

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

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ABSTRACT OF THESIS

The Texas State Lottery Act authorized a state lottery with a variety of games, many of which pay prizes in installments. Deferred payments suggest interest, and thus I.R.C. § 103, which excludes from income interest on state and municipal obligations. Revenue Ruling 78-140, which predates the Texas State Lottery Act, holds that interest on state lottery installment payments is not excludible. That ruling was correct on the facts, which included compulsory installment payments. However, two Texas on-line games, *Lotto Texas* and *Mega Millions*, are distinguishable, because, exploiting exceptions to the constructive receipt and related doctrines that were not recognized in 1978, each offers a cash election and each enables assignment of installment payments. As a result, interest on those jackpots actually paid in installments is potentially excludible, requiring only that the Lottery Commission report those obligations as tax-exempt securities. Other on-line and instant games would not qualify for an interest exclusion without significant changes, either because they do not offer installment payments in the first instance, or because their compulsory installment payments fall within the facts of Revenue Ruling 78-140.

To say the Texas Lottery Commission merely need report a *Lotto Texas* or *Mega Millions* installment jackpot as a tax-exempt security belies the complexity of I.R.C. § 149, which would impose a variety of requirements for the term of a qualified installment obligation. If either game meets the requirements of I.R.C. §§ 103 and 149, it is by happenstance rather than by design, and a more thoughtful and disciplined approach than the present is warranted before the public or the Lottery Commission embraces I.R.C. § 103 and exclusion of interest on Texas lottery prize installments.

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APPENDICES

Appendix A. Dawn Nettles, 0547 The Lotto Report: The Racing Form of the Texas Lottery, Nov. 17 - 30, 2005. © 2005 Dawn Nettles. Reprinted by permission.

Appendix B. Timeline and Summary of Lotto Texas Jackpot Rules.

Source: Tex. Lottery Comm'n, An Internal Audit of Lotto Texas Jackpot Prize Winner Awards 9 fig.1 (IA #05-002 Dec. 31, 2004) (on file with author)

Appendix C. Lotto Texas Payment Schedule, June 3, 1995, Draw #267

Source: Tex. Lottery Comm'n, Lotto Texas Payment Schedule, June 3, 1995, Draw #267 (among Mar. 1, 2005 Open Records response from Texas Lottery Commission) (on file with author).

Appendix D. *Lotto Texas*TM Drawing Results & Reserve Entry Form, Draw Date: 09/24/05; Draw #1343

Source: Tex. Lottery Comm'n, Download jackpot payment calculation for Lotto Texas for Saturday, September 24, 2005, http://www.txlottery.org/online/prizeamounts/lotwin20050924_3.pdf (last visited Dec. 22, 2005).

Appendix E. Tex. Lottery Comm'n, Lotto Texas Jackpot Winners (Dec. 20, 2005).

Source: Excel file MASTER LOTTO WINNERS May 2005_1.xls, attached to Dec. 20, 2005 e-mail from openrecords@lottery.state.tx.us (on file with author).

Appendix F. Interest Imputed on Installment Payments

Appendix G. Rev. Rul. 78-140 Amortization

I. INTRODUCTION

In November 1991, Texas voters approved a constitutional amendment endorsing the State Lottery Act, which, taken together, excepted state operated games from the general prohibition against lotteries. The Texas Lottery Commission (Commission or Lottery Commission) began as a division within the Comptroller of Public Accounts, but was reorganized as an independent agency effective September 1, 1993.

The “Texas Lottery” is not itself a particular game, but rather the trademark of the Texas Lottery Commission. The Commission maintains a revolving lineup of about 80 games, and, since inception, has offered hundreds of unique lotteries. For recent¹ examples, see Dawn Nettles, 0547 The Lotto Report: The Racing Form of the Texas Lottery, Nov. 17–30, 2005. *Infra*, app. A.

The Commission classifies its games as instant, or “scratch-off,” and on-line. Instant games include a pre-printed ticket with a latex film the player removes to reveal the results. On-line game tickets are printed at the time of sale by a computer terminal connected to a central system. On-line results are determined by a drawing of the winning numbers. The Texas Lottery currently offers five on-line games: *Mega Millions* with the add-on Megaplier feature, *Lotto Texas*, *Pick Three*, *Cash Five*, and *Texas Two Step*. *Mega Millions*, a recent addition, is a multistate game which Texas joined in October 2003. *Lotto Texas* and *Mega Millions* are the only games, instant or on-line, which offer both installment payments and a cash payment option at the player’s election (other games offer installment payments but a compulsory lump sum if the prize amount falls below a certain threshold).

Although the Commission sometimes refers to the on-line game *Lotto Texas* as its flagship product, the majority of games offered at any one time are instant rather than on-line.

¹ “Recent” as of December 2005, when the author concluded his research.

Perhaps because they offer a higher average payout (65.04% instant v. 47.84% on-line), instant games account for almost two-thirds of sales (\$2.3 billion of \$3.5 billion). The NASPL Lottery Resource Handbook 186 (N. Am. Ass'n of State & Provincial Lotteries CD-ROM, 2005) (apparently reporting calendar year 2004 figures). While Texas lottery sales overall continue to increase, the growth is attributable almost exclusively to instant sales, with on-line games generally in decline, falling by \$205 million in sales last year alone. Tex. Lottery Comm'n, FY 2005 Comprehensive Annual Financial Report: Financial 17–18, *available at* http://www.txlottery.org/info/fy05_cafr02fin.pdf (last visited Dec. 23, 2005) (comparing fiscal year 2004 and 2005 figures).

Lotto Texas has changed considerably since it was introduced. The first *Lotto Texas* jackpot, awarded in November 1992, was paid in 20 annual installments. The jackpot winner had no cash option, and installment payments could not be assigned voluntarily except by will or intestacy. Subsequent changes provide prizewinners more liquidity. In February 1997, a cash value option (CVO or cash option) was introduced, allowing players, at the time of purchase, to elect an immediate lump sum payment. At the same time, the annual payments were extended from 20 to 25. In September 1999, the State Lottery Act was amended to enable voluntary inter vivos assignment of installment prize payments. Tex. Gov't Code § 466.410; *see generally* Tex. Lottery Comm'n, Texas Lottery Commission Milestones (Dec. 2005) *available at* <http://www.txlottery.org/info/milestones.cfm> (last visited Dec. 23, 2005).

Texas does not offer a cash option except at the time the ticket is purchased. In 1999 the Lottery Commission proposed, then withdrew, rules that would have given prior prizewinners a 15-month option to elect cash payment of any remaining installments. 24 Tex. Reg. 3285 (Apr. 30, 1999) (proposed 16 Tex. Admin. Code § 401.312 (Converting Specific Installment

Payments)), *withdrawn by* 24 Tex. Reg. 7395 (Sep. 17, 1999). This was apparently the only serious consideration ever given to enabling a cash election after the prize was awarded. I.R.C. § 451(h) had been amended in 1998 to expressly allow a late election without running afoul of constructive receipt and related doctrines that otherwise would have accelerated recognition of income for all prizewinners receiving installment payments, not just those making the late election. History, or at least the Texas Register, does not record why the Lottery Commission entertained but rejected the notion.

In any event, the cash option has practically eliminated installment payment of *Lotto* jackpots. The 1999 assignment legislation briefly reversed the decline in CVO elections, but otherwise, the trend away from installment payments has continued to its logical conclusion, until 2004 and 2005, when every single jackpot winner elected the cash option. Either players consider the cost of installment assignments to be excessive, or they believe installment payments are a poor investment to begin with. Lottery newsletters suggest the latter. *See, e.g.*, Dawn Nettles, If You Win The Lotto Texas Jackpot ... Here's What You Really Won, Texas Lotto Report (Nov. 23, 2005), <http://www.lottoreport.com/shouldyouwin.htm> (last visited Nov. 25, 2005) (“Mark your playslip CVO (cash value option) - Do NOT choose Annual Pay.”).

Table 1. *Lotto* Jackpot Payment Methods

Year	CVO-Eligible <i>Lotto</i> Jackpots	Payment Method		Election Frequency	
		25AP	CVO	25AP	CVO
1997	38	23	15	61%	39%
1998	46	18	28	39%	61%
1999	32	5	27	16%	84%
2000 ¹	32	9	23	28%	72%
2001	24	5	19	21%	79%
2002	32	6	26	19%	81%
2003 ²	14	2	12	14%	86%
2004	6	0	6	0%	100%
2005	5	0	5	0%	100%
Aggregate	229	68	161	30%	70%

¹ Winning odds decrease as *Lotto*'s field of numbers expands from 50 to 54, effective July 2000.

² Winning odds decrease again as *Lotto* adds a bonus ball, beginning May 2003.

Author's analysis of Tex. Lottery Comm'n, Lotto Texas Jackpot Winners (Excel file MASTER LOTTO WINNERS May 2005_1.xls, attached to Dec. 20, 2005 e-mail from openrecords@lottery.state.tx.us² to rwhall@rwhpc.com) (on file with author) and Tex. Lottery Comm'n, Texas Lottery Commission Milestones (Dec. 2005) available at <http://www.txlottery.org/info/milestones.cfm> (last visited Dec. 23, 2005).

Mega Millions, first introduced in 2003, has always had the same payout structure. Like *Lotto Texas*, *Mega Millions* offers a cash value option, which must be elected at purchase, if at all. 28 Tex. Reg. 9532 (2003) (codified at 16 Tex. Admin. Code § 401.315(b)(3)). To date, two *Mega Millions* jackpots have been awarded to Texas players, both of whom had elected the cash option. Tex. Lottery Comm'n, Lotto Texas Jackpot Winners (Word file InstlmtPymtGms 0904.doc, attached to Dec. 20, 2005 e-mail from openrecords@lottery.state.tx.us) (on file with author). In the default, *Mega Millions* jackpots are paid in 26 annual installments. 16 Tex. Admin. Code § 401.315(b)(2). Nothing excepts *Mega Millions* jackpots from the assignment regulations, and so, in the event a prizewinner fails to elect the cash option, *Mega Millions* jackpot installments may be assigned just as *Lotto Texas* installments may.

² Open records requests may be e-mailed or sent U.S. mail to Texas Lottery Commission, Open Records Coordinator, P.O. Box 16630, Austin, Texas 78761-6630, openrecords@lottery.state.tx.us.

Although online sales are generally decreasing, *Lotto Texas* and *Mega Millions* remain significant games, with sales of \$306.7 million and \$217.8 million, respectively, in 2005. Tex. Lottery Comm'n, FY 2005 Comprehensive Annual Financial Report: Financial 18, *available at* http://www.txlottery.org/info/fy05_caf02fin.pdf (last visited Dec. 23, 2005) (*Mega Millions* includes \$177.5 base sales and \$40.3 million Megaplier sales).

A. The Texas State Lottery Act

1. History and Authority

The constitution of the Republic of Texas was silent regarding gaming. However, since statehood, every Texas constitution has expressly prohibited lotteries. Tex. Const. of 1845, art. VII, § 17; Tex. Const. of 1861, art. VII, § 17; Tex. Const. of 1866, art. VII, § 17; Tex. Const. of 1869, art. III, § 27, art. XII, § 36; Tex. Const. of 1876, art. III, § 47, *available at* <http://tarlton.law.utexas.edu/constitutions/constitutions.html> (last visited Dec. 26, 2005).

Only the current constitution of Texas, that of 1876, was ever amended to permit lotteries, and then not for 100 years. In 1971 the Legislature attempted to decriminalize charitable lotteries, but the exemption was declared unconstitutional. Tussey v. State, 494 S.W.2d 866 (Tex. Crim. App. 1973). A series of voter referendums and constitutional amendments followed, legalizing charitable bingo in 1980, charitable raffles in 1989, and, in 1991, a state operated lottery. Op. Tex. Att'y Gen. No. GA-0103 (2003) (discussing constitutional history). But for these exceptions, lotteries remain prohibited under Texas law. Tex. Const. art. III, § 47.

The State Lottery Act was originally codified at Vernon's Texas Revised Civil Statutes art. 179g, but is now found at chapters 466 and 467 of the Government Code. The Lottery Commission is overseen by three board members, who are appointed by the governor for staggered 6-year terms. Tex. Gov't Code §§ 467.021, 467.022. The board hires the executive

director, who serves at-will, and is responsible for daily administration. Tex. Gov't Code § 467.032.

The State Lottery Act grants the Commission rulemaking authority. Tex. Gov't Code §§ 466.015(a), 467.102. The Commission's rules are found in the Texas Administrative Code, Title 16, Part 9 (Texas Lottery Commission). Lottery game rules are found Chapter 401, subchapter D—

- § 401.301. General Definition
- § 401.302. Instant Game Rules
- § 401.303. Grand Prize Drawing Rule
- § 401.304. On-Line Game Rule (General)
- § 401.305. "Lotto Texas" On-Line Game Rule
- § 401.306. Video Lottery Games
- § 401.307. "Pick 3" On-Line Game Rule
- § 401.308. "Cash Five" On-line Game
- § 401.309. Assignability of Prizes
- § 401.310. Payment of Prize Payments Upon Death of Prize Winner
- § 401.312. "Texas Two Step" On-line Game
- § 401.313. Promotional Drawings
- § 401.314. Retailer Bonus Programs
- § 401.315. "Mega Millions" On-Line Game Rule

Before 1993, the Commission's rules were codified at Title 34, Part I, Chapter 7 of the Texas Administrative Code. *See, e.g.*, the former 34 Tex. Admin. Code § 7.305. 17 Tex. Reg. 9010 (Dec. 22, 1992) (current version at 16 Tex. Admin. Code § 401.305(e)(4)(B)).

