Jackpot! You Lose?: Molding a Hybrid Approach to Demonstrate that Marketability Restrictions on Lottery Winnings Warrant Departure from IRS Annuity Tables When Valuating an Estate

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I. INTRODUCTION

In 1998, six ping pong balls changed Sam's life.[1] Defying the odds,[2] he won the Ohio Super Lotto jackpot of $40 million. Sam, who was a sixty-one-

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[1] This fact pattern, while based loosely on the facts of *Negron*, is completely fictional. *See* Negron v. United States, 553 F.3d 1013, 1014 (6th Cir. 2009). This fact pattern essentially doubles the jackpot amount and then utilizes the same percentages for calculating annual payments, the lump sum payment, the annuity table's calculation, and the additional tax liability. *See id.*

year-old janitor at the time, did not feel capable of responsibly saving an immediate lump sum payment of $20 million, so he opted for twenty-six annual payments of just over $1.025 million, for a total payment near $27 million. The annual payments were a great solution for Sam because he wanted to ensure that he would be able to pass on a considerable fortune. Furthermore, state law prohibited the sale of annual lottery payments. Thus, once Sam elected to receive annual payments, he could not change his mind later in search of a lump sum even if he was tempted to cash out his annual payments through a market transaction.

Sam died in 2008 with fifteen annual payments remaining.[3] After winning the jackpot in 1998, Sam updated his will with his lawyer, Milo, who served as the executor of Sam's estate. According to Sam's will, his estate was to be divided equally amongst his parents, his sister, and his favorite nephew.

The Ohio Lottery informed Milo that, at his election, the remaining annual payments could be immediately cashed out for a one-time lump sum payment to the estate.[4] If Milo elected this option, the Ohio Lottery would pay the estate approximately $8.7 million, the difference between the $20 million that Sam would have had if he elected a lump sum in 1998 and the sum of the annual payments that Sam received until his death in 2008. If Milo made this election, it would reduce the sum of all payments from $27 million to $20 million; however, it would allow the beneficiaries to receive a greater amount immediately, instead of splitting the remaining annual payments as scheduled.

As a fiduciary to Sam's legatees, Milo decided to weigh all the facts and circumstances before making a decision. By 2008, Sam's parents were already in their late nineties. Because they did not have sufficient savings or occupations that provided a comprehensive retirement plan, they were still employed with no real prospect of retiring. Sam's sister previously worked as an assembly line worker, but, in 2004, an uninsured driver hit her as she walked to work. The accident prevented her from returning to work, and by 2008, she was behind on her mortgage and the bank was ready to foreclose on her home. Sam's favorite nephew was a graduate of a prestigious law school, but a slumping job market meant that he could not meet the monthly payments for his six-figure student loan debt on the salary from his position at a fast food restaurant.

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[2] "A Massachusetts Institute of Technology professor calculated that the odds of winning a lottery jackpot were the same as visiting a casino . . . and being dealt four straight royal flushes, then walking out into the lobby and meeting four complete strangers who had the same birthday." RANDY BOBBITT, LOTTERY WARS: CASE STUDIES IN BIBLE BELT POLITICS, 1986–2005, at 16 (2007).

[3] Because he died after receiving his payment for 2008, Sam received a total of eleven payments.

[4] This option is not always available. However, this Note proposes a comprehensive solution that also accounts for an executor's election. In regard to this circuit split, only the Sixth Circuit dealt with a case involving this option. For summaries of the cases, see *infra* notes 5–6.

Milo elected the lump sum payment to the estate, and the Ohio Lottery processed the payment for $8.7 million. Milo reported this amount on the estate tax return and prepared the distributions.

But the Internal Revenue Service (Service) notified Milo that he did not include the appropriate amount on the return for the estate. According to the Service, the lump sum payment to the estate was an annuity and was, therefore, to be valuated in accordance with the annuity tables found in the Internal Revenue Code (Code) and Treasury Regulations (Regulations). The Service informed Milo that it was improper for the estate to value the payment based on the rate in effect when Sam won the lottery. Instead, the Service's tables used a rate in effect when Sam died in 2008.

The Service determined that the proper figure to be included on the return was just over $10.6 million, approximately $1.9 million more than the Ohio Lottery actually paid the estate. As a result, the Service assessed an additional tax of nearly $1.27 million. Thus, according to the Service, even though the estate received only $8.7 million from the Ohio Lottery, the estate's tax liability would be determined using the $10.6 million figure.

Milo assumed it was a simple computational error and decided to pay the additional tax, with interest, and to file a refund claim. But, much to Milo's surprise, the Service denied the refund, pointing to the Code and Regulations. As a final resort, Milo filed suit in the district court for a refund.

The difficulty in resolving whether the Service's annuity tables apply is evidenced by a circuit split. The Fifth and Sixth Circuits force estates to utilize the annuity tables,[5] while the Second and Ninth Circuits depart from the tables to determine the appropriate value for the returns.[6] And while the Fifth and

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[5] In *Cook*, the lottery winner died just five months after winning $17 million in the Texas Lottery. Cook v. Comm'r, 349 F.3d 850, 851–52 (5th Cir. 2003). Texas law required annual payments and restricted marketability by imposing the requirement of a judicial order. *Id.* at 851. The decedent's executor hired a valuation expert who valuated the estate's interest at $1,529,749 using a discounted cash flow and a non-marketability factor. *Id.* at 852. The Service used the annuity tables to determine a value of $3,222,919, which resulted in an $873,554 tax deficiency. *Id.* The Fifth Circuit concluded that because other non-marketable annuities were valued under the tables, "the value produced under the valuation tables [was] not so unreasonable or unrealistic as to warrant" departure from the tables. *Id.* at 857. In *Negron*, two lottery winners died after receiving eleven of their twenty-six annual payments for a $20 million jackpot in the Ohio Lottery. *Negron*, 553 F.3d at 1014. Ohio imposed an absolute restriction on marketability but allowed the executrix—the same for each estate—to elect a one-time, lump sum payment in lieu of the remaining payments. *Id.* The estate reported the amount realized, but the Service concluded that, through application of the annuity tables, the two estates were responsible for a total deficiency over $470,000. *Id.* The Sixth Circuit, relying heavily on *Cook*, concluded that the Service's calculation was correct because the results were not "unrealistic and unreasonable." *Id.* at 1021 (internal quotation marks omitted).

[6] In *Shackleford*, the lottery winner received only three annual payments after winning the California Lottery in 1987. Shackleford v. United States, 262 F.3d 1028, 1030 (9th Cir. 2001). At the time, California prohibited assignment and the estate was forced to continue receiving annual payments. *Id.* The estate argued that the $1,543,397 tax liability, without an

Sixth Circuits rely heavily on the Code and Regulations, the Second and Ninth Circuits utilize a theoretical argument to conclude that, because of the marketability restrictions in place on the lottery winnings, the tables should be avoided.

