if any, in the two prior years. To the extent a capital loss is not carried back, it can be carried forward for up to five years. Thus, to the extent a corporate capital gain is offset by capital losses, the capital gain is not taxed.
4 Internal Revenue Code (I.R.C.) §1221(a).
None of the exclusions are applicable to this paper. Among other things excluded, however, is inventory and property held primarily for sale, depreciable business property and real property used in a business (which under I.R.C. §1231 receives special treatment), accounts and notes receivable from selling inventory or property held primarily for sale, and property created by personal efforts (e.g., a copyright, a literary, musical or artistic composition. See I.R.C. §1221 for other exclusions.

See United States v. Maginnis, 356 F.3d 1179, 1181 (9th Cir. 2004).

Also, see Davis v. Commissioner, 119 T.C. 1, 1 (2002) (other Tax Court citations omitted).


Davis, 119 T.C. at 6 (citing cases); Maginnis, 356 F.3d at 1185.


Citing 2 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, P47.9.5 at 47-68 (3d ed, 2000).

Note 12, supra.

Citing Sinclair, Note 13, supra.

Maginnis, 356 F.3d at 1181.

Supra, at 1185-1186 (citing other cases).

United States v. Dresser Indus., Inc., 324 F.2d 56 (5th Cir. 1963).

Note 19, supra, at 1185.

259 F.2d 916 (3d Cir. 1958)

See, e.g., Elliot v. United States, 431 F.2d 1149, 1154 (10th Cir.) (other citations omitted).

304 F.2d 125 (2nd Cir. 1962).

It may be noted that the taxpayers had no basis in the lottery payments to offset against the sales price.