The Commission exercises its rulemaking authority frequently. *See, e.g.*, 28 Tex. Reg. 3272 (2003), 27 Tex. Reg. 1477 (2002), 25 Tex. Reg. 4737 (2000), and 21 Tex. Reg. 10743 (1996) (*Lotto Texas* amendments). As explained below, the Commission also makes liberal use of its authority to promulgate supplemental rules and procedures. The result is often a daunting thicket of primary law.

2. Lottery Games

a. In general

The State Lottery Act defines "lottery" in generic terms, and does not prescribe the form

of permitted games, except that multiple games are anticipated, and sports and video games are prohibited. *Cf.* Tex. Gov't Code §§ 466.002(5) ("lottery" defined); 466.015(c)(1) (rulemaking authority extends to "*games to be conducted*") (*emphasis added*); 466.024 (prohibited games). In 2003, the Act was amended to expressly authorize multijurisdiction games. Tex. Gov't Code §§ 466.451.

The regulations describe three general classes of games: instant, on-line, and promotion. The regulations contain general definitions. 16 Tex. Admin. Code § 401.301. The definitions refer to a variety of rules and procedures that are not necessarily codified or even published. *E.g.*, 16 Tex. Admin. Code §§ 401.301(11), (27) (drawing procedures), § 401.301(13) (draw procedures), § 401.301(17) (game procedures), § 401.301(20) (Commission rules).

Some fundamental definitions are ambiguous and/or depend on undefined terms. *See e.g.*, 16 Tex. Admin. Code § 401.301(38) (prize amounts) (three alternate definitions; two depending on undefined terms "annuitized future value" and "net present cash value"). Others are circular. *See e.g.*, 16 Tex. Admin. Code § 401.301(41) (prize category contributions) ("contributions for each drawing to each prize category including direct and indirect prize category contributions"). To further muddy the waters, any general definition may be preempted whenever context "clearly indicates" a different meaning. 16 Tex. Admin. Code § 401.301 (preamble).

But for security procedures and a prizewinner's street address and phone number, all Commission records are available under the Open Records Act. Tex. Gov't Code §§ 466.022, 467.104. 16 Tex. Admin. Code § 403.101. Thus, uncoded or unpublished items may be requested from the Commission, provided one knows the nomenclature. The primary law applicable to any game or particular prize is thus a matter of legal research and Open Records

requests.

The effort to gather the applicable law is not always rewarded. The regulations often describe games in broad stroke, leaving essential matters to the Commission's discretion. Administrative discretion has proven a poor discipline, allowing the Commission to issue policies and procedures it may disregard, so long as it acts within the discretion afforded by the regulations it promulgates itself.

Lotto Texas presents an extreme example with respect to calculation of the amount to be awarded jackpot prizewinners: a 2004 audit found that policy and procedure approvals, effective dates, and revision (or superseded) dates were not adequately noted and maintained, leaving the auditors unable to determine which were in effect at any point in time. Tex. Lottery Comm'n, An Internal Audit of Lotto Texas Jackpot Prize Winner Awards 6 (IA #05-002 Dec. 31, 2004) (on file with author). To be fair, the audit also determined that all prize amounts actually awarded were within the Commission's discretion, and it found no instance where the Commission breached applicable policies, plans, procedures, rules, or law. *Id.* at 4 (discretion), 1 (compliance).

The audit was one of two following Dawn Nettles' complaints. Ms. Nettles, who publishes the Texas Lotto Report, has been a long-time critic of the Texas Lottery Commission. Rick Kennedy, Number Crunched: Self-Appointed lottery watchdog Dawn Nettles keeps her eye on the balls-and has some, too, Dallas Observer, Jun. 2, 2005, *available at* <http://www.dallasobserver.com/issues/2005-06-02/news/feature.html> (last visited Nov. 29, 2005); *see generally* Texas Lotto Report - The most comprehensive Lottery Publication and web site in the country, www.lottoreport.com (last visited Jan. 16, 2006). If the 2004 audit did not vindicate Ms. Nettles' complaint, it explained her frustration: the Commission's rules and practices can be unhelpful if

not impenetrable, even to the diligent.

b. Instant games

Instant games are known as “scratch offs,” so-called for the latex that players remove from the preprinted ticket. 16 Tex. Admin. Code § 401.301(20). Instant games account for the majority of the games the Commission has offered. *See, e.g.*, Tex. Lottery Comm’n, Scratch Offs Game List, available at <http://www.txlottery.org/scratchoffs/top3pf.cfm> (last visited October 23, 2005) (80 active scratch off games on October 23, 2005, alone). Prizes are generally smaller than on-line games, but can be significant. *Id.* (Monthly Bonus—\$2.4 million; Set for Life—\$5 million).

A general set of rules applies to all instant games. 16 Tex. Admin. Code § 401.302 (Instant Game Rules). Section 401.302(*l*) recites the classes of authority that bind scratch off players, including “Texas law, all rules, procedures, and final decisions of the Commission, and all procedures and instructions established by the executive director for the conduct of the instant game.”

Instant game procedures are not codified, but are simply published in the Texas Register. 16 Tex. Admin. Code § 401.302(b)(1). Additional requirements may be printed on the back of each ticket. *See, e.g.*, 30 Tex. Reg. 6311 para. 2.0 (2005) (Instant Game Number 618 “Casino Cash Out”). The executive director can have broad discretion with respect to instant games. *Id.*, para 4.0 (number of prizes), para. 5.0 (closing date); para. 6.0 (executive director’s decisions are final).

c. On-line games

On-line games rely on a computer system to print tickets at the time of sale. The ticket memorializes a combination of numbers selected by the player, or if the player requests a Quick Pick, generated at random. 16 Tex. Admin. Code § 401.301(31) (On-line ticket).

A general set of rules applies to all on-line games. 16 Tex. Admin. Code § 401.304 (On-Line Game Rules (General)). Section 401.304 recites the classes of authority that bind players, including “applicable laws, all Commission rules, regulations, policies, directives, instructions, conditions, procedures, and final decisions of the executive director.” Specific rules for particular on-line games are found elsewhere in subchapter D. 16 Tex. Admin. Code §§ 401.305 (Lotto Texas), 401.307 (Pick 3), 401.308 (Cash Five), 401.312 (Texas Two Step), 401.315 (Mega Millions).

The on-line games offer the largest prizes, and of those, *Lotto Texas* and the multijurisdiction *Mega Millions* are the biggest, with advertised prizes of \$36 million and \$64 million, respectively, the week of Christmas 2005. Tex. Lottery Comm’n, Lotto Texas - Prize Amounts 2005, available at <http://www.txlottery.org/online/payoutlotto.cfm?tYear=2005&tNumber=100000> (last visited Dec. 26, 2005); Tex. Lottery Comm’n, Mega Millions - Prize Amounts 2005, available at <http://www.txlottery.org/online/payoutmegamillion.cfm?tYear=2005&tNumber=10000> (last visited Dec. 26, 2005).

1) *Lotto Texas*

a) In general

Lotto Texas is the state’s largest on-line game by sales. The NASPL Lottery Resource Handbook 186 (N. Am. Ass’n of State & Provincial Lotteries CD-ROM, 2005).

Texas Administrative Code Chapter 16, Section 401.305, sets out the *Lotto Texas* rules and definitions, which supplement the Section 401.304 rules and the Section 401.301 definitions. In the event of a conflict, Section 401.305 prevails. Cf. 16 Tex. Admin. Code §§ 401.305(a), (b); 16 Tex. Admin. Code § 401.301 (general definition may be preempted whenever context “clearly indicates” a different meaning). The executive director is also authorized to issue additional instructions and directives. 16 Tex. Admin. Code § 401.305(a).

Before the Lottery Commission was reorganized as a separate agency, *Lotto Texas* rules were codified in the Texas Administrative Code at Chapter 7, Section 7.305. 17 Tex. Reg. 9010 (Dec. 22, 1992) (effective Feb. 16, 1993, per 18 Tex. Reg. 707 (Feb. 2, 1993)). The present *Lotto Texas* rules, effective since May 4, 2003, are found at Section 401.305. 28 Tex. Reg. 2352 (2003), *adopting* 28 Tex. Reg. 1317 (2003) (codified at 16 Tex. Admin. Code § 401.305). The rules were amended repeatedly in the interim; changes relevant to jackpot amounts are discussed below.

b) Jackpot amounts

Lotto Texas jackpot calculations have been the subject of considerable controversy, which ended only with amendments that define the current calculation method. The present rules call for the return of not less than 52% of *Lotto Texas* sales as prizes, with 75.2% of that as jackpots. Thus, in the aggregate, *Lotto Texas* jackpots should be 39.104% of *Lotto Texas* sales. Tex. Reg. 2352 (2003), *adopting* 28 Tex. Reg. 1317 (2003) (effective May 4, 2003; codified in relevant Part at 16 Tex. Admin. Code §§ 401.305(e)(2), 401.305(e)(3)(A)(iii)(I)). No jackpot minimum is legislated, but at present the Commission advertises and pays not less than \$4 million, regardless of sales. *See* Tex. Lottery Comm'n, Lotto Texas - Prize Amounts 2005, *available at* <http://www.txlottery.org/online/payoutlotto.cfm?tYear=2005&tNumber=100000> (last visited Dec. 26, 2005).

Prior to the 2003 amendments, jackpot payments were sometimes less than advertised, understandably generating controversy. *See, e.g.*, Clay Robison, Jr., Editorial, There's a Lotto lying going on at jackpot central, Hous. Chron., Jul. 2, 2005, *available at* <http://www.chron.com/disp/story.mpl/editorial/robison/3250229.html> (last visited Dec. 26, 2005); Rick Kennedy, Number Crunched: Self-Appointed lottery watchdog Dawn Nettles keeps her eye on the balls-and has some, too, Dallas Observer, Jun. 2, 2005, *available at* <http://www.dallasobserver.com/>

issues/2005-06-02/news/feature.html (last visited Nov. 29, 2005).

The disputed jackpots were paid under rules that set specific benchmarks, but then left the Commission discretion to award other amounts, which it did. *Cf.* Tex. Lottery Comm’n, An Internal Audit of Lotto Texas Jackpot Prize Winner Awards (IA #05-002 Dec. 31, 2004) (on file with author); Dawn Nettles, The Various Methodologies Used to Calculate Prize Payments for Lotto Texas Jackpot Winners, Texas Lotto Report (Feb. 4, 2005), <http://www.lottoreport.com/MethodologiesUsedTX.PDF> (last visited Nov. 28, 2005). For an overview, see the Timeline and Summary of Lotto Texas Jackpot Rules, which reproduces portions of the Commission’s 2004 internal audit. *Infra*, app. B. As indicated there, the rules have articulated no less than five schemes for determining the *Lotto Texas* jackpot amount.

The 2003 amendments removed one source of the Commission’s discretion by preempting the general rules and definitions. The general definitions include three alternate explanations of “prize amount,” apparently for the benefit of on-line, instant installment, and instant cash prizes. 16 Tex. Admin. Code § 401.301(38). The general definitions also define “prize structure” to include any value approved by the executive director. 16 Tex. Admin. Code § 401.301(44). Finally, the general on-line rules give the executive director discretion to set the amount of each prize. 16 Tex. Admin. Code § 401.304(11). The 2003 amendments expressly preempt these general definitions and rules. 16 Tex. Admin. Code § 401.305(a)(1) (preempting § 401.304 general on-line game rules); 16 Tex. Admin. Code § 401.305(a)(2) (preempting § 401.301 general definitions).

The 2003 amendments, did not, however, remove all sources of the Commission’s discretion. First, Section 401.303 (Grand Prize Drawing Rule) gives the executive director broad discretion regarding the grand prizes for drawings, i.e., first tier prizes for the on-line games,

e.g., *Lotto Texas* jackpots. The director's decisions under Section 401.303 are set out in draw procedures rather than the regulations. 16 Tex. Admin. Code § 401.303(b) (Grand Prize Drawing Rule) ("The executive director shall determine any prizes to be awarded and the method, manner, and timing of payment which shall be stated in the applicable draw procedures."). There is no provision for codification or publication of draw procedures, and so exercise of the Commission's discretion under Section 401.303 is not obvious.

Second, Section 401.313 (Promotional Drawings) gives the executive director carte blanche to designate promotional drawings and to determine procedures and prizes for those games. Here too, draw procedures rather than regulations document the director's determinations. 16 Tex. Admin. Code § 401.313(a). Thus, jackpot amounts remain with the Commission's discretion, notwithstanding the 2003 amendments.

