

**I.R.C. § 103 AND EXCLUSION OF INTEREST  
ON TEXAS LOTTERY PRIZE INSTALLMENTS**

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## Synopsis

- I.R.C. § 103 excludes interest on state obligations
- *Lotto Texas* and *Mega Millions* jackpots are state obligations
  - Installment interest is excludible
    - *If* prizewinner declined a cash election, *and*
    - *If* Lottery complies with I.R.C. § 149 et cet.
  - Installment winners entitled to income tax refund

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## Lottery History

- 17<sup>th</sup> century to Civil War—Lotteries fund defense, public works, churches, colleges
- 1832—Lottery sales exceed federal budget by a factor of 5
- 1847—Justice Catron likens lotteries to cholera, obscene paintings, and convicts
- 1878—Every state outlaws lotteries, but for Louisiana (1905)
- 1964—New Hampshire lottery created

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## Lottery Models

- Consumer Lottery
  - Antebellum American model
- Sumptuary Lottery
  - Traditional U.K. model
- Revenue Lottery
  - Uniform modern American model

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## Lottery Models (continued)

- Consumer Lottery (antebellum America)
  - Maximize consumer (player) welfare
  - Truth-in advertising restrictions
  - Unlimited product variety
  - High payout rate
- Historically, these attributes honored as much in the breach as in the performance

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## Lottery Models (continued)

- Sumptuary Lottery (traditional U.K.)
  - Meet unstimulated demand
  - Informational messages and warnings
  - Limited product variety
  - Low payout rate

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## Lottery Models (continued)

- Revenue Lottery (modern America)
  - Maximize government revenue
  - Few promotion restrictions
  - Unlimited product variety
  - Low payout rate

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## Lottery Models (continued)

- Common Attributes of Modern American State Lotteries
  - Government monopoly
  - High product variety
  - Low payout (~50%)
  - High implicit tax rate (30%+)
  - Unrestricted advertising (and immunity)

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## Texas Lottery

- Voter referendum authorized in 1991
- Texas follows the Revenue Lottery model
- Revolving lineup of 80 games
  - Hundreds of unique lotteries since 1991
  - For examples, see App. B, at p. 25
- Focus of this paper
  - *Lotto Texas*, Texas Lottery's flagship (25AP)
  - *Mega Millions*, a multi-jurisdiction game (26AP)

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## *Lotto Texas*

- An online game (as opposed to instant or promotional)
- 1992—First draw; jackpot paid in 20AP; no cash election
- 1997—25AP; cash election added
  - 68 25AP winners, though none recently
  - See App. A at p. 24 for annual breakdown

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## *Lotto Texas Payment Methods*

- 20AP—twenty annual payments
- 25AP—twenty-five annual payments
- CVO—cash value option, a voluntary election
- LS—lump sum, a compulsory cash payment when present value of winner's share falls below \$2,000,000

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## *Mega Millions*

- An online multi-jurisdiction game
- Texas joined in 2003
- Jackpot paid in 26AP; cash election
  - Two Texas cash winners
  - No Texas 26AP winner
- Payment methods similar to *Lotto Texas*, except for 26AP rather than 25AP

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## *Lotto Texas* Draw #267, 1995 (20AP)

- See Payment Schedule, App. D at 34
- 20AP installment
  - 20 payments of \$200,000
  - less withholding at 28% then 25%
- Constructive receipt drives 20AP format
  - LTR 8552022 approved cash option; *Lotto Texas* did not enable until 1997
  - LTR 9624009 approved installment assignments; *Lotto Texas* enabled in 1999

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## *Lotto Texas* Draw #1343, 2005 (CVO)

- \$4 Million prize advertised, 25AP default
- \$2,475,649.60 actually paid, immediately
- See App. E at 35
  - Cash Value Option (CVO) elected
  - Comptroller determines CVO value by cost of securities to fund 25AP, pp. 37–39

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## What if Draw #1343 was 25AP?

