DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

July 5, 2001

Number: **200141020**
Release Date: 10/12/2001
CC:INTL:Br2
TL-N-1019-01
UILC: 9114.03-44
871.02-03

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR RONALD D. PINSKY
Associate Area Counsel (Small Business/Self-Employed)

FROM: Phyllis Marcus, Chief
CC:INTL:Br2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated April 3, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be used or cited as precedent.

LEGEND

X =
State A =
Amount B =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

ISSUE

Whether X's winnings from the State A lottery are exempt from withholding under sections 871 and 1441 because of Article 20(2) of the Income Tax Convention between the United States and Israel (Treaty).

CONCLUSION

Sections 871 and 1441 of the Internal Revenue Code impose a 30% withholding tax on lottery winnings from a U.S. source. The Treaty does not exempt, or reduce, the taxation of U.S. source lottery winnings under sections 871 and 1441.

FACTS

State A operates a biweekly lottery drawing. Pursuant to State A regulations governing the lottery's operation, lottery winners receive their prizes in 20 annual installments and are not entitled to elect payment in the form of a lump sum distribution. State A lottery officials have indicated that the State purchases zero-coupon bonds for each year that lottery proceeds are to be distributed to a winner. State A is named as owner of the bonds and all payments made thereunder are remitted to State A. No specific prizewinner is a party to, or a named beneficiary of, the bond. Further, prizewinners cannot assign or pledge the funds held by State A.

In Year 1, X, a citizen of Israel, won the lottery. At that time, X was residing in the United States. After winning the lottery, X returned to Israel, where he still resides. Pursuant to the lottery regulations, X receives his winnings annually from State A. State A withholds 28% from X's winnings and sends X a Form W-2G for the annual payment.

On his Year 5 Form 1040NR, U.S. Nonresident Alien Income Tax Return, X claimed a refund for all amounts withheld. X attached a statement to that form stating that the income was "excludable under Article 20(2) of the Income Tax Treaty with Israel." Article 20(2) of the Treaty provides an exemption from withholding for certain annuity payments.

X also filed a Tax Court petition for tax Years 2 through 4. Therein, X claimed to be a resident and citizen of Israel for Years 3 and 4 and, as such, entitled to the same treaty benefits discussed above. Subsequent to filing the petition, X settled Years 2, 3, and 4 with the I.R.S. Appeals Office. The I.R.S. did not enter into a closing agreement in connection with future taxable years. X relies on Estate of Shackleford and a letter from the Appeal's Officer with a tentative conclusion to support his current refund claim.

LAW AND ANALYSIS

X's assertion that the lottery winnings received from State A are not subject to withholding by way of the annuity article in the Treaty fails for two reasons. First, regardless of payment structure, lottery winnings retain their classification as gambling income and, as such, are subject to a 30 percent withholding tax under sections 871 and 1441. Second, to qualify as an annuity under the Treaty, X must have paid adequate and full consideration for the periodic payments received. The sum of one dollar is not adequate and full consideration for a large lottery payout. Thus, even if the lottery winnings did not retain their classification as gambling winnings, the annuity provision of the Treaty does not apply.

1. The lottery winnings are properly classified as gambling winnings, subject to the 30% statutory rate of withholding.

Section 871(a) of the Internal Revenue Code (Code) imposes a 30 percent tax on U.S. source interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical income (FDAP) to the extent the income is not effectively connected with the conduct of a trade or business in the United States. Section 1441 requires all persons having the control, receipt, custody, disposal, or payment of FDAP to nonresident aliens to deduct and withhold a tax equal to 30 percent. Section 3402(q)(1) provides that any person making a payment of gambling winnings must deduct and withhold a tax equal to 28 percent. Section 3402(q)(2) provides that where the payment is made to a nonresident alien and subject to withholding under section 1441, the 28 percent withholding under section 3402(q)(1) does not apply.

For purposes of sections 871 and 1441, gambling winnings are considered FDAP. Barba v. United States, 2 Ct. Cl. 674 (1983). In Barba, a citizen and resident of Mexico not engaged in a U.S. trade or business won three separate keno games at two Nevada casinos. The taxpayer argued that the keno winnings did not fall within the meaning of section 871 income and, therefore, were not subject to U.S. taxation. The Court disagreed and held that the winnings were FDAP, subject to the statutory 30 percent withholding.