This Note proposes a hybrid approach for resolving whether the annuity tables apply in this situation. The solution combines the theoretical analysis of the Second and Ninth Circuits to emphasize the importance of marketability, while relying heavily on the Code and Regulations, which is consistent with the analysis by the Fifth and Sixth Circuits. However, because the Fifth and Sixth Circuits failed to apply a complete analysis, this Note also introduces additional elements to create a hybrid approach.

Resolving this issue is even more important because the Service might also be improperly valuating other annuities with marketability restrictions.[7] While some lottery winners may not elicit sympathy with respect to estate taxes, the implication of other restricted annuities presents an *even larger problem* for estate planning and the Service.

This Note develops a hybrid approach through an analysis of the characteristics of lottery winnings, the fundamentals of valuation, and the relevant statutory and regulatory framework. Part II begins by providing a description of lottery winnings, which establishes a context for applying valuation theory and the appropriate framework. To display the root problem, Part III demonstrates the proper approach to valuation. Because the ultimate calculation should be designed to determine the actual present value of the lottery winnings, this discussion focuses on the importance of classifying the payment streams as annuities, which are properly valued using a date of death discount rate. Furthermore, this Part advances the position that marketability is relevant for valuation purposes, even when an estate owns risk-free annuities. Part IV analyzes the Code and Regulations to determine whether the tables apply to these annuities and, since they do not, the Part establishes guidelines

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immediate source to pay the tax, "did not reflect the fair market value of the asset" since it could not be sold to raise money for the payment. *Id.* The Ninth Circuit departed from the tables, concluding that "there is little doubt that the statutory restrictions on transfer reduced the fair market value," which meant that the tables produced an unrealistic and unreasonable result. *Id.* at 1032. In *Gribauskas*, the decedent and his wife won almost $16 million in the Connecticut Lottery. Estate of Gribauskas v. Comm'r, 342 F.3d 85, 86 (2d Cir. 2003). After divorcing his wife, the decedent died with eighteen installments remaining. *Id.* In Connecticut, "all prizes in excess of $1 million . . . could not be accelerated under any circumstances," and third party assignment was absolutely restricted. *Id.* For an apparently inexplicable reason, the Service stipulated to the fact that non-marketability devalued the right to the annuity. *Id.* The Service valued the annuities at nearly $1 million more than the estate had and imposed a deficiency of $403,167. *Id.* at 86–87. The Second Circuit concluded that, specifically because the parties stipulated to the valuation principles, the tables produced an unrealistic and unreasonable result. *See id.* at 88.

[7] This is an ironic discovery considering that the Fifth and Sixth Circuits relied on the treatment of these other annuities to determine that the tables should apply in this problem. *See infra* Part IV.B.

for the proper calculations by utilizing the fundamentals that are developed in Part III. The hybrid approach is designed to address the problems in all of the circuits involved in this split. As a result, the analysis in each Part is often bifurcated to demonstrate the difference between the states that allow executor-elected lump sum conversions and the states that require continued annuity payments.

II. DEVELOPING THE PROBLEM: CHARACTERISTICS OF LOTTERY WINNINGS

The all-encompassing application of annuity tables is a simple, uniform solution to financial payments structured in myriad ways.[8] However, straightforward answers are rarely as simple in application as they are in prescription. With the definition of annuity as broad as the definition of income,[9] the Service ironically created ambiguity in its effort for simplicity.

To date, all of the circuits that have dealt with this problem turned to a judicial test to reach a conclusion.[10] The judicial test seeks to discover if application of the annuity tables would be unrealistic and unreasonable. But their inquiry is only relevant if § 7520(a) applies.[11] If the Code and Regulations actually preclude use of the Secretary's tables by themselves, then there is no need to discuss whether application of the tables produces an unrealistic or unreasonable result.[12]

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[8] *Cook*, 349 F.3d at 854 (citing Bank of Cal. v. United States, 672 F.2d 758, 760 (9th Cir. 1982)) ("In enacting § 7520(a)(1) and requiring valuation by the tables, Congress displayed a preference for convenience and certainty over accuracy in the individual case.").

[9] "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived . . . ." I.R.C. § 61(a) (2006). For the discussion on what constitutes an annuity, see *infra* Part III.A.

[10] All four of the circuits concluded that the tables applied unless they created an unrealistic and unreasonable result. *See, e.g.*, *Negron*, 553 F.3d at 1017–21 (discussing application of the unrealistic and unreasonable results doctrine); *Cook*, 349 F.3d at 854–57 (discussing application of the unrealistic and unreasonable results doctrine); *Gribauskas*, 342 F.3d at 87–89 (discussing application of the unrealistic and unreasonable results doctrine); *Shackleford*, 262 F.3d at 1030–33 (discussing application of the unrealistic and unreasonable results doctrine). This judicially developed test stems from the Tax Court's analysis. *See* Weller v. Comm'r, 38 T.C. 603, 612 (1962) ("[The tables' calculations] must be sustained unless it is shown that the result is so unrealistic and unreasonable that either some modification in the prescribed method should be made . . . or complete departure from the method should be taken, and a more realistic means of determining value is available." (citations omitted)).

[11] § 7520(a).

[12] This is because the purpose of the unrealistic and unreasonable results test is to determine whether departure from the tables is warranted *after* the court has made a determination that, based on the provisions of the Code and Regulations, the annuity falls within the grasp of § 7520(a). Essentially, you cannot get to the judicial test until you determine that the tables capture the annuities. If the tables do not capture the annuities, you never arrive at the unrealistic and unreasonable analysis. To confirm this as the approach, see *supra* note 10 and accompanying text.

If the Code and Regulations mandate departure from the tables, then conducting this judicial test ignores established exceptions to § 7520(a).[13] The danger of using the tables when they are inapplicable is that applying the tables could assume value that does not exist. If this happens, the tables calculate an inappropriately high taxable amount, thereby moving our system of taxation out of the realm of reality and into the sphere of phantom taxation.[14]

The characteristics of particular payment schemes determine whether departure is mandatory. As a result, it is important to understand the characteristics of these restricted rights before determining how to classify them under the Code.[15]

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[13] Even though § 7520(a) states that "any annuity" must be valued under the Secretary's tables, the Regulations provide exceptions for "restricted beneficial interests" and "other beneficial interests," thereby limiting the broad statement in § 7520(a) to what the Regulations call "ordinary annuity interests." *See* Treas. Reg. § 20.7520-3(b)(1)(i)–(iii) (as amended in 1995). Thus, conducting the judicial test to determine whether departure from the overly broad statement in the Code is warranted suggests a general disregard for the Regulations' explicit exceptions to the tables, specifically in instances in which the regulatory exceptions apply. The Code has no problem carving out exceptions to other overarching statements. For example, § 469(a) disallows a deduction for a passive activity loss, while the remainder of the section discusses the calculation for allowing such loss to offset passive activity gain, culminating in § 469(g), which allows a loss that was previously categorized as a passive activity to suddenly receive different treatment upon disposition, ultimately resulting in a deduction. I.R.C. § 469(a), (g). Furthermore, § 267(a) might lead one to believe that a loss on the exchange of property between certain related parties could never be deducted under any circumstance; however, § 267(d) gives the transferee favorable treatment in gain recognition, thereby achieving a markedly similar result to the one that § 267(a) seeks to block. § 267(a), (d). For further examples, see the treatment of vacation homes and home offices in § 280A.