As explained below, the payments actually made to jackpot winners are a function of the jackpot amount, but vary with the payment method, which includes annual installment, cash value option, and lump sum. See Texas Lottery Commission, Lotto Texas Jackpot Winners (Dec. 20, 2005) for a list of all 493 winners to date (column "Pmt" notes each winner's payment method as 20AP, CVO, LS, and 25AP). *Infra*, app. E. Annual installments are the default payment method for jackpot winners (installment winner). A cash option may be elected when the ticket is purchased (cash winner). If an installment winner's share falls below a certain threshold, a single cash payment is compulsory (lump sum winner).

i) 25 Annual Installments (25AP)

Since May 2003, the rules have provided that "the prize winner's share of the jackpot amount shall be paid in 25 *annual* installments." 16 Tex. Admin. Code § 401.305(e)(3)(A)(i) (effective May 4, 2003, per 28 Tex. Reg. 3293 (2003) and 28 Tex. Reg. 1317 (2003)) (*emphasis added*). Jackpots were originally paid in twenty installments. 34 Tex. Admin. Code §

7.305(e)(3)(A).

Notwithstanding the provision for annual installments, elsewhere a different rule delays the first payment until the winner claims the prize, with the remainder made annually on the 15th of the anniversary month of the winning draw. 16 Tex. Admin. Code § 401.305(e)(3)(A)(i). The Commission invariably follows the latter convention rather than attempting true annual installments, and must as a practical matter, because the prizewinner's identity is unknown prior to claiming the prize. On-line prizewinners have 180 days to claim the jackpot. 16 Tex. Admin. Code § 401.304(h)(2).

In practice, *Lotto Texas* installment prize payments are not an annuity due (equal periodic payments in advance) because the first payment may be delayed as much as 180 days, and also because the subsequent installments do not necessarily equal the first payment. The Commission generally pays all installments in more or less equal amounts, the subsequent installments being exactly equal, with the first payment adjusted so the sum of all installments totals the required jackpot amount. For a typical example, see Lotto Texas Payment Schedule, June 3, 1995, Draw #267, which shows the initial payment on claiming the prize, and then schedules the subsequent nineteen installments. *Infra*, app. C. Appendix C reflects the prizewinner's assignment of five installments to Great-West Life & Annuity Insurance Co. and then three installments to Lottery Receivables Company One, L.L.C., pursuant to Texas Government Code § 466.410. Note the withholding of federal income taxes. Note also that subsequent installments after the initial payment are exactly equal.

There is no express provision for interest on either the initial or subsequent installment payments. Absent interest, a \$4 million jackpot is paid in twenty-five payments, so the installment winner would receive \$160,000 on claiming the prize, regardless whether claimed on

the day of the winning draw or 180 days later, and then would receive another twenty-four annual installments of \$160,000. At a 4.5% discount (an arbitrary but, as Appendix E, *infra*, shows, a realistic figure), the present value of an annuity due of \$160,000 for 25 years would be \$2,479,280, considerably less than \$4,000,000.

The rules imply interest on installment payments might have been contemplated, by calling for funding of installments by the purchase of securities at the time of a jackpot winner is drawn, and by payment of those installments in an amount equal to the value of the matured security. 16 Tex. Admin. Code § 401.305(e)(3)(A)(i). The State Lottery Act, in contrast, provides for allocation of any interest to the unobligated portion of the general revenue fund. Tex. Gov't Code § 466.355(a). There is an apparent conflict between diversion of interest to the general revenue fund while also requiring the value of the matured security be paid the prizewinner, since debt instruments typically pay interest. These provisions are reconcilable if installments are funded by zero coupon securities, which are sold at a discount, and equal face value only upon maturity.

The Commission does use zero coupon securities as its benchmark for cash winners, thus both satisfying the letter of the law and avoiding any stated interest. *See, e.g., Lotto TexasTM Drawing Results & Reserve Entry Form, Draw Date: 09/24/05; Draw #1343* (listing zero coupon securities with a face value of \$160,000 and maturity dates and values corresponding to the subsequent installments), *infra*, app. D.

Whether the Commission actually purchases securities identified to each installment winner is unknown. By statute, the Comptroller is to “invest funds from the state lottery account as necessary to ensure the payment of the installments.” Tex. Gov't Code § 466.403 (Payment of Prize in Installments). The choice of investment, “securities, annuities, or other instruments,”

is left to the Comptroller's discretion, not the Lottery Commission's. Tex. Gov't Code § 466.403. Because the effective date of Section 466.403 is September 1, 1997, this statute followed the reorganization of the Commission as an agency independent of the Comptroller, and thus has more weight than if it preceded the reorganization, in which case the reference to the Comptroller rather than the Lottery Commission might be dismissed as an oversight.

The State Lottery Act limits prize payments to funds from the state lottery account, which itself is merely an account of the general revenue fund. *Cf.* Tex. Gov't Code §§ 466.355 (State Lottery Account), 466.403 (Payment of Prize in Installments). From the state's perspective, then, any particular investment is simply an accounting device, since by law the funds remain part of the general revenue fund. The possibility that the state invests in something other than the U.S. Treasury securities raises the issue of arbitrage, which can preclude application of I.R.C. § 103. For further discussion, see Section II.E.a, Arbitrage bonds, below.

ii) Cash Value Option (CVO)

In lieu of installments, *Lotto Texas* players may elect to be paid the jackpot in a lump sum. The election is made when purchasing the ticket. 16 Tex. Admin. Code § 401.315(b)(4). Unlike some states, Texas does not permit prizewinners, pursuant to I.R.C. § 451(h), to elect cash payment after the ticket is purchased, e.g., upon winning. The rules describe the cash election alternately as “net present cash value option,” “cash value option”, “cash option”, and “net present value.” 16 Tex. Admin. Code § 401.315(b)(4).

“Net present cash value option” and “net present value” suggest a present value calculation determines the amount paid under the cash value option. That is not quite the case, though the economic result is similar. The amount paid the cash winner is the cost to the state, foregone in the case of the cash winner, of funding installment payments. The rules set the cash jackpot at “the cost that the Comptroller of Public Accounts informs the commission is the cost

to purchase a 25-year annuity for the jackpot amount on the first business day after the drawing.” 16 Tex. Admin. Code § 401.315(b)(4).

As explained above, in the event of an installment winner, the rules direct the Commission, after the initial payment, to actually purchase securities to fund the remaining twenty-four installments. 16 Tex. Admin. Code § 401.305(e)(3)(A)(i). As illustrated by Appendix D, *infra*, the Comptroller does not quote a single private annuity, but instead provides the Commission the market price for twenty-four separate securities, of identical future value, but with staggered maturity dates leading the due date of each subsequent installment.

Note that the settlement date recited by the Lottery Financing Calculator at page 4 of Appendix D is September 29, 2005, four rather than one business day after the September 24 drawing. This discrepancy is within the executive director’s discretion under the grand prize drawing rules. 16 Tex. Admin. Code § 401.303(b) (“The executive director shall determine any prizes to be awarded and the method, manner, and timing of payment which shall be stated in the applicable draw procedures.”). Whether the applicable draw procedures permit such a discrepancy is unknown.

iii) Lump Sum (LS)

Even absent a cash election, an installment winner’s *Lotto Texas* jackpot is paid in cash if the “net present value” value of his or her share is less than \$2 million. 16 Tex. Admin. Code §§ 401.305(e)(3)(A)(i).

Though \$4 million prize minimums are now the expectation, obligatory lump sum payments are still possible at that amount. First, although the present discount rate, about 4.5%, yields a “net present value” of \$2,479,280, and hence permits installment payments, the discount rate could rise to as little as 7.0% to yield a “net present value” of \$1,995,088, thus falling below the installment threshold, and thereby forcing a cash payment even absent the election.

Second, *Lotto Texas* jackpots are pari-mutuel, meaning they are shared among the winners. 16 Tex. Admin. Code §§ 401.305(e)(3)(A)(i). Thus, multiple winners reduce each others' prize share pro rata. At the present rates, two winners would reduce the "net present value" of a \$4 million prize to \$1,239,640, forcing a cash payment even over an installment winner's objection.

2) *Mega Millions*

a) In general

Mega Millions is a multijurisdiction lottery which Texas joined in 2003, enabled by addition of subchapter J to Chapter 466 of the State Lottery Act. Tex. Gov't Code §§ 466.451–466.453. Section 466.451 authorizes both an agreement with other state lotteries and the adoption by the Commission of rules specific to multijurisdiction games.

The multijurisdiction agreement contains finance, operations, and on-line drawing procedures for *Mega Millions*. 16 Tex. Admin. Code § 401.315(b)(6). Texas' rules also provide for a "Mega Millions Finance and Operations Procedure." 16 Tex. Admin. Code § 401.315(h)(5). Finally, Texas *Mega Millions* players are bound by "all applicable statutes, administrative rules and regulations, and procedures of the party lottery of the state in which the Mega Millions ticket is issued, and by directives and determinations of the director of that party lottery." *Id.*

Section 401.315 sets out the Texas *Mega Millions* rules and definitions, which supplement the Section 401.304 rules and the Section 401.301 definitions. In the event of a conflict, Section 401.315 prevails. 16 Tex. Admin. Code §§ 401.315(a), 401.315(b), 401.301 (general definition may be preempted whenever context "clearly indicates" a different meaning).

To date, only two Texas players have won a *Mega Millions* jackpot. Both elected the Cash Value Option, described below.

For general information regarding *Mega Millions*, visit the Commission's web site at <http://www.txlottery.org/online/megamillion.cfm> (last visited Dec. 30, 2005), or the Official Home of Mega Millions at <http://www.megamillions.com/> (last visited Dec. 30, 2005).

b) Jackpot amounts

Mega Millions jackpots are a minimum of \$12 million. The rules anticipate the amount will increase with sales, but expressly provide the jackpot may be adjusted downward given a sales shortfall of \$12 million or more. 16 Tex. Admin. Code § 401.315(f)(3)(B)(i). Subject to these adjustments, *Mega Millions* jackpot amounts are 63.6% of a 50% prize pool, or 31.8% of *Mega Millions* sales. 16 Tex. Admin. Code § 401.315(f)(3)(A).

i) 26 Annual Installments

Mega Millions jackpots are generally paid in 26 annual installments. 16 Tex. Admin. Code §§ 401.315(b)(1). The rules suggest the jackpot amount is simply divided by 26, and paid in equal installments. Cf. 16 Tex. Admin. Code §§ 401.315(b)(2) (26 annual payments), 401.315(f)(3)(B)(v) (26 annual installments).

The timing of the initial installment is the same as for *Lotto Texas* installment winners: upon claiming the jackpot. 16 Tex. Admin. Code § 401.315(f)(3)(B)(v). However, subsequent *Mega Millions* installments are paid, not upon the draw anniversary, but upon the anniversary of the purchase of securities funding the installments.

The subsequent 25 payments shall be paid annually to coincide with the month of the Federal auction date at which the bonds were purchased to fund the annuity. All such payments shall be made within seven days of the anniversary of the annual auction date.

16 Tex. Admin. Code § 401.315(f)(3)(B)(v). Notice the specific reference to "Federal auction" and "bonds," implying Treasury debt, but not necessarily zero coupon instruments.

As first noted regarding *Lotto Texas* installments, the State Lottery Act delegates the choice of installment investments to the Comptroller, not the Lottery Commission. Tex. Gov't

Code § 466.403 (Payment of Prize in Installments). Although the *Mega Millions* investment rule (federal bonds) is within the Comptroller’s discretion, the State Lottery Act actually gives the Comptroller much broader investment authority. Tex. Gov’t Code § 466.403 (“securities, annuities, or other instruments”).

ii) Cash Value Option

Like *Lotto Texas*, *Mega Millions* players may also elect cash in lieu of jackpot installments. 16 Tex. Admin. Code § 401.315(b)(3) (“cash value option” is synonymous with the terms “cash option” and “net present value option”).

Unlike *Lotto Texas*, the amount of the *Mega Millions* cash jackpot is a financial calculation. Prior to each drawing, the Mega Millions finance committee determines a discount rate, which is divided into a cash winner’s jackpot share to determine the amount paid. 16 Tex. Admin. Code § 401.315(f)(3)(B)(iv). The rules do not define the finance committee, and so it is unclear whether the discount rate is determined by the Texas Lottery Commission or another entity.

iii) Lump Sum

If multiple jackpot winners reduce an individual installment winner’s share to less than \$1 million, a lump sum payment is compulsory. 16 Tex. Admin. Code § 401.315(f)(3)(B)(iii). In contrast to *Lotto Texas* lump sums, the \$1 million cutoff here refers to future payments, not the “net present value.” Given a \$12 million minimum jackpot, a *Mega Millions* installment winner would never be paid the compulsory lump sum unless sharing the jackpot with at least eleven other winners.

d. Promotional drawings

Promotional drawings are ad hoc games the Commission uses for advertising. Cf. 16 Tex. Admin. Code §§ 401.301(45) (Promotion), 401.301(46) (Promotional drawing). They also

include ad hoc modifications of existing games. *See, e.g.*, 16 Tex. Admin. Code § 401.307(e)(2) (changes to Pick 3 prize), 16 Tex. Admin. Code §§ 401.315(c), 401.315(e)(5), 401.315(f)(3)(G) (changes to *Mega Millions* ticket price, multiplier, and prizes).

Section 401.313 sets out the promotional rules. Texas Administrative Code §§ 401.313(a)–(d) refer players to “the applicable draw procedures” and give notice that prize awards are in the executive director’s discretion. Promotional drawing players are bound by “applicable laws, all Commission rules, regulations, policies, directives, instructions, conditions, procedures, and final decisions of the executive director.” 16 Tex. Admin. Code § 401.313(e).