The Tax Court has recognized that annual payments received from a lottery "should be classified as gambling winnings." See e.g., Rusnak v. Commissioner, 53 T.C.M. 835, 836 (1987). Accordingly, regardless of payment terms, the amounts X receives from State A are properly classified as gambling winnings, not annuities. This conclusion is further confirmed by the facts, which indicate that State A, and not X, is the owner of the bonds. It should be noted, however, that for purposes of sections 871 and 1441, this distinction is irrelevant. Both gambling winnings and annuities fall within the definition of FDAP and, as such, are subject to the statutory 30 percent rate of withholding. Because the amount withheld by State A is less than that required under sections 871 and 1441, X is required to file a Form 1040NR and remit the remaining tax due.

2. Notwithstanding the above, even if the lottery payments do not retain their classification as gambling winnings, the payments State A makes to X are not annuities within the meaning of Article 20(2) of the Treaty because X did not provide "adequate and full" consideration.

As described above, sections 871 and 1441 impose a 30 percent tax on payments of U.S. source FDAP made to nonresident aliens. In certain circumstances, however, the statutory rate of tax imposed on FDAP may be reduced, or eliminated entirely, by an income tax treaty.

Pursuant to Article 20(2) of the Treaty, "annuities paid to an individual who is a resident of one of the Contracting States shall be taxable only in that Contracting State." Thus, an annuity payment to an individual who is an Israeli resident is taxable only in Israel. X cites Estate of Shackleford to support his assertion that the lottery winnings should be treated as annuities for purposes of the Treaty.

In the Estate of Shackleford, the Court addressed whether lottery winnings, payable in periodic payments, fell within the definition of an annuity for purposes of estate tax laws. Specifically, the Court addressed whether the payments were annuities for purposes of valuation under section 7520. Estate of Shackleford v. United States, 99-2 USTC ¶ 60356 (E.D. Cal. 1999). Section 7520 and the regulations thereunder do not define the term annuity. Accordingly, the Court looked to its "normal and customary meaning." Id. Significantly, the "normal and customary meaning" of an annuity for estate tax valuation purposes is materially different than the Treaty definition of an annuity in that the latter specifically defines "annuity" and the definition requires "adequate and full consideration." Because the definition of an annuity is critical to the outcome of this issue, and the definition in the Treaty is materially different than that used for section 7520 purposes, X's reliance on Estate of Shackleford is misplaced.

Article 20(5) of the Treaty defines the term "annuity" 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)." The Treaty, the Technical Explanation to the Treaty, and the Report of the Senate Foreign Relations Committee on the Treaty are all silent with respect to what constitutes "adequate and full" consideration. Article 2(2) of the Treaty (General Definitions) provides that "[a]ny term used in this Convention and not defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined." Thus, U.S. law is relevant to determine what is meant by "adequate and full consideration."

Significant to this, the United States Tax Court has interpreted the meaning of identical, or substantially similar, annuity articles in other income tax treaties. See e.g., Perkins v. Commissioner, 40 T.C. 330 (1960), acq., 1964-1 CB 5 (United States-Italy); Lamm v. Commissioner, 34 T.C.M. 473 (1975) (United States-Sweden). In both cases, the Court focused on the consideration provided and held it to be insufficient given the "adequate and full" requirement in the respective treaty definitions of an annuity. Perkins, 40 TC at 339 ("evidence is completely lacking to substantiate petitioner's failure to contest the will was in any way consideration for the payments she received"); Lamm, 34 T.C.M. at 475 ("alimony payments fall well outside the scope of pensions and annuities, the payment of which, unlike alimony, is predicated upon the prior receipt of consideration").

In the present case, X purchased a lottery ticket for the sum of one dollar. In return, X is receiving Amount B per year for twenty years. It is not disputed that the sum of one dollar is adequate and full consideration for a lottery ticket. It is not, however, adequate and full consideration for the right to the periodic payments of Amount B over twenty years. Because the payments do not fall within the definition of an annuity in Article 20(2) of the Treaty, and there is no other article in the Treaty that would affect X's lottery winnings, they are not within the scope of the Treaty. Therefore, the proper rate of tax on the annual payments to X is 30 percent.

Finally, X may not rely on a letter from the Appeals Office to assert that no tax is due on the lottery payments in Year 5. Unless stated otherwise, any settlement for years prior to Year 5 is not applicable to Year 5. The IRS has not entered into an agreement with X for Year 5.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call Laurie Hatten-Boyd at (202) 622-3840 if you have any further questions.

/s/ Phyllis E. Marcus
Chief, Branch 2
Office of Associate Chief Counsel
(International)