[14] While it is arguable whether using income as the tax base is the best method, it is commonly justified on the belief that "taxes should be imposed on individuals in accordance with their relative abilities to pay," and income appropriately quantifies that ability. RICHARD SCHMALBECK & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION 21 (2d ed. 2007). Income is reality. While the source of the income may not be relevant to the Service, the value remains relevant in determining tax liability. If a taxpayer makes $50,000 in a year, the income tax treats the $50,000 as a starting point, pursuant to the principle that such a taxpayer has the ability to contribute a portion of the income that he or she actually received. But the justification of an income tax does not comport with the notion that the taxpayer's starting point may be an amount greater than his or her income. Increasing the tax rate for specific income levels may disturb some taxpayers, but it does not undermine the justification of the system; however, pretending that the taxpayer who made $50,000 should have the ability to pay taxes as if he or she had received $75,000 destroys the system's reliance on income as a measurement of an ability to pay.

[15] Of the four cases creating the split, *Negron* offers the most comprehensive comparison, laying out most of the relevant sections of the Code and Regulations and discussing how all of the other circuits classified the lump sum conversions; however, as this Note argues, the dive into the Code and Regulations ceased too early, and the Sixth Circuit overlooked a vital attribute of the Ohio Lottery's election scheme. *See generally Negron*, 553 F.3d 1013.

A. *Understanding the Lottery: Who Plays?*

Lotteries are a form of gambling that is monopolized by the state in which they exist.[16] The Code does not impose any tax on a wager placed in a lottery that is conducted under state law,[17] but taxes gambling winnings as ordinary income.[18] It is unlikely that the ordinary income classification—instead of capital gains—is a determinative factor when purchasing a lottery ticket; rather, purchasing a lottery ticket is likely more attributable to socioeconomic factors.[19]

Both the relative ease of access and inexpensiveness of lotteries seem to contribute to the body of gamblers that takes part in the drawings. Unlike more sophisticated forms of gambling that one might find in a Las Vegas casino, lotteries attract generally poor gamblers who are primarily over fifty-years-old and, if not retired, are employed in mainly blue collar occupations.[20] These age

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[16] *See* Chickasaw Nation v. United States, 534 U.S. 84, 87 (2001) (stating that lotteries are state-operated gambling operations). Currently, forty-three states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands have lotteries. *Lottery Results*, USA.GOV, http://www.usa.gov/Topics/Lottery-Results.shtml (last updated Mar. 27, 2012). The seven states that do not have state lotteries are Alabama, Alaska, Hawaii, Mississippi, Nevada, Utah, and Wyoming. *Id.* For a comprehensive discussion of why states choose to monopolize lotteries, see Lloyd R. Cohen, *The Lure of the Lottery*, 36 WAKE FOREST L. REV. 705, 725–29 (2001). The importance of this monopoly cannot be overstated. As developed in this Note, the fact that a state lottery can impose certain conditions (e.g., any array of marketability restrictions, the utilization of date of jackpot discount rates, and annuity buyout only by the state lottery itself) is a major factor in creating the disparity between an estate and the Service.

[17] § 4402(3). This principle also applies to lotteries conducted by American Indian tribes. *See* George Jackson III, Chickasaw Nation v. United States *and the Potential Demise of the Indian Canon of Construction*, 27 AM. INDIAN L. REV. 399, 414 (2002).

[18] I.R.C. § 61(a) (2006) ("[G]ross income means all income from whatever source derived . . . ."). However, gambling winnings can be offset by gambling losses in the taxable year. § 165(d). The IRS published the top seven facts to know about gambling winnings. *IRS Tax Tip 2010-34*, INTERNAL REVENUE SERV., http://www.irs.gov/newsroom/article/0,,id=108277,00.html (last updated Oct. 5, 2011). Some jurisdictions employ the substitute-for-ordinary income doctrine, which holds that "lump sum consideration . . . for something that would be treated as ordinary income in the future should be treated as ordinary rather than capital." *See* Timothy R. Koski, *A New Twist to the Substitute-for-Ordinary Income Doctrine: Third Circuit Adopts "Family Resemblance" Test to Characterize Sale of Lottery Proceeds as Ordinary Income*, 83 N.D. L. REV. 27, 29 (2007). Other courts rely on the fundamental differences between ordinary income and capital gains. *See, e.g.*, United States v. Maginnis, 356 F.3d 1179, 1182–83 (9th Cir. 2004).

[19] *See generally* Edward J. McCaffery, *Why People Play Lotteries and Why It Matters*, 1994 WIS. L. REV. 71.

[20] The poor spend a greater proportion of income on lotteries. REUVEN BRENNER & GABRIELLE A. BRENNER, GAMBLING AND SPECULATION: A THEORY, A HISTORY, AND A FUTURE OF SOME HUMAN DECISIONS 26 (1990). While not dispositive, two surveys—one conducted in Michigan between 1973 and 1980 of "big winners ($1 million or more)" and the other in New York between 1977 and 1978—resulted in findings that 60% of winners were above the age of fifty. *Id.* at 28. The winners had five children and six grandchildren on

characteristics might further augment the tax problem that lottery winnings pose to estate planning, since many of the winners would be at an age in which estate planning becomes more necessary.

B. *Understanding the Lottery: What Happens When You Win?*

When a taxpayer wins in a major state lottery,[21] the first decision that must be made is whether to take a one-time lump sum payment or, in the alternative, to opt for annual payments.[22] If a winner claims the cash prize instead of opting for annual payments, a state lottery actually only pays out roughly one-half the advertised prize amount since the winner immediately gets the money that the lottery would have invested in order to make the annuity payments.[23] An initial election of a lump sum—even though discounted by the state lottery as if it were a settlement of annuity payments—results in the inclusion of the amount of the lump sum in gross income,[24] and is not subject to the Secretary's annuity tables.

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average. *Id.* Further, the occupations of the winners who were not retired were "characteristic of the poor or the lower middle class: [t]he winners were janitors, factory workers, and so forth." *Id.*

[21] For a comprehensive discussion of why people play the lottery, see McCaffery, *supra* note 19.