Promotional drawing rules are so vague as to beg the question of their purpose. A clue is found in their proposal: “New rules § 401.313 and § 401.314 are adopted so that current agency practice with regard to lottery promotional drawings and retailer bonuses in connection with specific lottery games is embodied in agency rules.” 26 Tex. Reg. 9589 (Nov. 23, 2001). Apparently the Commission was acting arbitrarily anyway, and felt the need to codify its own discretion. As of October 2005, no promotional drawing game procedures had been published in the Texas Register.

Promotional drawings are a wildcard for counsel trying to determine the tax attributes of a particular prize. Suffice to say that no *Lotto Texas* or *Mega Millions* jackpot should be presumed to follow the rules and procedures described elsewhere without first determining whether promotional drawing rules were applied by the Commission.

B. Federal Income Taxation; Rev. Rul. 78-140

Lottery winnings are included in gross income. I.R.C. §§ 61, 74(a). The common wisdom is that income is recognized immediately by the cash winner, but is deferred until actual receipt by an installment winner. Practice bears out both assumptions, if only because state lotteries carefully structure their games to avoid the constructive receipt and related doctrines.

See, e.g., LTR 8552022 (Sep. 25, 1985) (cash option approved); LTR 9624009 (Mar. 12, 1996) (installment assignment approved). However, in theory, a presumption of immediate recognition applies to both cash and installment prizes. In the end, prizewinner's counsel cannot conclude installments defer recognition without examining the particular game.

When recognition is deferred, I.R.C. § 103 provides an opportunity to exclude interest on prize installments. The IRS has only addressed the issue once, ruling that interest was not excludible. Rev. Rul. 78-140, 1978-1 C.B. 27. On the facts, that ruling was correct, because the lottery at issue did not offer a cash option but instead made installments compulsory. Compulsory payments do not sound in the state's borrowing power, a requisite to tax-exemption.

Subsequent rulings have encouraged lotteries to offer a cash option. This new element of choice distinguishes state lotteries, including Texas', from that described in Revenue Ruling 78-140. *Lotto Texas* and *Mega Millions* jackpot installments arguably already meet the requirements of Section 103. Modest changes could resolve all doubt, encouraging players to avoid the cash election in lieu of installment payments of principal and tax-exempt interest.

1. Cash Prizes

Cash prizes are included in income. I.R.C. § 61 (gross income means all income from whatever source derived). Although Section 74 excludes certain prizes, these exceptions do not shield the typical state lottery. *Cf.* I.R.C. §§ 74(a) (inclusion as general rule), 74(b) (achievement awards transferred to charity), 74(c) (employee achievement awards), 117 (qualified scholarships), and 132(e) (de minimis fringes). Section 74 was enacted in 1954 in response to decisions that grappled with the boundary between excludible gifts and includible prizes. S. Rep. No. 1622, 83d Cong., 2d Sess. 13, 178–179 (1954); Robertson v. U.S., 343 U.S. 711 (1952). Fifty years later, the literature is still obligated to report that lottery prizes are not excludible as gifts. *See, e.g.*, Farhad Aghdami, The Morning After: Tax Planning for Lottery

Winners, 90 J. Tax'n 228 n.3 (Apr. 1999) *available at* 1999 WL 372250 (citing Comm'r v. Duberstein, 363 U.S. 278 (1960)). *See generally* Boris I. Bittker & Lawrence Lokken, Fed. Taxation of Income, Est. & Gifts ¶ 11.1 (2005) (Prizes and Awards) *available at* 1997 WL 439535.

2. Installment Payments

a. Principal

The principal amount of each installment is included in income, just as a cash prize. The only interesting question is the timing of recognition. I.R.C. § 451(a) and Treas. Reg. § 1.451-1(a) provide that an item of gross income is includable in income for the tax year in which actually or constructively received by the taxpayer. Thus, the constructive receipt doctrine requires inclusion in current income of all installment payments, not just the first one, if the lottery offers the prizewinner the option upon winning of either cash or installments. In contrast, if the cash election is offered only prior to winning, as in Texas, then inclusion of installment payments is deferred until actual receipt. LTR 8552022 (Sep. 25, 1985).

Since 1998, a qualified prize option has been enabled by I.R.C. § 451(h) that preempts the constructive receipt doctrine and permits a cash election within sixty days of winning a lottery without accelerating recognition of other installment winners' payments. This option is not available in Texas, but only because the Lottery Commission has not adopted the necessary rules. For a discussion of I.R.C. § 451(h) in other jurisdictions, see Farhad Aghdami, The Morning After: Tax Planning for Lottery Winners, 90 J. Tax'n 228, 228–230 (Apr. 1999).

Treas. Reg. § 1.451-2(a) provides that “income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.” Thus, the Tax Court has deferred recognition of a jackpot awarded the week following Christmas, but not actually collected until the new year, reasoning that the lottery’s requirements for claiming the

prize amounted to a substantial limitation or restriction. Paul v. Comm'r, 64 T.C.M. CCH 955 (1992) (winner mailed claim for ~\$1,000 prize rather than driving 68 miles to appear in person, thus delaying payment from Dec. 30 until Jan. 22).

b. Interest

1) Inclusion

Interest is generally includible in income. I.R.C. § 61(a)(4).

2) Determining interest

Interest on lottery prize installments may arise in several ways. First, in some jurisdictions, the lottery may purchase a bond or an annuity, and expressly designate a portion of the installment as interest on the unpaid balance. *See, e.g.*, Farhad Aghdami, The Morning After: Tax Planning for Lottery Winners, 90 J. Tax'n 228, 228 (Apr. 1999) *available at* 1999 WL 372250 (citing Rev. Rul. 78-140, 1978-1 C.B. 27 (interest component expressly designated)).

Second, the lottery may fund installment payments with securities, and pay over to the winner both the principal and interest, without expressly designating any interest. *See, e.g.*, 16 Tex. Admin. Code § 401.305(e)(1) (Lotto Texas prize amounts).

Third, interest may be imputed under original issue discount (OID) and related principles. These principles are of particular relevance to state lotteries, which typically disregard the time value of money when advertising prize amounts. *Cf.* Tex. Lottery Comm'n, Lotto Texas - Prize Amounts 2004, <http://www.txlottery.org/online/payoutlotto.cfm?tYear=2004&tNumber=10000> (last visit Nov. 27, 2005) (Jan. 24, 2004 draw advertised as \$70,000,000); Janet Rodrigues, Lottery winner comes forward / \$70 million pot passes 1 hurdle, Hous. Chron., Feb. 23, 2004, at A14, *available at* http://www.chron.com/CDA/archives/archive.mpl?id=2004_3731977 (cash value option only \$42,801,674).

Before the Tax Reform Act of 1984, tax law generally did not impute interest absent the

parties' agreement. Responding to taxpayers' increasingly aggressive practices, Congress enacted or amended several provisions of the Internal Revenue Code, including I.R.C. § 483 (Interest on certain deferred payments), and the original issue discount rules of I.R.C. §§ 1271–1274. *See generally* Stephen F. Gertzman, Federal Tax Accounting ¶ 11.0 at 11-3 to 11-9 (2d ed. 2005) (Definition of “Time Value of Money”).

Since Texas does not designate interest, and apparently limits its investments to zero coupon securities, interest on installment payments may be imputed. Consider the Lotto TexasTM Drawing Results & Reserve Entry Form, Draw Date: 09/24/05; Draw #1343. *Infra*, app. D. Assuming the \$4,000,000 jackpot (25AP) is paid as an annuity due of \$160,000 for 25 years, and the present value is \$2,475,649.60 (CVO), the imputed interest rate is 4.51568807%, as determined by iteration.

Appendix F, *infra*, Interest Imputed on Installment Payments, amortizes the principal and imputed interest paid to the installment winner, using the 4.51568807% rate, and illustrates \$1,524,350.40 interest out of \$4,000,000 total installments. Thus, even at a relatively low rate, interest is a significant portion of the payments, particularly in the initial years. *Cf.* Boris I. Bittker, et al., Fed. Income Taxation of Individuals ¶ 42.02[1] (2005) (Calculation of Original Issue Discount).

3. Interest Exemption—Rev. Rul. 78-140 limits I.R.C. § 103

Interest exemptions on state and municipal obligations have been available since 1913. *See generally* Boris I. Bittker & Lawrence Lokken, Fed. Taxation of Income, Est.& Gifts ¶ 15.1.1 n.2 (2005) (Tax-Exempt Interest) *available at* 1997 WL 439557. I.R.C. § 103(a) excludes from income interest on a “State or local bond.” The definition of “bond” extends to any state or local obligation, not just securities. I.R.C. § 103; *see generally* Boris I. Bittker & Lawrence Lokken, Fed. Taxation of Income, Est. & Gifts ¶ 15.1.2 (2005) (Obligations Eligible for

Exemption) *available at* 1997 WL 439557.

At least one commentator, Aghdami, argues the interest on lottery installment payments falls within the scope of I.R.C. § 103(a). Farhad Aghdami, The Morning After: Tax Planning for Lottery Winners, 90 J. Tax'n 228, 228 (Apr. 1999) *available at* 1999 WL 372250.

The Service disagrees, and has held that lottery interest is not excludible under I.R.C. § 103. Rev. Rul. 78-140, 1978-1 C.B. 27. A variety of principles limit the application of I.R.C. § 103, but Revenue Ruling 78-140 discussed none of them and offered no analysis.

A survey of the authority, discussed below, reveals the key: the sovereign borrowing power. An obligation must arise from an exercise of the borrowing power to be eligible for the I.R.C. § 103 interest exemption. In Revenue Ruling 78-140, the winner had no cash option, and installment payments were mandatory. Compulsory obligations may sound in the police or eminent domain powers, but not the borrowing power.

Given the novelty of state lotteries and the adverse authority of Revenue Ruling 78-140, the discussion below must venture somewhat afield. For a succinct overview of tax-exempt securities, see Boris I. Bittker, et al., Fed. Income Tax'n of Individuals, ch. 10 (2005) (Interest on State and Local Obligations).

Practitioners will also be interested in Treasury Announcement 95-51, 1995-32 I.R.B. 54 (Proposed Examination Guidelines for Municipal Financing Arrangements), and Jeffrey D. Berry and Tedd T. Termunde, Audit Guidelines for Tax-Exempt Debt Seek Consistency and Coordination with Other Agencies, 83 J. Tax'n 235 (Oct. 1995), *available at* 1995 WL 713890 (discussing Ann. 95-51 and concluding the Service historically tread lightly on municipal finance but grows more assertive).

II. I.R.C. § 103

A. The Code and Regulations

Revenue Ruling 78-140 issued under the Internal Revenue Code of 1954. At the time,

I.R.C. § 103(a)(1) read—

Sec. 103. Interest on certain governmental obligations.

(a) General rule.

Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia; and . . .

I.R.C. § 103(a)(1) (1954).

I.R.C. § 103(a)(1) of the 1954 Code is analogous to the current I.R.C. § 103(a). Extensive provisions from the former Code regarding private activity bonds, arbitrage bonds, and unregistered bonds were relocated and are now found at I.R.C §§ 141, 148, and 149. At present, I.R.C. § 103 reads, in its entirety—

Sec. 103. Interest on State and local bonds.

(a) Exclusion. Except as provided in subsection (b), gross income does not include interest on any State or local bond.

(b) Exceptions. Subsection (a) shall not apply to—

(1) Private activity bond which is not a qualified bond. Any private activity bond which is not a qualified bond (within the meaning of section 141 [26 USCS § 141]).

(2) Arbitrage bond. Any arbitrage bond (within the meaning of section 148 [26 USCS § 148]).

(3) Bond not in registered form, etc. Any bond unless such bond meets the applicable requirements of section 149 [26 USCS § 149].

(c) Definitions. For purposes of this section and part IV [26 USCS §§ 141 et seq.]—

(1) State or local bond. The term “State or local bond” means an obligation of a State or political subdivision thereof.

(2) State. The term “State” includes the District of Columbia and any possession of the United States.

I.R.C. § 103.

The Tax Reform Act of 1986 substantially revised and reorganized I.R.C. § 103. Sec. 1301(a), Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Notwithstanding, the jurisprudence is cumulative. H.R. Rep. No. 99-841 (1986), *as reprinted in* COMREP ¶ 1411.02 Tax-exempt bonds. ('86 TRA, PL 99-514, 10/22/86) at 1 (RIA) (“The conferees intend that, to the extent not amended, all principles of present law continue to apply under the reorganized provisions.”).

Note that the former Code exempted interest on certain “obligations,” while the current Code instead refers to “bonds.” This distinction is without a difference, because the current Code defines “bonds” as an “obligation.” Thus, older cases remain helpful in analyzing Revenue Ruling 78-140 and its application to the current Code.

Treas. Reg. § 1.103-1 has not been amended since the Tax Reform Act of 1986. Thus, its references relate to the 1954 Code. The regulation provides, in part—

§ 1.103–1 Interest upon obligations of a State, territory, etc.

(a) Interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as “State or local governmental unit”) is not includable in gross income, except as provided under section 103 (c) and (d) and the regulations thereunder.

(b) Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit.

...

The term “political subdivision”, for purposes of this section denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any State or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

T.D. 6220, 21 Fed. Reg. 10,484, Dec. 28, 1956, amended by T.D. 7199, 37 Fed. Reg. 15,486, Aug. 3, 1972.

