Lottery Winner v. Commissioner, 122 T. C. 142 (U. S. Tax Court 2004)

In *Lottery Winner v. Commissioner*, the U. S. Tax Court ruled that annual payments from the California State Lottery to an Israeli resident did not qualify as 'annuities' under the U. S. -Israel Income Tax Treaty, thus subjecting them to U. S. taxation. The court clarified that lottery winnings, considered as gambling proceeds, do not constitute 'annuities' due to the lack of 'adequate and full consideration' as defined by the treaty. This decision underscores the distinction between gambling winnings and annuities under international tax treaties and impacts how such payments are treated for tax purposes.

Parties

The petitioner, referred to as Lottery Winner, was the plaintiff, seeking to exempt his lottery winnings from U. S. taxation under the U. S. -Israel Income Tax Treaty. The respondent, the Commissioner of Internal Revenue, represented the U. S. government, opposing the exemption and arguing that the winnings were taxable under U. S. tax law.

Facts

The petitioner, an Israeli citizen, purchased a California State Lottery ticket for $1 in 1992 while residing in California. The ticket won the 'Super Lotto', entitling the petitioner to annual payments of $722,000 for 20 years. From 1997 to 1999, while residing in Israel, the petitioner received these payments but did not report them as income on his U. S. federal income tax returns. The Commissioner issued a notice of deficiency, asserting that the payments were taxable under section 871(a)(1)(A) of the Internal Revenue Code, which imposes a 30% tax on certain income received by nonresident aliens from U. S. sources.

Procedural History

The petitioner filed a petition with the U. S. Tax Court challenging the deficiency notice, arguing that the payments were exempt under the U. S. -Israel Income Tax Treaty. Both parties filed cross-motions for summary judgment, agreeing that there were no genuine issues of material fact. The Tax Court, applying Rule 121 of the Tax Court Rules of Practice and Procedure, granted summary judgment to the Commissioner.

Issue(s)

Whether the annual payments received by the petitioner from the California State Lottery constitute 'annuities' within the meaning of the U. S. -Israel Income Tax Treaty, thus exempting them from U. S. taxation under Article 20 of the treaty?

Rule(s) of Law

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Article 20(2) of the U. S. -Israel Income Tax Treaty states that ‘alimony and annuities paid to an individual who is a resident of one of the Contracting States shall be taxable only in that Contracting State. ‘ Article 20(5) defines ‘annuities’ as ‘a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered). ‘

Holding

The U. S. Tax Court held that the annual payments from the California State Lottery did not qualify as ‘annuities’ under the U. S. -Israel Income Tax Treaty because they were not made ‘in return for adequate and full consideration. ‘ Therefore, the payments were subject to U. S. taxation under section 871(a)(1)(A) of the Internal Revenue Code.

Reasoning

The court’s reasoning centered on the definition of ‘annuities’ in the treaty, which requires payments to be made in return for ‘adequate and full consideration. ‘ The petitioner argued that the $1 paid for the lottery ticket constituted such consideration, but the court rejected this, stating that the $1 was consideration for the chance to win (i. e. , a wager), not for the payments themselves. The court distinguished between the nature of lottery winnings as gambling proceeds and the characteristics of annuities, which require a direct exchange of consideration. The court also considered the petitioner’s reliance on *Estate of Gribauskas v. Commissioner*, but found it inapplicable as it dealt with a different statutory context and did not address the treaty’s specific requirement of ‘adequate and full consideration. ‘ The court further noted that the treaty’s silence on gambling winnings did not imply an exemption, and thus, the payments remained taxable under U. S. law.

Disposition

The Tax Court granted the Commissioner’s cross-motion for summary judgment, denying the petitioner’s motion and affirming the tax deficiency under section 871(a)(1)(A).

Significance/Impact

This case clarifies the scope of exemptions under the U. S. -Israel Income Tax Treaty, particularly regarding what constitutes an ‘annuity’ for tax purposes. It establishes that lottery winnings, even when paid out periodically, do not qualify as annuities under the treaty due to the lack of ‘adequate and full consideration. ‘ This decision impacts how lottery winnings are treated under international tax treaties and reinforces the distinction between gambling proceeds and annuities. It also serves as a precedent for interpreting similar provisions in other tax treaties and

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may influence how nonresident aliens report and pay taxes on gambling winnings from U. S. sources.

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