[22] *See, e.g.*, *Frequently Asked Questions*, ILL. LOTTERY, http://www2.illinoislottery.com/subsections/news03.htm (last visited Apr. 14, 2012); *Frequently Asked Questions About Claiming a Washington's Lottery Prize*, WASH. LOTTERY, http://www.walottery.com/Games/MegaMillions/ClaimYourPrize/Default.aspx (last visited Apr. 14, 2012); *Michigan Lottery*, MICHIGAN.GOV, http://www.michigan.gov/lottery/0,1607,7-110-46442_812_36111---,00.html (last visited Apr. 14, 2012). In Ohio, Super Lotto winners have sixty days to decide whether to continue with the annuity option or take a discounted lump sum. OHIO ADMIN. CODE 3770:1-9-53(H)(2) (2010). There are many factors to consider when deciding whether to take a lump sum payment or annual installments. A lump sum payment results in an immediate realization considerably less than the advertised jackpot, but if you are a competent investor, the difference can be recouped—likely with profits in excess of the jackpot—over what would have been the installment period. In regard to the issue at hand, an upfront lump sum election would prevent the Service from imposing the annuity tables. For a discussion of factors to consider should you be lucky enough to win the lottery, see Fin. Planning Ass'n, *Winning the Lottery or a Pension: One Lump or Many?*, PRAC. PLANNER (Apr. 2004) http://www.practicalplanner.com/financial_articles/Winning_the_Lottery_Lump_Sum_or_Annuity.pdf.

[23] *See, e.g.*, *If You Win a Jackpot*, MO. LOTTERY, http://www.molottery.com/whenyouwin/jackpotwin.shtm (last visited Apr. 14, 2012).

[24] JOSEPH BANKMAN ET AL., EXAMPLES AND EXPLANATIONS: FEDERAL INCOME TAX 90 (5th ed. 2008). "You must withhold federal income tax from the winnings if the winnings minus the wager exceed $5,000. Withhold 25% of the proceeds (the winnings minus the wager). This is regular gambling withholding." *Instructions for Forms W-2G and 5754 (2012)—2. Sweepstakes, Wagering Pools, and Lotteries: Withholding*, INTERNAL REVENUE SERV., http://www.irs.gov/instructions/iw2g/ar02.html#d0e401 (last visited Apr. 14, 2012). Lottery winnings can be offset by gambling losses. I.R.C. § 165(d) (2006).

If a winner elects to receive annual payments of lottery winnings, the annual payments are considered annuities for federal income tax purposes.[25] The problem at hand arises when a winner elects to receive annual payments of lottery winnings and dies before receiving all of the payments.[26]

III. THE PROBLEM: DYING WITH REMAINING ANNUAL PAYMENTS

The Service imposes an estate tax on the transfer of the taxable estate of a decedent who is a citizen or resident of the United States.[27] The estate tax is based on a valuation at the time of death,[28] and the value varies depending on the decedent's interest in the property at death.[29] If a decedent owned an annuity, the value of the estate includes the amount,[30] and while the general rule for valuation is the fair market value at the decedent's death,[31] annuities are valued under the Secretary's tables.[32]

In determining the taxable amount for an estate, the Service requires imposition of the annuity tables for the purpose of calculating "the value of *any* annuity."[33] This statement, simple in form but not necessarily in application, "display[s] a preference for convenience and certainty over accuracy in the individual case."[34] But for this treatment to be correct, a question must be answered: Does "any" really mean "all"?[35]

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[25] "The term 'annuity' is very broad and references 'one or more payments extending over any period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic.'" Negron v. United States, 553 F.3d 1013, 1016 (6th Cir. 2009) (quoting Treas. Reg. § 20.2039-1(b)(ii)).

[26] It is important to remember that there are two valuating parties in these scenarios and this problem arises, at the most fundamental level, because the estate's treatment—whether the state lottery allows an executor election—is not endorsed by the Service.

[27] I.R.C. § 2001(a) (2006).

[28] § 2031(a).

[29] § 2033.

[30] § 2039(a).

[31] Treas. Reg. § 20.2031-1(b) (as amended in 1965). The Regulations state that "fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *Id.* "To provide a proper value for estate tax purposes, the hypothetical buyer must hold the same property rights as the estate." *Negron*, 553 F.3d at 1020 (citing Davis v. United States, 491 F. Supp. 2d 192, 197 (D.N.H. 2007)). "The relevant value is the value in the hands of the decedent, not the value to a hypothetical buyer holding a different property interest with substantially greater risks." *Id.* (citing Estate of Donovan v. United States, No. Civ.A.04-10594-DPW, 2005 WL 958403, at *5 (D. Mass. Apr. 26, 2005)).

[32] I.R.C. § 7520(a).

[33] *Id.* (emphasis added).

[34] Cook v. Comm'r, 349 F.3d 850, 854 (5th Cir. 2003) (citing Bank of Cal. v. United States, 672 F.2d 758, 760 (9th Cir. 1982)). By no means should this statement suggest that the tables calculate inaccurate figures. Ostensibly, the tables are not *narrowly* tailored; however, if they are *appropriately* tailored to the annuities at issue here, the result will in

A. *Do These Estates Own Annuities?*

The term "annuity" is defined broadly to capture all annuities. An annuity can be a single payment, can extend over any period of time, and is not required to be equal, unconditional, or periodic.[36] The Regulations clarify further that a decedent has the right to receive an annuity as long as he or she had an enforceable right—immediately before death—to receive payments in the future.[37]

Different state lotteries treat obligations upon the death of a lottery winner differently. In some states, if a winner opts for the annual payments, the payments continue to the estate on an annual basis.[38] Unsurprisingly, the Service continues to treat these payments as annuities.[39] However, other states allow the executor to elect a one-time, discounted lump sum payment in lieu of the remaining annual payments.[40] Even though this payment mirrors an initial lump sum election, it does not receive the same tax treatment because it is a settlement of remaining annuity payments.[41] Accordingly, the Service also treats the lump sum payment to the estate as an annuity.[42] The first step in analyzing whether the annuity tables apply is to confirm that the Service is correct that the estates own annuities in both of these situations.

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fact be accurate, or at least more accurate than less appropriate calculations by estates or state lotteries.

[35] § 7520(a). The answer to this question is developed throughout this Note.

[36] *See* Treas. Reg. § 20.2039-1(b) (as amended in 1986). Thus, an annuity can be unequal, conditional, and sporadic. *See id.*

[37] *Id.*

[38] *See, e.g.*, *FAQs*, DEL. LOTTERY, http://lottery.state.de.us/faqs.asp#18 (last visited Apr. 14, 2012); *FAQs*, GA. LOTTERY, http://www.galottery.com/help/faqs#5 (last visited Apr. 14, 2012). Three of the four circuits involved in this circuit split evaluated fact patterns in which the annual payments continued to the estates. The Sixth Circuit evaluated the Ohio Lottery's method of allowing the executor to elect a one-time, lump sum payment to the estate. For more detailed descriptions of these cases, see *supra* notes 5–6.

[39] *See* § 20.2039-1(b).

[40] *See, e.g.*, OHIO REV. CODE ANN. § 3770.07(D)(2)(b)(5) (West 2006).