B. Qualified Obligations

1. Political subdivision

The Code limits the interest exemption to state and local bonds, which means an obligation of a state or political subdivision. I.R.C. §§ 103(a), (c)(1). How far does the definition of “political subdivision” extend, and may it encompass state lotteries? May it encompass entities organized by multi-jurisdiction lotteries?

A survey reveals three criteria for eligible entities: i) a state subdivision, ii) a public purpose, and iii) more than an insubstantial taxing, eminent domain, or police power.

a. In general

In Estate of Shamberg, in reviewing the Revenue Acts of 1936 and 1938, the court cited U.S. attorney general rulings that the interest exclusion was not limited to a “true governmental subdivision such as a county, township, etc.,” but extended to “any subdivision of the state created for a public purpose although authorized to exercise a portion of the sovereign power of the state only to a limited degree,” such as assessment districts for the construction of streets, sewage disposal, irrigation, flood control, harbor improvements, and the like. Comm’r v. Estate of Shamberg, 144 F.2d 998, 1003-1004 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). Thus, the court allowed an interest exemption on obligations of the Port of New York Authority, even though it had no power to exercise traditional political functions.

b. Governmental power

The current regulations make clear that a sovereign power is the *sine qua non* of a political subdivision.

The term “political subdivision”, for purposes of this section denotes any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any State or local governmental unit may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

Treas. Reg. § 1.103-1(b) (37 Fed. Reg. 15,486 (Aug. 3, 1972)) (emphasis added).

Federal concepts of sovereign power are not synonymous with state sovereign immunity. For example, as a matter of state law, sovereign immunity attaches to all acts of the State of Texas and its subdivisions. Loyd v. ECO Res., Inc., 956 S.W.2d 110, 122 (Tex. App.—Houston [14th Dist.] 1997, no pet.) (sovereign immunity protects the government when it is performing a governmental function); Hencerling v. Texas A & M Univ., 986 S.W.2d 373, 374–375 (Tex. App.—Houston [1st Dist] 1999, pet. denied) (all acts of the State and its subdivisions, but not all municipal acts, are governmental). *See generally*, O’Connor’s Texas Causes of Action ch. 22-A § 2.2 at 644 (2005) (Suit based on governmental act). Thus, Texas state hospitals and universities generally enjoy sovereign immunity. *See, e.g.*, Ripley v. Univ. of Tex. Health Sci. Ctr., 2004 U.S. Dist. LEXIS 27918 (W.D. Tex. May 17, 2004) (state hospital); Thomas v. Univ. of Houston, 2005 U.S. App. LEXIS 23952 (5th Cir. Nov. 4, 2005) (state university).

Those same Texas hospitals and universities would not be political subdivisions for I.R.C. § 103 purposes, though, unless some sovereign power was delegated. Tex. Learning Tech. Group v. Comm’r, 958 F.2d 122, 125–126 (5th Cir. 1992), citing Philadelphia Nat’l Bank v. United States, 666 F.2d 834, 839 (3rd Cir. 1981), cert. denied, 457 U.S. 1105 (1982) (Temple University not a political subdivision because sovereign power had not been delegated); Old Colony Trust Co. v. United States, 438 F.2d 684 (1st Cir. 1971) (hospital not a political subdivision in part because it did not exercise any sovereign powers).

A de minimis delegation is not sufficient. Legislative history from the 1986 Tax Reform

Act defines “political subdivision” as a unit of government that has “more than an insubstantial amount” of “the power to tax, the power of eminent domain, [or] the police power (in the law enforcement sense).” Staff of Joint Comm. on Tax’n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 1151 (Comm. Print 1987) (cited by Boris I. Bittker & Lawrence Lokken, Fed. Taxation of Income, Est.& Gifts ¶ 15.1.2 n.12 (2005) (Obligations Eligible for Exemption) *available at* 1997 WL 43955).

Congress’ reference to just three powers comports with prior and subsequent authority. “Case law both before and after the promulgation of Regulation § 1.103–1(b) has required an entity to be authorized to exercise some sovereign powers in order to be considered a political subdivision. The power to tax, the power of eminent domain, and the police power are the generally acknowledged sovereign powers. All of the cases addressing the meaning of the term ‘political subdivision’ under the Internal Revenue Code have required the entity to possess at least one of the three generally recognized sovereign powers in order to be classified as a ‘political subdivision.’” Tex. Learning Tech. Group v. Comm’r, 958 F.2d 122, 124 (5th Cir. 1992). Of these, the taxing power is the most significant. *Id.* (citing 30 Op. Att’y Gen. 252 (1914)).

c. “On behalf of”

The regulations allow exempt obligations to be issued “by or on behalf of” a state or political subdivision. Treas. Reg. § 1.103-1(b). *See* Rev. Rul. 63-20, 1963-1 CB 24 (conditions that must be met to establish that obligations of nonprofit corporations are issued “on behalf of” state or political subdivision); Rev. Proc. 82-26, 1982-1 CB 476 (procedures for obtaining a ruling on issue). This principle has been reaffirmed under the 1986 revisions of I.R.C. § 103. H.R. Rep. No. 99-841 (1986), *as reprinted in* COMREP ¶ 1411.02 Tax-exempt bonds. (‘86 TRA, PL 99-514, 10/22/86) at 1 n.3 (RIA) (“The conference agreement continues the present-

law rule allowing bonds to be issued either by or on behalf of qualified governmental units.”).

The Shamberg court concluded the regulation referred to bonds “issued by a state agency to carry out a public purpose where the [state] is not named as obligor,” e.g., the Port Authority’s bonds, which were serviced by user fees, since the Port Authority had no power to levy taxes or assessments. Comm’r v. Estate of Shamberg, 144 F.2d 998, 1005–1006 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945). *See generally* Boris I. Bittker & Lawrence Lokken, Fed. Taxation of Income, Est.& Gifts ¶ 15.1 (2005) (Tax-Exempt Interest) *available at* 1997 WL 439557.

Thus, Treas. Reg. § 1.103-1(b) enables a state or political subdivision to outsource functions to certain entities whose obligees may still enjoy an interest exemption.

d. A diversion regarding the taxing power

The contemporary observer may associate a state lottery with the restraint rather than the exercise of any sovereign power. Although the state may use its power to suppress the lottery, does it follow that a governmental power is employed to instead operate one? If so, which power? History and economics, if not precedent, support the proposition that state lotteries affirmatively exercise a governmental power, specifically, the taxing power.

1) Jurisprudence

The jurisprudence repeatedly identifies lotteries with the taxing power, but does so in dicta, often straining to rely on other powers or theories. Thus, in Cohens, the Supreme Court acknowledged the taxing power enabled Congress to authorize the District of Columbia lottery, while citing Virginia’s police power to suppress sales in its jurisdiction, before disingenuously concluding Congress did not intend extra-territorial sales in the first instance. Cohens v. Virginia, 19 U.S. 264 (1821).

Much later, in Stone, the Supreme Court affirmatively avoided linking lotteries to the taxing power. In its first articulation of the reservation of powers doctrine, the Court sought a

sovereign power on which to justify the State of Mississippi's abrogation of a lottery franchise. It hung its hat on the police power rather than the taxing power. The Court went so far as to deny the taxing power was a core sovereign power, straining to distinguish Stone from contrary decisions such as Dartmouth College. Stone v. Miss., 101 U.S. 814, 819–820 (1880) (citing Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518 (1819)).

The reserved powers doctrine traces back to Stone v. Mississippi. In 1867, the provisional government of the State of Mississippi granted a corporate charter to the plaintiff permitting him to run a lottery for profit. In 1870, the state ratified a new constitution as part of Reconstruction and the new constitution banned lotteries such as plaintiff's. The legislature enacted a ban, the state fined Mr. Stone for running his lottery, and Stone sued. The Court upheld the new ban, reasoning, essentially for the first time, that states can neither waive nor bargain away their police powers. Police powers were by then defined to mean state and local governmental control over the public's health, safety, and morality. So as not to lose the connection to public welfare, the Court labeled lotteries a "pestilence," more harmful than other forms of gambling. Therefore, regulation of lotteries fit squarely within the state's police powers and the state always reserved the power to regulate lotteries.

Theoretical difficulties in such a rule appeared immediately when the Court attempted to distinguish Dartmouth College v. Woodward, which held that the Contracts Clause prevented New Hampshire from altering Dartmouth College's charter, granted by the king of England before the Revolution. The Court in Stone argued that taxation is not a police power because "government was not organized for the purpose of taxation, but taxation may be necessary for the purposes of government." This distinction between police power and taxation breaks down where taxation serves policy goals by discouraging certain activity. The Court then argued that the lottery charter was not a protected contract because it did not involve property rights: instead the charter involved "governmental rights" because it was so linked to the police power. Of course, the charter involved both property and governmental rights, just like taxation.

Alan R. Burch, Purchasing the Right to Govern: Winstar and the Need to Reconceptualize the Law of Regulatory Agreements, 88 Ky. L.J. 245, 261–262 (Winter 1999-2000) (footnotes omitted).

It is without dispute today that the power to tax is a sovereign power. Tex. Learning Tech. Group v. Comm'r, 958 F.2d 122, 124 (5th Cir. 1992) (citing 30 Op. Att'y Gen. 252 (1914)) (taxing power among the most significant). Because it may be the only sovereign power some state lotteries exercise, some history is in order to cement the association.

2) History

The lottery has an ancient history, most in the last two or three millennia sounding in public finance. Moses used it to distribute land. *Numbers* 26:55. The Hun Dynasty financed the Great Wall of China with keno. Julius Caesar repaired Rome with the lottery. GeLotto, [A History of Lotto and the UK Lottery](http://www.lottery-uk.info/history1.html), <http://www.lottery-uk.info/history1.html> (last visited Dec. 3, 2005).

One of the first recorded European lotteries, in 1446, was a private lottery held by the widow of Flemish painter Jan Van Eyck to dispose of his paintings. *Id.* The first state lottery in England, proclaimed in 1567, funded harbor repairs. In 1612, royal lotteries were held for the benefit of the Virginia colonies. Frances Emmett Williams, [Lotteries, Laws and Morals](#) 24–25 (1st ed. 1958).

Lotteries were also instruments of public finance in the United States, especially in colonial times and the nation's early history, before the maturation of banking and local taxation. Before the War of Independence, Benjamin Franklin, John Hancock, and George Washington each sponsored or managed lotteries for defense or public works. During the revolution, the Continental Congress authorized a ten-million-dollar lottery to raise money for the army then in the field. *Id.*

Eighteenth century New York employed lotteries to fund economic development, including hemp growing, glass blowing, grape growing, and manufacturing. At the same time, the majority of lotteries, by number if not sales, were ecclesiastical.

Thus we read of lotteries to gather £1350 for St James Church, Lancaster; £500 to enlarge Trinity Church, Oxford; £450 for the Presbyterian Church, Middletown; 3,000 pieces of eight to finish the Episcopal Church in Third Street; £3,000 for a new Presbyterian Church in Baltimore, and 3,000 pieces of eight to finish the steeple of the Second Presbyterian Church, Third and Arch Streets [Philadelphia].

Williams, *supra*, at 29–30 (citing A.R. Spofford, Annual Report of the American Historical Society (1892)).

The new federal government’s lottery sponsorship was limited, but did include one of 690,000 guilders as an incentive for the Amsterdam bankers who subscribed to a 2,000,000 guilder loan negotiated by John Adams. *Id.* at 30. Although history records several “national” lotteries, the most prominent were actually District of Columbia or City of Washington lotteries.

Absent an effective banking system or efficient means of local taxation following the Revolution, lotteries remained standard sources for public and private financing. A private lottery was a rough substitute for the modern mortgage, enabling a cash sale of substantial property, particularly when encumbered by a prior lien that was due on sale. Public lotteries were familiar alternatives to ad valorem or other taxation. From 1790 until the Civil War, lotteries funded fifty colleges (including Harvard, Yale, Princeton, and Columbia), 300 schools, and 200 churches. During this same period, twenty-four of thirty-three states used lotteries to finance civic improvements such as courthouses, jails, hospitals, orphanages, and libraries. N. Am. Ass’n of State & Provincial Lotteries, Lottery History, <http://www.naspl.org/history.html> (last visited Dec. 2, 2005).

Lotteries reached enormous proportions.

In 1832, in the eight states of New York, Virginia, Connecticut, Rhode Island, Pennsylvania, Delaware, North Carolina, and Maryland, 420 lotteries were drawn, the tickets selling for a grand total of \$53,136,930. “But,” said the Boston Mercantile Journal, “this sum, with the addition of 25 per-cent brokerage, makes an amount of \$66,420,000—that is, five times the sum of the annual expenses of the American government, and of nearly three times the whole yearly revenue.”

Williams, *supra*, at 42–43. The figures above exclude drawings in Maine, Missouri, Kentucky, Alabama, Tennessee, Louisiana, and fifty county and local lotteries in Virginia. *Id.*

1832 may have been the lottery’s American apogee. Whether it was endemic corruption,

individual ruin, or maturing fiscal and financial systems, the lottery became a pariah. By 1847, Justice Catron could analogize the lottery to cholera, obscene paintings, and convicts. Thurlow v. Mass., 46 U.S. 504, 628 (1847).

