

Davis v. Commissioner, 116 T. C. 35 (U. S. Tax Court 2001)

In *Davis v. Commissioner*, the U. S. Tax Court ruled that the lump sum payment received by petitioners for assigning their rights to future lottery winnings was ordinary income, not capital gain. This decision reaffirmed longstanding tax law principles, rejecting the petitioners' argument that their assignment constituted a sale of a capital asset. The ruling clarifies that rights to future income, such as lottery payments, do not qualify as capital assets under the Internal Revenue Code, impacting how lottery winners and similar recipients must treat such income for tax purposes.

Parties

James F. Davis and Dorothy A. Davis, as cotrustees of the James and Dorothy Davis Family Trust (Petitioners) v. Commissioner of Internal Revenue (Respondent).

Facts

James F. Davis won \$13,580,000 in the California State Lottery on July 10, 1991, to be received in 20 equal annual payments of \$679,000. The Davises, as cotrustees of their family trust, assigned the rights to receive a portion of 11 of these future annual payments (from 1997 to 2007) to Singer Asset Finance Co. , LLC (Singer) for a lump-sum payment of \$1,040,000. The assignment was approved by the California Superior Court on August 1, 1997. The Davises reported this lump sum as a long-term capital gain in their 1997 tax return, while the Commissioner determined it to be ordinary income.

Procedural History

The Commissioner issued a notice of deficiency to the Davises for their 1997 federal income tax, asserting that the \$1,040,000 lump sum received from Singer was ordinary income, resulting in a deficiency of \$210,166. The Davises filed a petition with the U. S. Tax Court challenging this determination. The case was submitted fully stipulated, with the Tax Court reviewing the matter *de novo*.

Issue(s)

Whether the \$1,040,000 received by the Davises in exchange for assigning their rights to future lottery payments constitutes ordinary income or capital gain under Section 1221 of the Internal Revenue Code?

Rule(s) of Law

Section 1221 of the Internal Revenue Code defines a "capital asset" as property held by the taxpayer but excludes certain types of property, including claims to ordinary income. The Supreme Court has held that rights to future income, such as those at issue here, do not qualify as capital assets (see *Hort v. Commissioner*, 313 U. S. 28

(1941); Commissioner v. P. G. Lake, Inc. , 356 U. S. 260 (1958); Commissioner v. Gillette Motor Transp. , Inc. , 364 U. S. 130 (1960); United States v. Midland-Ross Corp. , 381 U. S. 54 (1965)).

Holding

The Tax Court held that the \$1,040,000 received by the Davises was ordinary income, not capital gain, as the right to receive future lottery payments does not constitute a capital asset under Section 1221 of the Internal Revenue Code.

Reasoning

The court's reasoning focused on the nature of the right assigned by the Davises, which was a right to receive future ordinary income (lottery payments). The court applied the principle established in a line of Supreme Court cases that rights to future income are not capital assets. The court rejected the Davises' reliance on *Arkansas Best Corp. v. Commissioner*, 485 U. S. 212 (1988), noting that this case did not overrule the aforementioned line of cases but was distinguishable as it involved the sale of capital stock, not a claim to ordinary income. The court emphasized that the purpose of capital-gains treatment is to address the realization of appreciation in value over time, which was not applicable to the Davises' situation. The court also considered policy implications, noting that treating such assignments as capital gains could lead to tax avoidance strategies, undermining the tax code's integrity.

Disposition

The Tax Court entered a decision for the Commissioner, affirming the determination that the \$1,040,000 received by the Davises was ordinary income, resulting in a tax deficiency.

Significance/Impact

Davis v. Commissioner reinforces the principle that rights to future income, such as lottery winnings, are not capital assets under the tax code. This ruling has significant implications for lottery winners and others receiving periodic payments, as it clarifies that lump-sum payments received in exchange for such rights must be treated as ordinary income. The decision ensures consistent application of tax law and prevents potential tax avoidance schemes. Subsequent courts have followed this precedent, maintaining the distinction between capital gains and ordinary income in similar contexts.