[41] All four circuits concluded that the estates owned annuities, including the Sixth Circuit, which evaluated two estates that had lump sum options. In *Negron*, the Sixth Circuit stated, "Every court that considered whether the IRS annuity tables should be used . . . prior to December 14, 1995, found that the remaining lottery payments were annuities." Negron v. United States, 553 F.3d 1013, 1017 (6th Cir. 2009). "For valuation dates after December 13, 1995, every court . . . has determined that the payments were annuities . . . ." *Id.* at 1018–19. Even though the circuits split over whether to apply the tables, this discrepancy results because the Second and Ninth Circuits concluded that the annuity tables produced unrealistic and unreasonable results, and not because they found the payments not to be annuities. *See* Estate of Gribauskas v. Comm'r, 342 F.3d 85, 89 (2d Cir. 2003); Shackleford v. United States, 262 F.3d 1028, 1033 (9th Cir. 2001).

[42] *See* Treas. Reg. § 20.2039-1(b) ("The term 'annuity or other payment' as used with respect to both the decedent and the beneficiary has reference to *one* or more payments extending over any period of time." (emphasis added)).

When a state lottery requires estates to receive continued annual payments of restricted lottery winnings, the Service's stance that the estate owns an annuity is correct,[43] because the estate owns the right "to one or more payments extending over any period of time."[44] The fact that the lottery winner died does not implicate any exception to the definition of an annuity because the relevant rights are unchanged and, therefore, the result is essentially a continuation of the facts and circumstances prior to the decedent's death.

At first glance, it is less clear that an estate owns an annuity when the state lottery empowers the executor to make a lump sum election.[45] In order for this Note to also apply in this situation, the lump sum option must not destroy the appropriateness of annuity treatment.[46] But concluding that the *option alone* does not negate annuity treatment is insufficient, as evidenced by the fundamental difference in the tax treatment between initially *electing* a lump sum and initially *electing* annual payments.[47] In order to ensure that these situations truly involve annuities, *an actual lump sum election by an executor* must not destroy annuity treatment.

Thus, for a marketability-related solution to involve the decisions rendered by all four of the circuits that dealt with estate-owned, restricted lottery winnings, it must be correct for the Service to treat an executor-elected lump sum *payment* as an annuity.[48] But to resolve this inquiry, we must ask a fundamental question: Is it correct for the Service to define a lump sum payment in settlement of prior-elected annual payments as an annuity when the Service does not treat an initial lump sum election as an annuity?

The Service is correct to treat the lump sum payment to the estate as an annuity,[49] because its treatment is rooted in reality.[50] When the lottery winner

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[43] This is true even if the only restriction is a judicial order, which would allow the estate to sell the right to the remaining payments. *See, e.g.*, Cook v. Comm'r, 349 F.3d 850, 851 (5th Cir. 2003); I.R.S. Tech. Adv. Mem. 96-16-004 (Dec. 29, 1995).

[44] *See* § 20.2039-1(b).

[45] *See, e.g.*, OHIO REV. CODE ANN. § 3770.07(D)(2)(b)(5).

[46] In other words, if these streams are not appropriately classified as annuities, the Service cannot apply the annuity tables regardless of whether the lottery winnings are encumbered by marketability restrictions.

[47] *See supra* Part II.B, stating that the Service does not treat the original choice to take a lump sum as the settlement of an annuity.

[48] This analysis is required because concluding that the *right* to make the election did not destroy annuity treatment would not resolve this problem if an *actual election* did destroy annuity treatment.

[49] This does *not* mean that the Service's treatment *overall*, in applying the annuity tables, is correct. Rather, because the lump sum payment to the estate is an annuity, the Service is correct in looking to the tables. This Note will demonstrate how these payments, while annuities, are *not* properly valued under the Service's annuity tables. In summary, this is because there are various categories of annuities and only ordinary annuities are properly valued under the tables. For this discussion, see *infra* Part IV.

[50] All four circuits agree with the Service's treatment as well. For reference, see *supra* note 41 and accompanying text.

dies, his or her estate has the right to receive either one payment or the outstanding annual payments.

This result should occur regardless of the number of outstanding payments as long as there is at least one. The Regulations define an annuity broadly as the right to "one or more payments extending over any period of time," which can "be equal or unequal, conditional or unconditional, periodic or sporadic."[51]

The correctness of this treatment can be confirmed by analyzing, at two alternative times, an estate that does not have the power to elect a lump sum payment. For example, if the decedent owned the right to ten more annual payments of $100,000 at death, then, under § 20.2039-1(b), the winner owned the right to ten more *annuity* payments.[52] And, if the decedent instead died nine years later and therefore owned the right to one more payment of $100,000, then, under § 20.2039-1(b), the winner owned the right to one more *annuity* payment.[53]

Practically, the lump sum payment is an annuity because the estate owned the right to at least one more payment. This is true even though the payment is in the form of a lump sum for an amount less than the total of the remaining payments, because the one-time payment—in its purest form—is an acknowledgement that the decedent owned the right to receive annual payments, and the payments can be annuities even if they are "unequal."[54] If, in the example above, the executor made a lump sum election in lieu of the ten remaining payments, the ten-year right to the annuity would be accelerated and paid. This result would not change the character of the underlying stream because the one-time payment is no different than if the estate was entitled to just one more annual payment, and the fact that the lump sum amount is not equal to the prior payment amounts is irrelevant under the Regulations.[55]

This determination, however, that these estates own annuities is insufficient, alone, to solve this problem. The calculations themselves must also be representative of the underlying annuity stream in order for the application of the tables to reach an accurate tax result.

B. *Calculating the Present Value of Annuities: Determining the Correct Rubric for Valuation*

Determining the appropriate method for calculating present value is important for at least two reasons. First, if the annuity tables apply to the payments at hand, the tables should be designed to valuate the payments correctly. Second, if the tables do not apply and some other present value calculation is warranted, such a calculation should be fundamentally sound.

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[51] Treas. Reg. § 20.2039-1(b) (as amended in 1986).

[52] *See id.*

[53] *See id.*

[54] *Id.*

[55] *See id.*

In general, the sum of remaining annuity payments does not reflect the present value of the right to the payments.[56] The correlation is skewed largely due to inflation and, as a result, a discount rate is used to determine the present value of the remaining payments.[57] The present value is the current worth of a future sum of money or stream of cash flows given a specified rate of return.[58] Fundamentally, "money to be paid or received in the future is not worth as much as money to be paid or received today."[59] Even when there is no risk that a payer will default, the right to receive $1000 a year from now is worth something less than $1000 today.[60]

The Secretary's tables[61] establish that the present value of an annuity is its fair market value,[62] which is ultimately included in the estate.[63] Fair market value is defined in the Regulations as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[64] Additionally, "[t]he fair market value of a particular item of property includible in the decedent's gross estate *is not to be determined by a forced sale price*."[65] There is no alternative definition of fair market value within the Code specifically relating to non-marketable assets.