New York amended its constitution to prohibit lotteries in 1821. Michigan and Tennessee followed suit in 1835, as did Arkansas in 1836. The trickle of prohibition turned into a flood, and the 19th century saw a total of thirty-six states adopt constitutional amendments restricting or prohibiting lotteries (Rhode Island (1843), New Jersey (1844), Louisiana (1845), Texas (1845), Iowa (1846), Illinois (1848), Wisconsin (1848), California (1849), Ohio (1851), Indiana (1851), Maryland (1851), Virginia (1851), Minnesota (1857), Oregon (1857), Kansas (1859), West Virginia (1863), Nevada (1866), Missouri (1865), Nebraska (1866), Mississippi (1869), Alabama (1875), Colorado (1876), Georgia (1877), Delaware (1879), Florida (1885), South Carolina (1886), Montana (1889), North Dakota (1889), Washington (1889), Idaho (1890), Kentucky (1891), and Utah (1896)). Williams, *supra*, at 43–44.

In the interim, by 1878, every state but Louisiana had also enacted statutes prohibiting the lottery. N. Am. Ass'n of State & Provincial Lotteries, Lottery History, <http://www.naspl.org/history.html> (last visited Dec. 2, 2005). Louisiana, that perennial backslider, reinstituted the lottery in 1864, and did not abolish it again until 1895. Williams, *supra*, at 36–38. It took two acts of Congress and a Supreme Court decision to effectively end the Louisiana Lottery, in 1905. N. Am. Ass'n of State & Provincial Lotteries, Lottery History, <http://www.naspl.org/history.html> (last visited Dec. 2, 2005).

The first legal state lottery in the 20th century, in New Hampshire, was not created until 1964. New York created the second in 1967. Federal law was amended in 1975 to enable radio and TV advertising of state lotteries, encouraging a revival that, on recent count, included

government lotteries in 37 states and the District of Columbia. N. Am. Ass'n of State & Provincial Lotteries, Lottery History, <http://www.naspl.org/history.html> (last visited Dec. 2, 2005).

3) Economic analysis—the Revenue Lottery

Clotfelter and Cook, in their study sponsored by the National Bureau of Economic Research, consider four aspects of lotteries: legalization, provision, marketing, and implicit taxation.

Until New Hampshire approved a lottery in 1964, every state prohibited lotteries. The *legalization* of lotteries as an activity is thus a first step in the operation of any state lottery. As obvious as that may be, the shift from prohibition to legal status inevitably implies a level of approval that may be meaningful for its own sake from the standpoint of public policy. *Provision* is a second aspect of all state lotteries currently operating. In each case the state has made its own government agency the sole provider of lottery products rather than opening up the market to competition or allowing private firms to bid for franchises. The third aspect common to state lotteries is *marketing*, which includes the development of new lottery products as well as the advertising that has become a familiar feature in lottery states. And fourth, by channeling lottery profits to the state treasury, states subject lottery purchases to *implicit taxation*.

Charles T. Clotfelter & Philip J. Cook, Selling Hope: State Lotteries in America 13 (1st Harv. U. Press paperback ed. 1991) (emphasis in original).

Clotfelter and Cook identify three lottery models: the Revenue Lottery, the Consumer Lottery, and the Sumptuary Lottery. They observe that the Revenue Lottery is the common and exclusive modern American model.

State lotteries today are remarkably alike. Each is a government-operated monopoly. Each pays out roughly fifty cents on the dollar in prizes. Each one is organized as a business enterprise on the wholesale level between a private industry that supplies lottery products and a network of private retailers who sell the products. Each one employs the techniques of modern marketing to design and promote these products. In all that they do, lotteries share a fundamental objective: to generate as much revenue as possible for the state.

Id. at 242. By way of comparison, prize payouts closer to ninety cents on the dollar were required in colonial lotteries, absent a government monopoly. *See, e.g.*, George Sullivan, By

Chance a Winner: The History of Lotteries 23–24 (1972) (quoting *Boston Gazette* for November 1, 1762 regarding a Massachusetts lottery to rebuild Faneuil Hall).

As to the other two models:

The Consumer Lottery takes as its primary objective to serve the interests of its customers. It provides at low cost a product that consumers want to buy and in doing so implicitly accepts the basic implication of consumer sovereignty—that the consumer knows best. In contrast to this nonjudgmental model is the Sumptuary Lottery, which is based squarely on paternalism, emphasizing the hazards of gambling. If the state disapproves of gambling but chooses to legalize it anyway, perhaps in order to take it out of the hands of illegal operators, it could establish a tightly controlled lottery designed to keep consumption to a minimum.

Clotfelter & Cook, *supra*, at 243.

Clotfelter and Cook summarize their models as follows:

Model	Objective	Promotion	Product variety	Payout rate
Revenue Lottery	Maximize government revenues	Few Restrictions	Unlimited	Low
Consumer Lottery	Maximize consumer (player) welfare	Truth-in-advertising restriction	Unlimited	High
Sumptuary Lottery	Accommodate existing demand while discouraging excessive involvement	Informational messages and warnings	Limited	Low

Id. at 242 tbl.12.1.

Clotfelter and Cook’s description of the Revenue Lottery predates the Texas Lottery, but describes it perfectly. It follows the pattern established in other states, offering about a 50% payout for online games (47.84% in FY 2004). The NASPL Lottery Resource Handbook 185–187 (N. Am. Ass’n of State & Provincial Lotteries CD-ROM, 2005). The implicit tax rate is consequently high, about 30% in Fiscal Year 2004 (\$1,009.5 million plus \$60,764,140 unclaimed prizes transferred to the state, out of \$3,662.5 million in sales). Tex. Lottery Comm’n, FY 2005 Comprehensive Annual Financial Report: Introduction, available at <http://>

www.txlottery.org/info/fy05_cafr01intro.pdf (last visited Dec. 23, 2005). Texas is not among those states that mandate a minimum tax rate. However, of those that Clotfelter and Cook noted, a plurality mandated 30%. Clotfelter & Cook, *supra*, at 164–165 tbl.9.1. Thus, in terms of both payout and implicit tax, the Texas Lottery online games are well within the Revenue Lottery model.

4) Conclusions regarding the taxing power

The contemporary state lottery is less than fifty years old. However, the prior American experience lasted almost 300 years, with public and private lotteries welcome as an innovative and essential tool of finance, before disrepute led to a century of prohibition. The jurisprudence of that earlier era is ambiguous, sometimes but not always associating government lotteries with the taxing power. Current state lotteries, including the Texas Lottery, are state monopolies organized on a revenue model, for the exclusive purpose of public finance, thus exercising the sovereign power of taxation.

2. Interest on an obligation—the borrowing power

I.R.C. § 103 has been further limited to voluntary encounters with a state or political subdivision, on the theory that only obligations arising under an exercise of the borrowing power are eligible for the interest exemption. The borrowing power is distinguished by the lender's voluntary participation: for I.R.C. § 103 purposes, a compulsory loan is an oxymoron. Compulsory transactions may invoke the state's police power or power of eminent domain, but not the borrowing power. *See, e.g., King v. Comm'r*, 77 T.C. 1113 (1981), *acq.*, 1984-2 C.B. 1 (1984) (interest paid on involuntary transfer of property to governmental entity was not excluded from income whereas interest paid on voluntary transfer was).

C. I.R.C. § 149 Registration

I.R.C. § 103(b)(3) limits the interest exemption to obligations that comply with I.R.C. §

149, which generally requires publicly offered bonds with a maturity of more than one year to be issued in registered form rather than as bearer bonds. Book entry bonds conforming to the Treasury Regulations are treated as in registered form. I.R.C. § 149(a)(3)(A).

D. Reporting Requirements

Issuers of I.R.C. § 103 securities are required to submit a detailed report by the 15th of the second month following the quarter of issue, generally to include the issuer's name and address, date of issue, amount of net proceeds per issue, the stated interest rate, term, and face amount of each obligation, etc. I.R.C. § 149(e). Absent willful neglect, the deadline may be extended. I.R.C. § 149(e)(3).

Recipients of tax-exempt interest are required to report the amount received or accrued each year on their annual return. I.R.C. § 6012(d).

E. Disqualified Obligations

a. Arbitrage bonds

The temptation exists for a state to raise funds with a tax-exempt bond issue and then to reinvest the proceeds in safe but taxable federal securities that offer a higher yield, thereby earning profits solely at the expense of the Federal Treasury. State of Wash. v. Comm'r, 692 F.2d 128, 128–130 (D.C. Cir. 1982) (describing the general scheme and a specific example). For greater profits, the state might instead invest in corporate securities.

I.R.C. § 103(b)(2) denies the interest exemption to arbitrage bonds, as defined by I.R.C. § 148, to include any obligation whose proceeds are reasonably expected to be used in whole or in part to acquire higher yielding investments (not just federal securities) or to replace funds used to acquire such investments. I.R.C. § 148 reaches intentional arbitrage, whether or not originally anticipated. Thus, I.R.C. § 148 applies if (1) arbitrage is reasonably expected as of the date of issuance, whether or not arbitrage actually occurs, or (2) arbitrage intentionally occurs, whether

or not it was reasonably expected as of the date of issuance. Issuers of tax-exempt securities can protect their investors by seeking a declaratory judgment from the Tax Court under I.R.C. § 7478, by complying with an administrative procedure for “no arbitrage” certificates, by rebating any ill-gotten profits to the United States under § 148(f), or, in certain cases, paying a penalty (in lieu of rebating arbitrage profits) under § 149(f)(4)(B)(iv)(V). *See generally*, Boris I. Bittker, et al., Fed. Income Taxation of Individuals, ¶ 10.03[1] (2005) (Arbitrage Bonds).

b. Hedge bonds

“Section 149(g) denies tax-exempt status to certain ‘hedge bonds.’ Generally speaking, a hedge bond is a bond the proceeds of which will not be expended within a reasonable period of time after its issuance, which was issued early to avoid the risk of rising interest rates. A ‘hedge bond’ is defined as any bond other than a bond that meets the following requirements: (1) the issuer reasonably expects 85 percent of the spendable proceeds of the bond to be expended within three years of the date of issuance and (2) the bond complies with specific statutory limitations on the interim investment of the proceeds until they are expended for the intended purpose.” Bittker, *supra*, at ¶ 10.03[2] (2005) (Hedge Bonds).

c. Private activity bonds

I.R.C. § 141 was designed to limit the use of I.R.C. § 103 exemptions for industrial development bonds, which apply the proceeds to finance ordinary business facilities. A private activity bond is defined as any bond meeting either the “private business use” and “private security or payment” tests of I.R.C. § 141(b)(1) and 141(b)(2), or the “private loan financing” test of I.R.C. § 141(c).

The “private business use” test of I.R.C. § 141(b)(1) is satisfied if more than 10 percent of the proceeds are for any “private business use,” a term that is defined by I.R.C. § 141(b)(6) as any direct or indirect use in a trade or business carried on by any person other than a

governmental unit.

The “private security or payment” test of I.R.C. § 141(b)(2) is met if payment of the principal of, or interest on, more than 10 percent of the bond issue proceeds (1) is secured by any interest in property used in a private business or by the payments in respect of such property or (2) is to be derived from payments in respect of property, or borrowed money, used in a private business.

A bond issue meets the I.R.C. § 141(c) “private loan financing” test if the amount to be used to make or finance loans to nongovernmental persons (e.g., students or homeowners) exceeds the lesser of 5 percent of the proceeds or \$5 million.

Bittker warns his readers that, “Because the statutory rules are fearfully intricate, the details must be left to works addressed to specialists in municipal bond law; only the highlights are summarized here, and even so, it must be borne in mind that almost every generalization is subject to qualifications and exceptions.” Bittker, *supra*, at ¶ 10.02[1] (2005) (Private Activity Bonds; Introduction). For the reasons explained below, at Section IV.D.3, Private activity bonds, the Texas Lottery Commission’s present rules regarding *Lotto Texas* and *Mega Millions* jackpots require no further inquiry than indicated by the above summary.

F. Limitations on Benefits of Qualified Obligations

Even after an obligation meets all the I.R.C. § 103 requirements, there remain numerous limitations. *See generally*, Bittker, *supra*, at ¶ 10.01[1][b] (2005) (Limitations on the Benefits of the Exemption). Two of particular relevance to state lotteries are i) the taxation of gains (as distinguished from interest) on the sale or other disposition of exempt securities, and ii) I.R.C. § 265(a)(1), which disallows deductions for other expenses (e.g., legal advice) allocable to tax-exempt interest.

a. Taxation of gain on sale

The gain on sale or other disposition of tax-exempt securities is taxable. Rev. Rul. 81-63, 1981-1 CB 455. *See generally*, Bittker, *supra*, at ¶ 10.01[1][b] (2005) (Limitations on the Benefits of the Exemption).

b. Disallowance of deductions for expenses allocable to tax-exempt interest

“Section 265(a)(1) disallows amounts otherwise deductible under Section 162 (relating to trade or business deductions) or Section 212 (relating to expenses for the production of income) if allocable to exempt interest, whether any exempt interest is actually received or accrued. Items disallowed by § 265(a)(1) include payments for investment advice, safe-deposit and custodial facilities, clerical assistance, fiduciary services, and legal advice. If a taxpayer’s portfolio includes both exempt and taxable securities, Section 212 expenses must be allocated between the two classes, ordinarily in proportion to the amount of income derived from each.” Bittker, *supra*, ¶ 10.04[3] (2005) (Disallowance of Investment Expenses).

