INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 29, 1999

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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year Involved:
Date of Conference:

LEGEND:

Taxpayer =
State =
$w =
$x =
$y =
$z =
A =
B =
C =
Year 1 =
Year 2 =
Month a =
Month b =
Month c =
Buyer =
State Court =

ISSUE:

Are the proceeds that result from the sale of the right to receive lottery winnings capital gain or ordinary income?

CONCLUSION:

The proceeds that result from the sale of the right to receive lottery winnings are ordinary income.

FACTS:

In Month a, Year 1, Taxpayer won the right to receive a gross pre-tax amount of $w from the State lottery payable in A annual installments of $x, less Federal income tax withheld.

The State lottery is funded by State's investment in U.S. Treasury zero coupon bonds, which, as they mature, provide the funding for State's payments to lottery winners. The State lottery is the owner and beneficiary of these securities. The securities are not set aside for the exclusive benefit of the lottery winners and are not beyond the reach of other creditors of State. The lottery winner receives no written, formalized contract acknowledging the promise to pay the prize over A years. Lottery winners receive a letter from State certifying that they are winners and indicating how the prize will be paid.

Pursuant to two approved State Court petitions, in Month b, Year 2, Taxpayer sold to Buyer the rights to B annual lottery payments for the sum of $y and in Month c, Year 2, sold to Buyer the rights to C annual lottery payment for the sum of $z.

LAW AND ANALYSIS:

In order to treat gain from the sale or exchange of an asset as capital gain, the asset disposed of must be a capital asset as defined in § 1221 of the Internal Revenue Code. Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of the listed exceptions. Section 1221 excludes the following five categories of property from the definition of capital assets: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167 or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; and (5) certain publications of the United States Government. Section 1.1221-1 of the Income Tax Regulations states that "The term 'capital assets' includes all classes of property not specifically excluded by section 1221."

Despite § 1221's apparent broad definition of capital asset, the Supreme Court has found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset;" rather, the term "capital asset" "is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." Commissioner v. Gillette Motor Co., 364 U.S. 130, 134 (1960) (citing Burnet v. Harmel, 287 U.S. 103, 106

(1932)). Accordingly, the Court has held that interests that are concededly "property" in the ordinary sense are not capital assets. Gillette Motor Co., 364 U.S. at 134-135; see, e.g., Hort v. Commissioner, 313 U.S. 28 (1941) (unexpired lease); P.G. Lake, Inc. v. Commissioner, 356 U.S. 260 (1958) (oil payment rights) discussed infra.

Gillette was a case in which the Federal government temporarily took possession and assumed control of the taxpayer's trucking company during World War II. The government later compensated the taxpayer for use of the facilities in the amount of the facilities' fair rental value. In its analysis, the Court noted that the taxpayer's right to use its transportation facilities was a valuable property right compensable under the Fifth Amendment, but was nonetheless not a capital asset within the meaning of the predecessor provisions of §§ 1221 and 1222. The right "is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years." Gillette, 364 U.S. at 135. The Court held that the payment received was, in substance, rental payment for the use of its facilities and hence, was ordinary income.

The Court in Gillette relied in part on two earlier Supreme Court cases that established the principle that a purported transfer of a property interest that is really an assignment of future ordinary income it not property within the meaning of § 1221.

The earliest of these cases, Hort v. Commissioner, 313 U.S. 28 (1941), involved a taxpayer lessor who received a lump-sum payment in consideration for the cancellation of a long-term lease. The Court found that the amount received for cancellation of the lease was not a return of capital because the amount received was merely a substitute for rental payments which would themselves be taxed as ordinary income. Accordingly, the Court held that the amount received in lieu of those payments also must be characterized as ordinary.

The substitute for ordinary income theory was again applied in Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958). This case was a consolidation of cases having similar facts. The facts of the lead case were that a taxpayer corporation assigned an oil payment right to its president in consideration for the cancellation of a debt owed the president. The Court initially set out that the purpose of the capital gains provisions is "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." P.G. Lake, 356 U.S. at 265 (quoting Burnet v. Harmel, 287 U.S. at 106). The Court then found that the assignment was not a conversion of a capital investment, because, as was the case with Hort, the lump sum received, in the amount of the canceled debt, was a substitute for what would otherwise be received at a future date as ordinary income. The amount received did not represent payment for an increase in the value of income-producing property. In making this determination, the Court was influenced by the fact that the pay-out of the oil payment rights could be ascertained with considerable accuracy, noting that the payments at issue were so assured that one of the purchasers obtained a low-interest loan secured only by the deed of trust of the oil payment right.

In U.S. v. Midland-Ross, 381 U.S. 54 (1965), the Supreme Court examined whether earned original issue discount was a capital asset. Citing Hort, P.G. Lake, and Gillette, the Court stated that in applying the capital gains provisions, courts exclude from capital asset treatment "property representing income items or accretions to the value of a capital asset themselves properly attributable to income." Midland-Ross, 381 U.S. at 57. The Court noted that earned original issue discount does not involve the realization of appreciation in value accrued over a substantial period of time and that the earning of discount to maturity is predictable and measurable. Based on this, it held that earned original issue discount is a substitute for ordinary income, in this case interest, which also must be characterized as ordinary income.