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[56] *See* SCHMALBECK & ZELENAK, *supra* note 14, at 20–21. Professors Schmalbeck and Zelenak provide an example of a present value calculation using an 8% discount rate over a twenty-year period. *Id.* According to the present value table, the present value of $1 at the end of twenty years using an 8% discount rate is 21.5 cents. *Id.* Thus, the sum of the remaining annuity payments, because they are due over time, is not equal to the present value of the right to the remaining payments. *See id.* This also means that by investing just $215 today, a person could fund a $1000 liability in twenty years. *Id.*

[57] *See* Negron v. United States, 553 F.3d 1013, 1014 (6th Cir. 2009). A calculation is necessary because $1000 today has more purchase power than $1000 in the future. For a summary of the time value of money, see Shauna Carther, *Understanding the Time Value of Money*, INVESTOPEDIA (Sept. 1, 2008), http://www.investopedia.com/articles/03/082703.asp.

[58] *Present Value*, INVESTOPEDIA, http://www.investopedia.com/terms/p/presentvalue.asp (last visited Apr. 14, 2012).

[59] ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS 19 (2006).

[60] *Id.* "If one had $1,000 today, one could invest it for a year in a riskless investment and thereby earn one year's interest in addition to the original $1,000. Thus, $1,000 payable a year from now has to be worth somewhat less than $1,000 in hand today." *Id.*

[61] *See generally* Treas. Reg. § 20.2031-7(d) (as amended in 2009); Temp. Treas. Reg. § 20.2031-7T(d) (as amended in 2009). Section 20.2031-7 applied between April 30, 1999 and May 1, 2009 (not inclusive). § 20.2031-7(e). Section 20.2031-7T is a temporary section that applies on or after May 1, 2009. § 20.2031-7T(d).

[62] Temp. Treas. Reg. § 20.2031-7T(a)–(b) (referencing § 20.2031-7(a)).

[63] I.R.C. § 2039(a) (2006).

[64] Treas. Reg. § 20.2031-1(b) (as amended in 1965). The Regulation provides: "For example, the fair market value of an automobile . . . is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public . . . ." *Id.*

[65] *Id.* (emphasis added).

To determine present value, future cash flows are discounted at the discount rate, and the higher the discount rate, the lower the present value of the future cash flow.[66] Therefore, determining a discount rate is the key to properly valuing a cash flow,[67] and the utilization of diverging discount rates can create diverging valuations. In general, the discount rates in this problem can be divergent for two reasons: first, the factors that make up discount rates can be different, and second, the selection of the appropriate discount rate can be different based on timing.

1. *The Key to the Key: What Makes a Discount Rate?*

Developing a discount rate is an inexact process.[68] Practically, there cannot be a uniform discount rate for the purposes of every type of calculation because the future values of different property, resources, and streams are not dependent on each other.[69] As a result, the development of a discount rate is often dependent on the underlying instrument.[70]

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[66] *See id.*

[67] *See id.*

[68] *See* HAMILTON & BOOTH, *supra* note 59, at 29 ("Unfortunately, there is no simple answer to the question of which discount rate to use in all circumstances in the real world.").

[69] This is because a discount rate is comprised of various factors. *See, e.g.*, PAT DORSEY, THE FIVE RULES FOR SUCCESSFUL STOCK INVESTING: MORNINGSTAR'S GUIDE TO BUILDING WEALTH AND WINNING IN THE MARKET 144–45 (2004); HAMILTON & BOOTH, *supra* note 59, at 29; *infra* note 71 and accompanying text. A change in interest rates can make some investments more desirable than others because the investments, while impacted by interest rates, are not impacted by the desirability of the substitute investments. *Compare* FRED CRANE, CALIFORNIA REAL ESTATE PROPERTY MANAGEMENT 325 (4th ed. 2007) ("[R]eal estate values go flat or decrease during periods of increasing . . . interest rates . . . ."), *with* GEORGE A. FONTANILLS & TOM GENTILE, THE STOCK MARKET COURSE 164 (2001) (stating that as interest rates increase the value of the dollar increases). Furthermore, some investments may move in the same direction in response to a change in the interest rate, but because one will necessarily occur before the other, the first to change is inherently independent of the subsequent to change. *See* JOEL G. SIEGEL ET AL., INTERNATIONAL ENCYCLOPEDIA OF TECHNICAL ANALYSIS 151 (2000) ("When interest rates rise, the dollar will turn up first. After a time the advancing dollar will push interest rates lower, and the bond market will see a positive response. Stocks will then move upwards."). This process continues in a cyclical fashion that may encompass several years. *Id.* at 151–52.

[70] Since different investments have different attributes, the factors determining the discount rate for two different investments will be different because the attributes are taken into account when determining the appropriate discount rate. *Compare* SANJAY MOHAPATRA, BUSINESS PROCESS AUTOMATION 230 (2009) (discussing the use of the weighted average cost of capital and benchmark returns for similar projects), *with* MICHAEL CURLEY, HANDBOOK OF PROJECT FINANCE FOR WATER AND WASTEWATER SYSTEMS 60–61 (1993) (discussing the use of the consumer price index amongst other methods).

Risk and opportunity cost are two of the most pertinent factors in determining an appropriate discount rate.[71] When risks or interest rates increase, a discount rate increases.[72] The higher the discount rate, the lower the present value of the right to receive annuity payments.[73]

Another important facet of the discount rate is marketability. Marketability essentially measures the ability to transfer rights. A restriction on marketability is anything that inhibits this capability, and marketability restrictions can range in force from the requirement of a signature, to a judicial order, and even all the way to a full restriction on assignability. It is a "basic economic tenet that an asset subject to marketability restrictions is worth less than an identical asset without marketability restrictions."[74] Marketability restrictions are significant within this context because some states severely limit the winner's dominion over his or her lottery winnings.[75]

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[71] DORSEY, *supra* note 69, at 144. "The choice depends on the current level of market interest rates, the investment alternatives available to the parties, and the risk in the loan or investment to be made." HAMILTON & BOOTH, *supra* note 59, at 29.

[72] DORSEY, *supra* note 69, at 144–45. If investment *A* is significantly riskier than investment *B*, but they are otherwise identical, investment *B* will have a greater present value because increased risk leads to an increased discount rate, which results in a lower present value. Since a higher level of risk means a higher discount rate, there is a correlation between increased risk and a decreased present value. When initially investing, people will seek to be compensated for increased risk. However, when evaluating how much a risky investment is worth, the risk, which increases the discount rate, ultimately results in a lower present value because there is a chance that the investor could lose part or even all of the investment before realization is possible.

[73] HAMILTON & BOOTH, *supra* note 59, at 30 ("Of course, the greater the risk, the higher the discount rate (and the lower the present value of that payment) will be.").

