Estate tax on lottery winnings

If estates consisted only of cash and marketable securities, determining their values and death taxes due would be simple. But estates often have assets that are very hard to value, and much estate tax litigation with the IRS concerns getting that value right.

Take lottery winnings, for example. Three people shared a $20 million Ohio Super Lotto jackpot in 1991. Two of them, Mildred Lopatkovich and Mary Susteric, died in 2001, having collected only 11 of their 26 annual payments of $256,410.26. Carol Negron, executor for both estates, made an election for the estates to receive the balance of the lottery winnings as a lump sum. The reason for her election is not certain, but the estates could have been in a death tax cash crunch. The lottery annuity was not assignable and could not be used as collateral to borrow money to pay taxes. The lump sum election created substantial ready cash. Under the Ohio rules, the value of the lump was computed with a 9.0% discount rate, the interest rate in effect in 1991 when the prize was won. Each woman had collected $2.8 million of her $6.6 million share of the prize, and the election put $2.2 million into each estate. Negron reported that taxable value and paid federal estate taxes on it.

IRS has a very different formula for valuing lottery annuity winnings. The Service relies upon market interest rates at the time of death, which in this case were well below the 9.0% actually used to determine the lump sum. For the Lopatkovich estate the interest rate was 5.0%, boosting the taxable value of her annuity by some $500,000; the Susteric date of death yielded a 5.6% interest rate, so her increase was only about $390,000. The executor paid the additional estate tax and filed for a refund, arguing that the IRS tables do not value lottery annuities accurately. The District Court agreed with the estate's position.

Considering the rarity of lottery winners, and the widespread choice by winners to opt for lump sums over annuities, there has been a remarkable amount of litigation over the proper valuation of lottery annuities for estate tax purposes when winners die before the annuity terminates. The issue has been whether the IRS tables create an accurate value when the tables don't account for the fact that lottery annuities are restricted; they can't be used as collateral to borrow funds to pay death taxes. Taxpayers have won some and lost some.

In the case of the Ohio lottery winners, they lost when the IRS appealed their case to a higher court. "It is tempting," said the Court of Appeals, "to accept the argument that a person's

estate should not be taxed on a lottery annuity amount that it did not receive." Indeed, ordinary people might find that fully persuasive. But in this case the different values arise because the federal discount rate didn't match the Ohio rate. "The two discount rates yielded different results because they served different purposes: one approximated the value of the unpaid annuity as if it had been a lump sum from the beginning; the other valued the annuities as an ongoing annuity or a continuing stream of periodic payments." It is just the estate's bad luck that the high rate operated to reduce the size of the lump sum, and the low rate served to increase the estate's taxes.

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