It is instructive to compare the substitution for ordinary income cases, wherein the interest at issue is held not to be property within the meaning of § 1221, with cases in which a capital asset is found to have been transferred. In Estate of Shea v. Commissioner, 57 T.C. 15 (1971), acq., 1973-2 C.B. 3, the court held that the sale of a shipping charter, a contract to provide cargo space on the taxpayer's ships, was a sale of "property" resulting in capital gain. Although Estate of Shea examined the term "property" within the meaning of § 1231, the term has the same meaning under § 1221 as it has under § 1231. See Hollywood Baseball Assoc. v. Commissioner, 423 F.2d 494 (9th Cir.), cert. denied, 400 U.S. 848 (1970). In its holding, the court stressed that the value of the charter was not primarily due to the inherent "right to earn future income" within it; rather, the value was determined by its rate as compared to prevailing market rates. Thus, the difference between the amount paid for the charter and the amount received upon its disposition represented appreciation in value over time due purely to the action of market forces. This was precisely the type of profit for which capital gain treatment is intended, the court reasoned, citing Gillette.

In United States v. Dresser Industries, Inc., 324 F.2d 56 (5th Cir. 1963), the taxpayer transferred to a patent holder the "exclusive" feature of a grant to the taxpayer of a license to practice a patent for hire. The court recognized that all payments for income-producing property are substitutes for ordinary income, in the sense that the value of any property is the discounted present value of the future stream of income it is estimated it will produce. However, the court concluded that, in this case, the transfer was the transfer of a right to earn income, as distinguished from a right to earned income to be paid in the future, and hence, was property within the meaning of § 1221.

In a case similar to Dresser, it was held, without elaboration, that a taxpayer may not convert ordinary income into capital gain by selling his dividend right. Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942). In that case, the income was already earned, and only had to be collected.

In Ferrer v. Commissioner, 304 F.2d 125 (2d Cir. 1962), the taxpayer held, and later disposed of, (1) a lease from a playwright of a right to produce a play, (2) a negative right to prevent disposition of film rights until after production of the play, and (3) the affirmative right to receive a stated percentage of film proceeds. The court acknowledged the difficulty in determining whether a property interest is property that constitutes a capital asset within the meaning of § 1221, but went on to determine that courts generally have found a taxpayer who transferred an estate in, an encumbrance on, or an option to acquire an interest in property which, if itself held, would be a capital asset to have transferred "property" that is a "capital asset." Those cases are to be distinguished from others in which the taxpayer merely had an opportunity to obtain periodic receipts of income by dealing with another, by rendering service, or by virtue of an ownership of a larger "estate." The court held that because the lease of the play and the negative right to prevent disposition of film rights represented equitable interests in the copyright of the play, those interests were property within the meaning of § 1221, the disposition of which resulted in capital gain. The taxpayer's right to receive a percentage of film proceeds, on the other hand, did not represent an equitable interest, but merely a right to future ordinary income; accordingly, the proceeds received upon the disposition of that right must be taxed as ordinary income.

The instant case is distinguishable from those cases in which property constituting a capital asset was found. Unlike the taxpayer in Estate of Shea, the payment that Taxpayer received did not represent appreciation in value over time due to market forces, but was merely the discounted present value of her future ordinary income stream. Unlike the taxpayer in Dresser, Taxpayer did not transfer the right to earn income; the income at issue was already earned and merely had to be collected. Like the taxpayer in Rhodes' Estate, Taxpayer cannot covert future ordinary income into current capital gain by anticipatory transfer. Unlike the taxpayer in Ferrer with respect to that taxpayer's interests in the lease of the play and the negative power to prevent disposition of film rights, Taxpayer does not have an equity interest in the lottery winnings. The State lottery is the owner and beneficiary of the Treasury securities used to fund the lottery. Taxpayer's situation is more analogous to that of the taxpayer in Ferrer with respect to his right to receive a percentage of film proceeds, because that interest, as here, is merely a right to receive future ordinary income.

Based on the above, we conclude that Taxpayer realized ordinary income on the sale of her lottery winnings. Like the taxpayers in Hort and P.G. Lake, what Taxpayer received was a lump-sum payment in exchange for the transfer of a future ordinary income stream. Like the taxpayers in Hort, P.G. Lake, Gillette, and Midland-Ross, what Taxpayer received was a substitute for ordinary income. Those cases dictate that the amount received upon the sale of an ordinary income stream is a substitute for ordinary income and must be taxed as ordinary income.

Taxpayer's assignment of her lottery winnings was not a conversion of a capital investment. The amount received did not represent payment for an increase in the value of income-producing property. Indeed, Taxpayer did not hold income producing property, but merely the right to collect an ordinary income stream. Like the oil payment right in P.G. Lake and the earned original issue discount in Midland-Ross, the lottery payment right is predictable, measurable, and can be ascertained with considerable accuracy. In short, Taxpayer simply converted future ordinary income into present income. Accordingly, the lump-sum received upon that conversion must be characterized as ordinary income.

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