[74] Negron v. United States, 553 F.3d 1013, 1019 (6th Cir. 2009) (citing Estate of Donovan v. United States, No. Civ.A.04-10594-DPW, 2005 WL 958403, at *3 (D. Mass. Apr. 26, 2005)). The Fifth and Sixth Circuits held that marketability restrictions are factored into the annuity tables. *See Negron*, 553 F.3d at 1020; Cook v. Comm'r, 349 F.3d 850, 856 (5th Cir. 2003). However, in an uncomfortable step of logic, both circuits later concluded that a marketability factor is not necessary in these instances because the income stream was guaranteed, and then proceeded to apply the tables that they concluded accounted for non-marketability. *See Negron*, 553 F.3d at 1020 (citing *Cook*, 349 F.3d at 857). Because marketability restrictions reduce the value of an income stream, the courts essentially acknowledged that it was acceptable to understate the value of the remaining payments, which, as the courts held, need not be evaluated using a marketability factor. Even though the payments were devalued, the result was not unrealistic or unreasonable and, therefore, the tables were utilized. *See id.* at 1021. This issue is developed throughout this Note.

[75] *E.g.*, OHIO REV. CODE ANN. § 3770.07(D)(1) (West 2004) (disallowing general assignability, but allowing for the payment to the executor). In most states, future payments of lottery winnings can be assigned. *E.g.*, FLA. STAT. ANN. § 24.1153 (West 1999); MASS. GEN. LAWS ch. 10, § 28 (2004); TEX. GOV'T CODE ANN. § 466.410(a) (West 2004); *Winners' Handbook*, CAL. LOTTERY, 8 (2012), http://static.www.calottery.com/~/media/Publications/Popular_Downloads/Winners-handbook-Complete-update-02-23-12.ashx.
While the Texas statute does not allow assignments for payments in the final two years of the prize payment schedules, the Texas Court of Appeals invalidated the distinction, resulting in assignability of all installments. Tex. Lottery Comm'n v. First State Bank of

One of the reasons why marketability affects the discount rate is because marketability is linked to the discount rate's risk factor.[76] In *Negron v. United States*, the Sixth Circuit argued that annuity payments by state lotteries for fixed amounts are effectively devoid of any real risk because the future payments are backed by a state agency.[77] As a result, the Sixth Circuit, in calling the annuity a "guaranteed income stream," determined that a marketability factor is irrelevant when an annuity is riskless.[78] However, this conclusion is difficult to reconcile with the court's ultimate decision to apply the tables because it creates a contradiction: since a discount rate—absent some other prevailing factor—moves in tandem with risk, applying the Secretary's tables, which apply uniformly to anything deemed an annuity, could result in an overstated discount rate if the tables account for both risk *and* non-marketability.[79] One way to

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DeQueen, 254 S.W.3d 677, 685 (Tex. App. 2008). California restricts assignments in the final three years and the Second District refused to adopt the Texas holding. Stone St. Capital, LLC v. Cal. State Lottery Comm'n, 80 Cal. Rptr. 3d 326, 335 n.9 (Ct. App. 2008). In fact, several financial companies purchase lottery payments for lump sum cash. *See, e.g.*, WOODBRIDGE STRUCTURED FUNDING, LLC, http://www.woodbridgeinvestments20.pth4.com/ (last visited Apr. 14, 2012); J.G. WENTWORTH, http://welcome.jgwentworth.com/?kid=1BMV6 (last visited Apr. 14, 2012). However, the assignment must usually be approved by court order. *E.g.*, TEX. GOV'T CODE ANN. § 466.410(b).

In *Davis v. Commissioner*, 119 T.C. 1 (2002), a California Lottery winner, entitled to fourteen future annual installments of $679,000, assigned a portion of the future installments to Singer Finance Asset Company, LLC. *Id.* at 3. However, the winner, in order to legally assign the payments, obtained an order from Sacramento County Superior Court approving the assignment. *Id.* The requirement of a court order in these states is a marketability restriction.

> Market value is used to describe the price of an asset, assuming that a willing buyer and willing seller can come to terms under normal market conditions. . . . Fair market value, like market value, assumes that each party is knowledgeable and can evaluate the risks and rewards associated with the transaction. . . . A minority interest, by definition, does not have a controlling interest in the asset and therefore may have limited marketability, which may reduce its market value.

MARY-JO KRANACHER ET AL., WELLS, FORENSIC ACCOUNTING AND FRAUD EXAMINATION 468 (2011).

[76] An absolute restriction on marketability forces the winner to bear the entire risk because it destroys the opportunity to sell the stream and move away from the risk.

[77] In *Negron*, the Sixth Circuit concluded that the tables must be used even though the "property right at issue [was] a legally enforceable, virtually risk-free right to receive annual payments that cannot be assigned to a third party." 553 F.3d at 1020.

[78] *Id.* (citing *Cook*, 349 F.3d at 857).

[79] In essence, the court created a contradiction through the combination of the notion that marketability was irrelevant when valuating a riskless annuity and the application of the default annuity tables that, according to the court itself, utilize a marketability factor; however, the court used the "unreasonable and unrealistic results" test and held that, even considering the discrepancies between the factors used in determining the discount rate and the characteristics of the future lottery payments, the results were not unreasonable and unrealistic. *Id.* at 1021.

correct this contradiction is through a demonstration that marketability is a relevant factor to consider when valuating an annuity regardless of the level of risk involved.

For marketability to be a relevant factor, a restriction on marketability must *affect* the value of the property.[80] But, in order for the marketability restriction to affect the value of the property, the Sixth Circuit's determination (that the absence of risk necessarily results in the irrelevance of marketability) must be incorrect. This can be accomplished by combining theoretical principles with practical applications.

At the most basic level, labeling the state backing of an obligation as risk-free presumes a very narrow definition of risk: risk of default. The state's backing of an obligation does nothing to account for risk of lost opportunities. Moreover, marketability is still relevant in instances of riskless annuities because the present value of a fixed income stream can be amorphous—even if the annuity payments were truly risk-free—due to the principle that any agreed-upon price between a willing buyer and seller should hinge on *all* the factors underlying the income stream.[81]

It can be demonstrated that marketability affects value for estates that cannot make a lump sum election in at least two ways. First, values concluded by competing valuators can lead to wildly different results not only when only one valuator is accounting for marketability, but also when both valuators are factoring in limitations on market transactions. In *Cook v. Commissioner*, the decedent's executor hired a valuation expert who valuated the estate's interest at $1,529,749 using a discounted cash flow and a non-marketability factor, while the Service used the annuity tables to determine a value of $3,222,919.[82] If the Fifth and Sixth Circuits are correct that the tables account for non-marketability,

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[80] It appears that the Fifth and Sixth Circuits would require a showing that risk is relevant before they would conclude that a restriction on marketability was also relevant. *See Negron*, 553 F.3d at 1020 ("A marketability factor is not necessary to determine the value of a guaranteed income stream . . . ." (citing *Cook*, 349 F.3d at 857)).