III. REVENUE RULING 78-140 REEXAMINED

A. The Ruling

The Service wasted few words in dismissing exclusion of lottery interest:

Rev. Rul. 78--140
Section 103. -- Interest on Certain Governmental Obligations
26 CFR 1.103--1: Interest upon obligations of a State, Territory, etc.
(Also Section 61; 1.61--7.)
1978--1 C.B. 27; 1978 IRB LEXIS 440; REV. RUL. 78--140
January, 1978

State lottery; interest on prize payable in installments. Amounts designated as interest to be paid on the unpaid annual installments of the grand prize of a state lottery, with the interest and the installments totaling the stated amount of prize, will not be excludable from the gross income of the winner under section 103(a)(1) of the Code.

A state lottery proposes to offer a grand prize of \$1,000,000 in one of its games. The lottery will enter into a contract to pay the winner a principal amount of \$600,000 in 25

annual installments of \$24,000 each and to pay annually additional amount designated as interest at a fixed rate on the unpaid balance. The total payments will equal \$1,000,000. Under no circumstances will the winner be entitled to receipt of or control over the grand prize except to the extent of annual payments. The winner's right to the annual installment payments will be unassignable except by will or intestacy. The deferred prize winnings will not be placed in trust or escrow, but will be an unsecured contractual obligation of state.

Held, the annual amounts designated as "interest" to be paid by the lottery will not be excludable from the gross income of the lottery winner under the provisions of *section 103(a)(1) of the Internal Revenue Code* of 1954.

Rev. Rul. 78-140, 1978-1 C.B. 27 *available at* 1978 IRB LEXIS 440 (*emphasis in original*).

B. The Facts

Suppose a grand prize was actually awarded on the facts of Revenue Ruling 78-140. Given a drawing in January 1978, our hapless jackpot winner is not a millionaire, but only a thousandaire, waiting 24 years (assuming an annuity due) to collect ever smaller installments, each further decimated by inflation as he endures a fixed rate of 5.55555555%, beginning in the Carter administration, and continuing through Reagan, Bush, Clinton, and Bush, again, until he finally collects his last, miserable check in 2002, for \$25,333.33. Rev. Rul. 78-140 Amortization, *infra*, app. G.

Even crueler than the interest rate (prime was already 7.75 and would hit 21.50 before Carter left office) is the prize' utter lack of liquidity. No cash option was available, either at purchase or later, and no inter vivos assignment was permitted. Such restrictions were necessary in 1978, prior to rulings narrowing application of the constructive receipt doctrine. *See, e.g.*, LTR 8552022 (Sep. 25, 1985) (cash option approved); LTR 9624009 (Mar. 12, 1996) (installment assignment approved). Consider the alternative: inclusion in income of the \$600,000 present value, with only an initial \$24,000 to cover the tax liability (the top marginal rate in 1978 was 70%).

Further, pity the estate holding this "prize." For federal estate tax purposes, the

remaining installments are valued under I.R.C. § 7520 tables, with no discount for lack of marketability. Cook v. Comm’r, 349 F.3d 850 (5th Cir. 2003).

The provision for fixed principal payments is novel, but otherwise the prize in this ruling was familiar and unremarkable: i) it was awarded by a state lottery, and ii) constructive receipt was assiduously avoided.

C. The Rationale

The facts omitted reveal as much as those disclosed. There are simply no details by which to judge the I.R.C. § 103 requirements of a political subdivision, registration, and reporting, or to test for disqualified arbitrage, hedge, or private activity bonds. Instead, the ruling merely recites the prize’ financial attributes and enumerates the taxpayer’s restrictions. It is those restrictions, essential to avoiding the constructive receipt doctrine, that explain the ruling.

Because death and forfeiture were the prizewinner’s only opportunities for avoiding installment payments, the transaction giving rise to interest was involuntary. Different commentators cite Revenue Ruling 78-140 for the proposition that I.R.C. § 103 extends only to obligations incurred in the exercise of the state’s borrowing power. *E.g.*, RIA Federal Tax Coordinator 2nd ¶ J-3002 (2005) (‘Bond’ Defined for Purposes of Income Tax Exemption for State and Local Bonds) *available at* Westlaw FTC P J-3002. The ruling’s installments, so goes the argument, do not implicate a borrowing power because any “loan” is compulsory, as the winner must accept whatever interest rate the state imposes. Boris I. Bittker & Lawrence Lokken, Fed. Taxation of Income, Est. & Gifts ¶ 15.1.2 n.19 (2005) (Obligations Eligible for Exemption) *available at* 1997 WL 439557. Absent exercise of the state’s borrowing power, a qualified obligation does not exist, and that is the end of the inquiry. Hence the terse ruling.

D. Applicability Today

On its facts, Revenue Ruling 78-140 was correct then, and remains so now. However,

subsequent authority offering relief from the constructive receipt doctrine has enabled rule changes that distinguish contemporary lottery games from the 1978 model. A cash election at purchase, an election within 60 days of winning, and the opportunity for inter vivos assignment are all possible now without concerns of constructive receipt. Cash options, though not an inter vivos assignment, invoke the state's borrowing power. As a result, Revenue Ruling 78-140 can no longer stand for the proposition that interest on any lottery installment is includible in income, but must be limited to those games lacking a cash option.

Revenue Ruling 78-140 remains relevant, e.g., in Texas, where, in contrast to *Lotto Texas* and *Mega Millions*, most lottery games with installment prize payments offer no cash option at all. Such games fall squarely within the facts of the 1978 ruling, and so interest on those installments cannot be excluded under I.R.C. § 103.

The force of Revenue Ruling 78-140 is avoided altogether, though, by installment prizes which include a cash option, because the election exposes the state to the risk of full payment, at *the taxpayer's* discretion, not the state's. A cash option includes the essence of the state's borrowing power, the taxpayer's own power to avoid the loan and hence compel immediate payment. This is equally true of the cash option at purchase (LTR 8552022 (Sep. 25, 1985)) and the election within 60 days of winning (I.R.C. § 451(h)).

In contrast, the opportunity for an inter vivos assignment (e.g., Tex. Gov't Code § 466.410) does not implicate the state's borrowing power. An assignment of installment prize payments merely changes the state's obligee, rather than exposing it to any risk of immediate payment. Thus, though installment assignments might fall within a constructive receipt safe harbor, and though they improve the prizewinner's liquidity, in and of itself, the power to make inter vivos assignments does not distinguish a lottery game from that found in Revenue Ruling

78-140.

IV. I.R.C. § 103 AND THE TEXAS LOTTERY

Lotto Texas and *Mega Millions* installment prize payments are qualified obligations, and, but for timely I.R.C. § 149(e) reports (which deadline the Service may extend), interest on those installments is excludible from the prizewinner's income under I.R.C. § 103. However, the exemption will be lost if an untoward rule change disqualifies the obligation any time during its 20–26 year term.

A. Qualified Obligation

The Texas Lottery Commission is a I.R.C. § 103 political subdivision of the State of Texas, and, where a cash election is offered, but not otherwise, its installments prize payments are qualified obligations under I.R.C. § 149.

1. Political subdivision

The Texas Lottery is admittedly an atypical government activity:

The legislature recognizes that the operation of a lottery is a unique activity for state government and that the structures and procedures appropriate to the performance of other governmental functions are not necessarily appropriate to the operation of a state lottery.

Section 1 of Acts 1991, 72nd Leg., 1st C.S., ch. 17.

Regardless, the Lottery Commission meets every definition of a state or political subdivision. It is an executive agency of the State of Texas and enjoys sovereign immunity. *See generally* Tex. Gov't Code chs. 466, 467 (State Lottery Act; Texas Lottery Commission); Stewart v. Texas Lottery Comm'n, 975 S.W.2d 732 (Tex. App.—Corpus Christi 1998, no writ) (immunity as to lottery games). It serves a public purpose, school funding, and pays all net revenue to the Texas Foundation School Fund, over \$7 billion through 2004. Tex. Gov't Code § 466.355(b)(4) (foundation school fund receives net revenue annually); The NASPL Lottery

Resource Handbook 185 (N. Am. Ass’n of State & Provincial Lotteries CD-ROM, 2005).

The Lottery Commission exercises more than the “insubstantial amount” of the “power to tax” envisioned by the Tax Reform Act of 1986, collecting \$1 billion on gross sales of \$3.5 billion in 2004 alone. The NASPL Lottery Resource Handbook 187 (N. Am. Ass’n of State & Provincial Lotteries CD-ROM, 2005). As a benchmark, the City of Houston’s total general revenue for fiscal year 2004 was \$1.5 billion. City of Houston, Office of the City Controller, Comprehensive Annual Financial Report for the fiscal year ended June 30, 2004 at 174–175, *available at* <http://www.houstontx.gov/controller/cafr04/statisticalsection9.pdf> (last visited Nov. 30, 2005).

The Lottery Commission also exercises a significant police power, using rules promulgated itself to summarily resolve multimillion dollar disputes involving every type of game, whether instant, on-line, or promotional. *Cf.* 16 Tex. Admin. Code § 401.302(d)(5) (liability for void instant ticket limited to replacement or refund); 16 Tex. Admin. Code § 401.302(l) (instant game players bound by director’s decisions); 16 Tex. Admin. Code § 401.304(e)(3) (liability for void on-line ticket limited to replacement or refund); 16 Tex. Admin. Code § 401.304(e)(5) (on-line game players bound by director’s decisions); 16 Tex. Admin. Code § 401.313(e) (promotional game players bound by director’s decisions); Stewart v. Tex. Lottery Comm’n, 975 S.W.2d 732 (Tex. App.—Corpus Christi 1998, no writ) (\$19 million jackpot summarily denied).

The Commission promulgates its rules, including those just cited, under an express delegation by the Texas Legislature. Tex. Gov’t Code §§ 466.015(a), 467.102. This rulemaking authority is yet another expression of the Commission’s sovereign powers, which, taken together, confirm that the Texas Lottery Commission is a political subdivision within the

meaning of I.R.C. § 103.

Recall that the regulations allow exempt obligations to be issued “by or on behalf of” a state or political subdivision. Treas. Reg. § 1.103-1(b). Thus, the Commission could outsource all or part of its functions, e.g., servicing of installment payments, to another entity, perhaps a public corporation, and remain within the requirements of I.R.C. § 103.

2. Interest on an obligation—the borrowing power

a. Instant games

Revenue Ruling 78-140 still controls those installment prizes lacking a cash option. The only games the Texas Lottery has offered meeting that criteria are eight different instant games—

Table 2. Texas Lottery Instant Games Paid by Installment Without a Cash Option

Game	Duration	Payout
Win for Life	11/8/1993–3/1/1994	\$52,000/yr for life – W, M, Q
Monthly Money	3/10/2000–1/30/2002	\$30,000/yr for five years – M, A
Weekly Bonus	5/14/1997–4/2/1998	\$26,000/yr for 20 years – W, M, Q, A
\$130,000 Bonus	4/14/2004–11/30/2004	\$500/week for 5 years
Weekly Grand	multiple eds. 5/3/1995–	\$52,000/yr for 20 years – W, M, Q, A
Twice as Grand	2/26/2003–	\$104,000/yr for 20 years – W, M, Q, A
Set for Life	9/22/2004–	\$5,000/week for 20 years
Monthly Bonus	5/30/2005–	\$10,000 a month for 20 years

W = weekly, M = monthly, Q = quarterly, A = annually

From Word file *InstlmtPymtGms0904.doc*, attached to Dec. 20, 2005 e-mail from openrecords@lottery.state.tx.us to rwhall@rwhpc.com (on file with author).

For lack of a cash option, interest on those installment payments is includible in income. Should the Commission subsequently offer a cash option, each particular prize should be reviewed to determine whether all other I.R.C. § 103 criteria are satisfied.

b. On-line games

Lotto Texas and *Mega Millions* are the only on-line games with an installment prize, and both offer a cash option. Thus, interest on those installments is excludible from the

prizewinner's income, subject to the other I.R.C. § 103 requirements. Texas' other on-line games, *Texas Two Step*, *Cash Five*, and *Pick 3*, do not offer installment payments. Also, the lower tier *Lotto Texas* and *Mega Millions* prizes are not paid in installments, and so no portion of those prizes is excludible.

c. Promotional games

Although the Commission promulgated a separate set of rules for promotional games, 16 Texas Administrative Code Section 401.313 (Promotional Drawings), in practice it classifies its games as either instant or on-line. Thus, "promotional games" are less a category than an admonition: as noted, above, at Section I.A.2.d, Promotional drawings, the Commission's unfettered discretion may be visited upon any particular prize, in the form of "commission rules, regulations, policies, directives, instructions, conditions, procedures, and final decisions of the executive director," which are not necessarily published in the Texas Register or elsewhere. 16 Tex. Admin. Code § 401.313(e). For example, the Commission might offer installments based on one investment return, then invest funds at a higher rate, inviting disqualification as an arbitrage bond. The immediate burden of such discretion is the necessity of empirical research regarding each prize, since the primary law is not determinative.

d. Prior games

Given such long payout periods (20AP, 25AP, 26AP), notwithstanding that every recent jackpot winner has opted out of installment payments, there remain plenty of prizewinners still receiving installments. See Tex. Lottery Comm'n, Lotto Texas Jackpot Winners (Dec. 20, 2005), *infra*, app. E. In fact, the relative youth of the Texas Lottery means even the first jackpot winner, drawn November 1992, still has installment payments remaining. As the Lottery Commission notes at the end of Appendix E, 298 installment prizes are still being paid (68–25AP, 230–20AP).