- Hypothetical amortization, App. G at 49
  - \$4,000,000 total prize payment
  - \$1,524,350.40 interest
  - \$2,475,649.60 principal
- Principal = App. E CVO, but paid 25AP
- Interest and 4.51568807% discount rate determined by iteration

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## Interest Treatment

- Texas Lottery Commission withholds as if interest were included in income (App. D)
- Rev. Rul. 78-140 would include it income
  - State lottery game reviewed, App. H at 50
  - No cash election
  - Exclusion denied without elaboration
- Rev. Rul. 78-140 is correct, but should be limited to compulsory installments

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## Rev. Rul. 78-140 is Correct

- I.R.C. § 103 is limited to
  - State obligations: requires exercise of taxing, police, or other sovereign power
  - Obligations arising under borrowing power: requires taxpayer's voluntary extension of credit to the state
- Rev. Rul. 78-140 game made compulsory installment payments, i.e., the obligation did not arise under the borrowing power

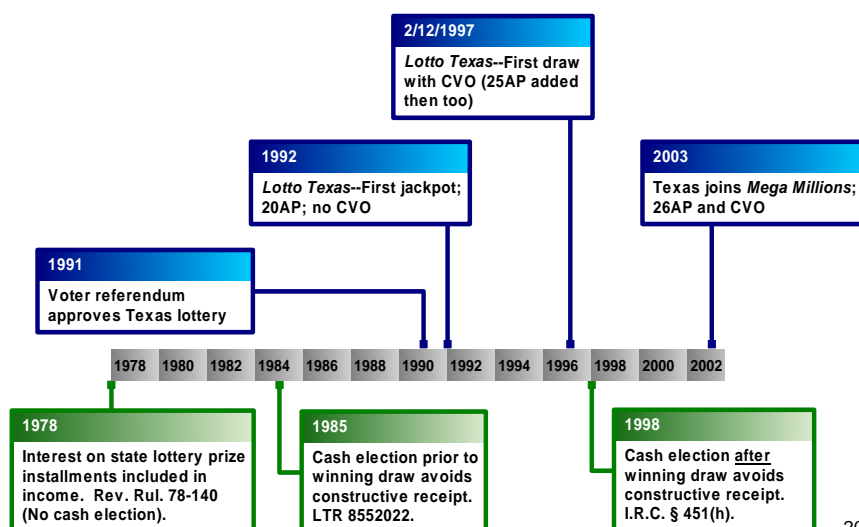
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## Rev. Rul. 78-140 is Limited

- LTR 8552022 subsequently approved cash election prior to a winning draw
- I.R.C. § 451(h) amended to permit CVO election after jackpot awarded
- Cash elections remove element of compulsion from installment payments
- Thanks to CVO, *Lotto Texas 25AP* and *Mega Millions 26AP* installments arise under borrowing power, within I.R.C. § 103

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## Cash Election (CVO) Timeline



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## Challenges Beyond I.R.C. § 103

- I.R.C. § 149 registration
- Reporting requirements
  - I.R.C. § 149(e) (Texas Lottery Commission)
  - I.R.C. § 6012(d) (Prizewinner)
- Disqualification
  - Arbitrage bonds
  - Hedge bonds
  - Private activity bonds

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## State Lottery Act and its Hurdles

- Can't tell what the state is supposed to do
  - Circular definitions
  - Uncodified, unpublished procedures and rules
  - Discretion substitutes for careful drafting
- Can't tell what the state is actually doing
  - *Lotto Texas* jackpot calculations a mystery, Section II.A.2.c.i(b) at 4; App. C at 33
- Rules change before anyone learns them

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## Good Test Cases

- *Lotto Texas* 25AP jackpot winners
  - Any of the 68 past 25AP jackpot winners
    - Post mortem successors, e.g., heirs and devisees
    - Judicial assignees, e.g., factors or ex-spouses
    - The more recent, the better, due to limitations
      - Claims for refund
      - I.R.C. § § 149(e) and 6012(d) reporting
  - Future 25AP jackpot winners
- Future *Mega Millions* 26AP jackpot winners

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## Bad Test Cases

- *Lotto Texas* 20AP jackpot winners
- *Lotto Texas* LS (Lump Sum) jackpot winners (cash not elected, but paid anyway)
- *Lotto Texas* and *Mega Millions* lower tier winners
- Instant game winners, App. I at 51

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## Final Thoughts

- States are not going to abandon the Revenue Lottery model
- Consumers grow weary of online games
- Interest exemptions are a drafting and compliance burden, but could stimulate sales of both online and instant games