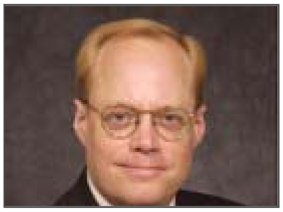
Forbes



Robert W. Wood

THE TAX LAWYER

TAXES 5/23/2015

As Jackpot Hits $214 Million, Winning The Lottery Where It's Tax Exempt

Winning the lottery is a common dream, a real pie in the sky goal. Winning big is even better, but winning can mean big liabilities too. In fact, it is well-known that lottery winners sometimes end up in financial trouble. They may be beset by relatives and other claimants who want some of their new-found wealth. Then, aggressive salespeople descend, the taxman arrives, and the happy dance can turn into a tale of woe. Time and again, winners have trouble paying taxes and resolving disputes.

It’s one reason there are some terribly important things to do when you win the lottery. So whether it is a Powerball Jackpot, the MegaMillions, or anything else, be careful. Even state taxes can mess you up. And that’s why it’s worth considering where you are when you buy and win. Pennsylvania doesn’t tax lottery winnings. So far, at least.

In fact, some lawmakers in the state have realized they are losing out. Governor Wolf’s budget plan includes a proposal to tax all lottery winnings over a paltry $600. That would supposedly generate $15 million next year, a sum that estimates say would ramp up to $25 million within three years. But like many tax rules, even ‘no tax’ often doesn’t mean that.

If you aren’t a resident of Pennsylvania, you’ll pay state tax where you live. And even if you live in Pennsylvania, you still pay federal income tax. Although taxes on winning tickets are a downside. most people assume their after-tax loot will still put them on easy street forever. Yet some winners inevitably think about shaving taxes where they can. Can you win the lottery in one state, then move to another? There’s no state tax in Nevada, Texas, Florida, Washington, Alaska, South Dakota, and Wyoming.

You can move, sure, but it won't help your taxes. Most states tax lottery winnings the way the IRS does, by withholding taxes. So taking your winnings and crossing the state line won't help. How about crossing to Canada? If you are a Canadian citizen, you can win their lottery and pay no taxes. But winning as an American and then moving to Canada won't help. And if you're an American winning the Canadian lottery, the IRS and your home state *still* get to tax you, if your home state has an income tax.

One more shocker to many? California actually exempts state lottery winnings from its income tax. According to the California Lottery's Winners Handbook, winnings are exempt from state and local income taxes. Some winners are part of an office pool. Some lotteries allow you to claim your winnings as part of a group, with an individual payout. That is useful since joint payouts can be messy, especially if your pool isn't crystal clear.

It can spoil the elation you have over winning if your friends, family or co-workers claim a share of the loot. Take the Californian, Ms. Eva Reyes, who won $1 million. The owner of the liquor store where she bought the ticked sued her. The store owner claims that Ms. Reyes promised to split winnings—$350,000 each after taxes—for fronting the money to buy the tickets. The plaintiff claims there is a signed note guaranteeing him half.

But Ms. Reyes claims the deal was for $50,000, not half. The stakes and tax problems are larger on bigger lottery prizes. Unless there is a true partnership, a winner may be taxed on it all, yet only be allowed a partial write-off for the damages paid to those claiming a share. The technical reasons are limitations on tax deductions and the dreaded AMT, the alternative minimum tax. Even if you win a lawsuit, you may have to pay the IRS, even on your attorney's fees paid directly to your lawyer.

Not every lottery case involves co-workers or friends. Sometimes the disputes are with family members, which can be even worse. In *Dickerson v. Commissioner*, an Alabama Waffle House waitress won a $10 million lottery jackpot on a ticket given to her by a customer. The trouble started when she tried to benefit her family and spread the wealth. The Tax Court held she was liable for gift tax when she transferred the winning ticket to a family company of which she owned 49%. Tax advice before the plan would have avoided the extra tax dollars, that were generated because the tax plan was half-baked. She shouldn't have assigned her claim in a waffle house.

For alerts to future tax articles, follow me on Forbes.com. Email me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.