

THE LOTTERY WINNINGS EXCEPTION TO FEDERAL GIFT TAXES

Sunday, March 18, 2012

An interesting circumstance often shows up with lottery winners. After they have won, it seems that a very high percent of them had arrangements in place before they bought their lottery tickets to share their winnings with family members. Due to this arrangement, when the proceeds are paid, they are paid into an entity owned by multiple family members. This allows those family members to share directly in the lottery winnings.

This is all fine if there was in fact a bona fide and binding arrangement to share the proceeds. However, if there was not, this arrangement should result in a gift as to the value of the lottery proceeds that are effectively transferred to the family members. Given the high multi-state Powerball and other payouts that occur these days, these transfers can be significant.

Some have wondered whether many of these pre-existing arrangements really exist, or are only a product of post-lottery planning. Seeing the number of these arrangements, one gets the feeling that many believe there is a "lottery winnings" exception to federal gift taxes that gives a free pass to the sharing of the winnings among family members.

A recent Tax Court case warns that there is no such lottery exception, and that the IRS will scrutinize the bona fides of such lottery sharing arrangements and assert gift taxes when appropriate.

In this case, the winner created a corporation after the win, which corporation claimed the lottery proceeds. The winner and her spouse owned 49% of the stock, and the remaining 51% were other family members. The IRS asserted a gift as to 51% of the proceeds. The winner claimed there was a binding contract to share the proceeds and thus no gift.

The court had a number of problems with finding an enforceable contract. There was no written agreement. There was no obligation by any family member to buy a certain number of tickets. The tickets were not kept in a place where all family members had access to the tickets. Each family member did not know if another had bought a ticket. There was no fixed sharing percentage for winnings established before the win. It was unclear how much of the proceeds would be retained by the winner. It was unclear how many family members were a party to the agreement. In the end, the Tax Court found that while perhaps an informal family agreement existed, it was too indefinite, uncertain, and incomplete for enforcement.

The court noted that in the appropriate circumstances an enforceable lottery sharing agreement can exist. For example, it cited *Pearsall v. Alexander*, 572 A.2d 113 (DC 1990) when two men who worked together would go to a liquor store twice a week after work and purchase a package of vodka, orange juice, two cups and two lottery tickets. They would then use any winnings to buy additional tickets. The court there found an enforceable sharing agreement.

The taxpayers alternately asserted a “partnership” among the family members to avoid a gift. They cited *Estate of Winkler v. Comm.*, T.C. Memo. 1997-4. In that case, the court found a valid lottery partnership when a family regularly purchased tickets and placed them into a special “family ticket” bowl. When a large ticket hit for them, a family meeting was called and sharing percentages were agreed upon (so apparently the failure to have an agreement in advance on sharing percentages will not by itself be fatal to a partnership arrangement). The partnership was respected for gift tax purposes.

The Tax Court distinguished *Winkler* from the current facts because the lottery tickets were purchased on a regular and consistent basis in *Winkler*. Also, all family members met with the accountant and lawyer after the win. In the current case the taxpayer made all the decisions on what happened to the proceeds – there was no joint effort.

Thus, there can be valid arrangements that allow for sharing of proceeds that will not give rise to a gift. However, they need to have elements of regular and consistent purchases, a clear agreement to share winnings, common knowledge of all participants

of purchases, and joint decision making as to winnings. Absent such elements, a gift will result if sharing occurs – there is no lottery winnings exception to gift taxes.

Dickerson v. Comm., TC Memo 2012-60