Nothing within I.R.C. § 103 precludes the Commission from offering prior winners a cash option with respect to their remaining payments. However, a late election invites application of the constructive receipt doctrine, which would accelerate recognition of the remaining installments by those prizewinners who declined to exercise the option, accelerating recognition of not only principal, but also interest, thus defeating the purpose. The I.R.C. § 451(h) election is only available within 60 days of winning, and so offers no protection to any prior installment winners, that last of which won in July 2003. *Infra*, app. E. Thus, there is no authority for offering a cash election to prior winners more than 60 days after winning.

However, as noted in Section I, Introduction, above, a cash election has been in place since 1997, and 68 of 229 *Lotto Texas* jackpots subsequently awarded went to installment winners. Subject to the Service' extension of the Commission's reporting requirements, those 68 installment winners are eligible for exemption of their installment interest.

3. Summary of Qualified Obligations

In summary, only those *Lotto Texas* and *Mega Millions* installment jackpots with a cash option are I.R.C. § 103 qualified obligations.

Table 3. Summary of Qualified Obligations

<i>Lotto Texas</i> Installments			
Date of Award	Draw Number	CVO Offered	Qualified Obligation
11/28/92 – 2/8/97	5 – 443	No	No
2/12/97 – present	444 –	Yes	Yes
<i>Mega Millions</i> Installments			
Every <i>Mega Millions</i> installment jackpot (at least in Texas) offered the cash option and so is a qualified obligation.			

B. I.R.C. § 149 Registration

I.R.C. § 149(a)(1) denies the I.R.C. § 103 exemption to select bonds that are not registered. The definition of “registered-required bond” excludes three categories of bonds from

this requirement, including i) those “not of a type offered to the public,” ii) those that mature within a year of issue, and iii) I.R.C. § 163(f)(2)(B) bonds issued only for foreign persons.

The odds of being offered a so-called *Lotto Texas* or *Mega Millions* bond are 1 in 47,784,352 or 175,711,536, respectively. Tex. Lottery Comm’n, How to Play Lotto Texas (Jan. 1, 2006), *available at* <http://www.txlottery.org/online/howlotto.cfm> (last visited Jan. 1, 2006); Tex. Lottery Comm’n, How to Play Mega Millions (Jan. 1, 2006), *available at* <http://www.txlottery.org/online/howmegamillion.cfm> (last visited Jan. 1, 2006). Such “bonds” should therefore be exempt from registration under I.R.C. § 103, as among those “not of a type offered to the public.” I.R.C. § 149(a)(2)(A).

C. Reporting Requirements

I.R.C. § 149(e) requires the issuer to submit a detailed report by the 15th of the second month following the quarter of issue. The information report is obligatory, but its deadline may be extended in the Secretary’s discretion. I.R.C. §§ 149(e)(1), (3).

I.R.C. § 149(e) is easy enough to meet, but note that it requires an information return by the issuer, not the taxpayer. Hence, an installment prizewinner could not claim the interest exemption without the cooperation of the Commission, which alone can make the necessary report. In other words, a I.R.C. § 103 exemption requires the Commission’s active participation.

I.R.C. § 6012(d) requires the taxpayer, i.e., the prizewinner, to report the amount received or accrued each year. Since lottery winners are notoriously good at math, it might be fun to allow them to impute their own interest. The better practice might be for the Commission to give winners the necessary information when claiming their prize.

D. Disqualified Obligations

1. Arbitrage bonds

I.R.C. § 148 denies the interest exemption to arbitrage bonds, that is, bonds whose

proceeds are reinvested in higher yielding investments. I.R.C. § 148 applies if (1) arbitrage is reasonably expected as of the date of issuance, whether or not arbitrage actually occurs, or (2) arbitrage intentionally occurs, whether or not it was reasonably expected as of the date of issuance. In other words, neither remedial measures nor a change in circumstances will excuse the unintentional or ill-considered arbitrage.

As set out above, the rules leave the Commission considerable discretion, which it exercises liberally. Further, as the Internal Audit showed, the Commission has been known to lose track of its internal policies and procedures. Finally, the State Lottery Act delegates ultimate investment authority to the Comptroller, not the Texas Lottery Commission. Together, this is a recipe for accidental arbitrage, since a strict investment discipline must be maintained twenty-four years or longer.

a. *Lotto Texas*

On their face, the *Lotto Texas* rules foreclose the possibility of arbitrage, by calling for the immediate purchase of securities whose proceeds determine the amount and timing of installments paid the prizewinner. 16 Tex. Admin. Code § 401.305(e)(3)(A)(i). The investments can never be higher yielding than the installments, because every penny of principal and interest is paid over to the prizewinner. Whether this happens in fact must be confirmed case by case, given the Commission's discretion and past practices.

b. *Mega Millions*

The *Mega Millions* rules are problematic with respect to arbitrage. There is no self-correcting rule as in *Lotto Texas*. While there is provision for funding installments with "Federal" "bonds," nothing requires that all proceeds of those investments be paid over to the prizewinner, and thus there is room for an investment that yields more than the taxpayer's prize. 16 Tex. Admin. Code § 401.315(f)(3)(B)(v). The present rules do not need amendment to avoid

that result, provided the *Mega Millions* investments and proceeds are handled just like *Lotto Texas*.

2. Hedge bonds

I.R.C. § 149(g) provides a safe harbor that, for lottery purposes, is more than generous, requiring expenditure of 10% of the proceeds within the first year, 30% within two years, 60% within three years, and 85% within five years. I.R.C. § 149(g)(2).

If annual installment payments represent a jackpot “bond” then the foregone cash payment, the CVO amount, represents the “proceeds.” A determinable CVO amount is thus a requisite to determining with certainty whether the jackpot falls within the safe harbor. Given that only 85% of the proceeds need be reinvested within five years, though, there is room for a 15% variance in the CVO calculation. That should be some comfort, given the uncertainties of the CVO determination discussed previously.

a. *Lotto Texas*

Lotto Texas rules effectively require the immediate investment of all proceeds. 16 Tex. Admin. Code § 401.305(e)(3)(A)(i) (funding of installments by the purchase of securities at the time of a jackpot winner is drawn). Although a winner may have 180 days to claim, and thus reveal his or her identity, the cash election or its absence is recorded at the time of sale, and hence immediate investment is truly possible. Thus, absent a cash election, *Lotto Texas* proceeds should be 100% invested within days, falling well within the I.R.C. § 149(g)(2) safe harbor for hedge bonds.

b. *Mega Millions*

Mega Millions rules imply the purchase of bonds to fund installments. The timing intended is obviously within the first year, because the rules anticipate the second payment to be a function of the date of purchase. 16 Tex. Admin. Code § 401.315(f)(3)(B)(v) (“subsequent 25

payments shall be paid annually to coincide with the month of the Federal auction date at which the bonds were purchased to fund the annuity”).

Unlike *Lotto Texas*, the amount of the *Mega Millions* cash jackpot is a financial calculation. Prior to each drawing, the Mega Millions finance committee determines a discount rate, which is divided into a cash winner’s jackpot share to determine the amount paid. 16 Tex. Admin. Code § 401.315(f)(3)(B)(iv). Whenever the rates for Federal bonds differ from the finance committee’s discount rate, the *Mega Millions* scheme leaves open the possibility of investing more or less than all the proceeds. If less than 15% of the proceeds are never invested, the jackpot would fall outside the hedge bond safe harbor.

3. Private activity bonds

The State Lottery Act avoids altogether the “private business use” and “private security or payment” tests of I.R.C. §§ 141(b)(1) and 141(b)(2), and the “private loan financing” test of I.R.C. § 141(c).

By its terms, the lottery franchise is limited to a governmental entity, first the Comptroller, and now the Texas Lottery Commission. Thus, the proceeds are not for any private business use.

Assuming installments are funded by investments in Treasury debt, the private security or payment tests are not met. However, given that the Comptroller’s investment discretion extends to securities, annuities, or other instruments, this assumption must be confirmed with respect to each prizewinner claiming an interest exemption.

Finally, lottery installments do not meet the private loan financing test, because any loan is *from* the individual taxpayer *to* the state. The private loan financing test only reaches loans *to*, not *by* nongovernmental persons.

E. Limitations on Benefits of Qualified Obligations

1. Taxation of gain on sale

Texas Government Code § 466.410 permits voluntary inter vivos assignment of installment payments on the order of a Travis County District Court. *E.g., see*, Tex. Lottery Comm’n, Lotto Texas Payment Schedule, June 3, 1995, Draw #267 (reflecting assignment of two different series of installments on orders issued in cause nos. GN100169 and GN304870), *infra*, app. C. The prizewinner-assignor undoubtedly would receive a premium for a tax-exempt security, and any gain on sale would be taxable to the prizewinner. Rev. Rul. 81-63, 1981-1 CB 455.

2. Disallowance of deductions for expenses allocable to tax-exempt interest

The Commission encourages jackpot winners to seek tax and legal counsel before claiming their prize. As reflected by Appendix E, the claimant is often a trust or limited partnership, which invariably generates legal expenses. I.R.C. § 265(a)(1) disallows amounts otherwise deductible under I.R.C. § 162 or I.R.C. § 212 if allocable to exempt interest.

V. OBSERVATIONS

I.R.C. § 103 presents an exciting opportunity for the Texas Lottery Commission. From the players’ perspectives, little or no rule changes would be necessary to exclude interest on installment payments from *Lotto Texas* and *Mega Millions* jackpot prizewinner’s income. With addition of a cash option, this benefit could be extended to installment payments on instant games.

Lotto Texas is ready for *retroactive* exclusion of interest on installment payments, at least for jackpots drawn after February 10, 1997, when the CVO was introduced, provided only that the Commission, with a favorable exercise of the Service’ discretion, reports those prizes as tax-exempt. This would extend a second windfall to installment winners, and generate new

enthusiasm for the game. A similar opportunity would exist for *Mega Millions*, except that the only two Texas jackpot winners to date elected the cash option.

But for reporting, the Commission's practices already comport with I.R.C. § 103, at least with respect to *Lotto Texas* jackpots. However, so many rules and procedures remain uncodified, and so many are indeterminate, that empirical analysis of each prize remains necessary. It would greatly assist taxpayer's counsel for the Commission to reconcile and codify each rule touching the tax attributes of exempt prizes, to limit the inquiry required of either the taxpayer or the Internal Revenue Service when performing a I.R.C. § 103 analysis.

Given the long horizon of arbitrage disqualification, a compliance program is in order, to ensure that qualifying investments are undisturbed for the duration, or, if changes are necessary, that they are made with an eye towards the exemption requirements.

Compulsory lump sum payments should be ended for games offering tax-exempt installment interest, to avoid accelerating income to prizewinners who intentionally declined the cash election.

Finally, a I.R.C. § 451(h) cash option within 60 days of winning should be offered, allowing the prizewinner an opportunity for tax counsel before electing or foregoing tax-exempt interest on installment payments.

VI. CONCLUSION

Since Revenue Ruling 78-140 issued, the Service and Congress have ameliorated the harsher consequences of the constructive receipt doctrine with respect to lottery prize installments. As a result, cash options now qualify state lottery installment obligations for exclusion of interest under I.R.C. § 103. The Texas Lottery Commission's rules already avoid the arbitrage and hedge bond exceptions, and it remains only to embrace the exemption by filing

the required information returns and adopting compliance programs appropriate to the long terms of the *Lotto Texas* and *Mega Millions* installment prize payments.

Appendix A. Dawn Nettles, 0547 The Lotto Report: The Racing Form of the Texas Lottery, Nov. 17–30, 2005. © 2005 Dawn Nettles. Reprinted by permission.

Appendix B. Timeline and Summary of Lotto Texas Jackpot Rules

Source: Tex. Lottery Comm'n, An Internal Audit of Lotto Texas Jackpot Prize Winner Awards 9 fig.1 (IA #05-002 Dec. 31, 2004) (on file with author)

Appendix C. Lotto Texas Payment Schedule, June 3, 1995, Draw #267

Source: Tex. Lottery Comm'n, Lotto Texas Payment Schedule, June 3, 1995, Draw #267 (among Mar. 1, 2005 Open Records response from Texas Lottery Commission) (on file with author).

Appendix D. *Lotto Texas*TM Drawing Results & Reserve Entry Form, Draw Date: 09/24/05;
Draw #1343

Source: Tex. Lottery Comm'n, Download jackpot payment calculation for Lotto Texas for Saturday, September 24, 2005, http://www.txlottery.org/online/prizeamounts/lotwin20050924_3.pdf (last visited Dec. 22, 2005).

Appendix E. Tex. Lottery Comm'n, Lotto Texas Jackpot Winners (Dec. 20, 2005)

Source: Excel file MASTER LOTTO WINNERS May 2005_1.xls, attached to Dec. 20, 2005 e-mail from openrecords@lottery.state.tx.us (on file with author).

Appendix F. Interest Imputed on Installment Payments

Appendix G. Rev. Rul. 78-140 Amortization