[81] The buyer–seller approach to fair market value adopted in the Regulations seeks a transaction where the parties are aware of the "relevant facts." *See* Treas. Reg. § 20.2031-1(b) (as amended in 1965).

> When calculating a discount for lack of marketability, a valuation analyst needs to gather certain data. Some data, such as the nature of the illiquid asset and the likely period of illiquidity, relate the costs of bearing the risk of holding an illiquid asset. Other data, however, are needed to know whether that cost must be borne or can be reduced or eliminated through some financial transaction. When such a transaction is possible and likely to be effective, the cost of the lack of marketability is the lesser of the transaction costs and the costs of bearing the risk of holding the asset. In measuring those holding risks, the analyst should also be aware that data on the size of reported discounts for certain transactions may contain biases that push the measured values to both underestimate and overestimate that cost.

BVR'S GUIDE TO DISCOUNTS FOR LACK OF MARKETABILITY 4-4 (Paul Heidt & Adam Manson eds., 2008 ed.).

[82] *Cook*, 349 F.3d at 852.

then the discrepancy between the expert's valuation and the Service's valuation shows that non-marketability itself can result in wildly different valuations. Alternatively, if these circuits are incorrect, this discrepancy suggests that the tables overstate the value of the annuities *because* they do not account for marketability.[83] Second, the risk-free argument is erroneous because, by only considering one aspect of the valuation, it muddies the principle that risk and marketability are linked.[84] In essence, the risk-free argument confuses the link between the two factors by instead purporting that each factor is entirely dependent on the existence of the other. However, a valuation of an annuity that only factors in the impact of risk is incomplete. In order to reach the most accurate valuation, one must not only analyze the difference between a restricted, risk-free annuity and a restricted, risky annuity, one must also analyze a restricted, risk-free annuity and an *unrestricted*, risk-free annuity.[85] The risk-free argument presumes that since the holder of a non-marketable annuity bears the entire risk of the annuity,[86] if the annuity is risk-free, non-marketability is irrelevant because it did not result in the owner bearing any risk. This stance ignores the fact that the decedent owned something that could not be sold and if it could have been sold, third parties would be free to value the *right not to bear risk* in any way that they felt was correct.

If the executor can make a lump sum election, an additional argument can be made to demonstrate that marketability affects value. In these instances, because the executor is restricted to "selling" the remaining annuity payments to the state lottery, the lump sum payment is set at a predetermined price. The predetermination of the price, therefore, results from the marketability restriction and, as a result, the marketability restriction itself determines the *only* economic value the estate is eligible to realize if the executor makes a lump sum election.[87] Since the Fifth and Sixth Circuits argue that continued annual

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[83] In other words, a non-marketability factor would reduce the valuation by the tables. If the valuation was reduced on account of non-marketability, it appears that non-marketability is relevant.

[84] If an annuity is both restricted and risk-free, there are at least two fair market value considerations. Those considerations are marketability and risk.

[85] For example, imagine that the symbol $ represents value and the greater the number of $s the greater the value, with $$$ representing maximum value—the most desirable annuity. Therefore, the greater the number of factors that *increase* the discount rate, the lower the number of $s. The above text is therefore comparing these situations: (1) restricted, risk-free annuity ($$) vs. restricted, risky annuity ($), and (2) restricted, risk-free annuity ($$) vs. unrestricted, risk-free annuity ($$$). The existence of a marketability restriction is relevant with respect to its relationship with an appropriate discount rate even when the annuity is risk-free because it still impacts the discount rate.

[86] *See supra* note 76 and accompanying text.

[87] This is not to say that the state lotteries' calculations are designed to value the stream that the decedent owned as an annuity. For proof that the state lotteries are not concerned with properly valuating these annuities, see *infra* Part III.B.2.

payments are risk-free,[88] then the lump sum payment is also guaranteed by implication.[89] However, the notion that the payments are risk-free actually cuts against the argument to ignore marketability in this case because the marketability restriction plays the essential role in determining the value the estate can derive from mutually exclusive, risk-free payments.[90]

Because marketability affects the value of the property, a restriction on marketability is a relevant factor to consider when properly valuating these payments. But, according to the Massachusetts District Court, the "unassignable nature of the lottery winnings does affect *a* value of the property, simply not the relevant one."[91] The Sixth Circuit extrapolated by concluding that the "relevant value was the value of the property in the hands of the decedent, not the value to a hypothetical buyer holding a very different property interest with substantially

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[88] *See* Negron v. United States, 553 F.3d 1013, 1020 (6th Cir. 2009) (citing Cook v. Comm'r, 349 F.3d 850, 857 (5th Cir. 2003)).

[89] This is because the lump sum payment comes from the same source.

[90] Because any risk-free nature should decrease a discount rate thereby increasing the present value of the remaining annuities toward an amount closer to the sum of the remaining payments, the marketability restriction at hand is extremely relevant because it ignores the notion of the risk-free nature by affixing a value based on factors in effect at the time the decedent won the lottery, which cannot possibly account for the exact amount of risk (or lack thereof) at death. This value, because it is predetermined and based on historic factors, can be completely different than the value of a similar risk-free annuity without a marketability restriction. For example, if one risk-free $1,000,000 annuity payment without marketability restrictions remained due at death and the prevailing rate was 5%, the estate would receive a payment of roughly $952,380.95 (this is because this amount invested at 5% for one year would yield roughly $1,000,000). Since there is no real risk of default by the state agency, there is no reason to further discount the value; therefore, the risk-free nature produces what is essentially the highest value possible. Now assume the annuity is encumbered by the marketability restriction at issue in this Note. As a result, the state lottery runs a calculation that acts like the decedent elected a lump sum at the time of the jackpot, imposes the rate in effect at that time, and calculates the amount due based on what the winner would have been paid, less the sum of the annuities already paid. The executor can only accept the state lottery's offer and that offer, as a result of the way the initial lump sum payment is calculated, *see supra* note 22 and accompanying text, could potentially be nominal. However, even if the amount was $500,000, the fact that the executor could only transact with the state lottery—the marketability restriction itself—costs the estate over $450,000 (for which it will potentially have tax liability depending on the value of the estate). The value, therefore, was directly impacted by the marketability restriction even though the payment was virtually risk-free, and because the risk-free nature actually *increased* the value of the present value calculation, the marketability restriction actually resulted in a *larger* disconnect between the amount realized and the potential taxable amount. A riskier investment would have devalued the present value calculation (for example, if risk warranted a 10% discount for a total of 15%, the present value would have been roughly $869,565), which would have closed the gap (in this case by over $80,000). Concluding that marketability was irrelevant ignored the option to take the lump sum, an option which altered the value of the annuities because it allowed for the unequal options of *immediate* realization of $*X* or *deferred* realization of $*Y1* + $*Y2* + . . . $*Yn*.

[91] Estate of Donovan v. United States, No. Civ.A.04-10594-DPW, 2005 WL 958403, at *4 (D. Mass. Apr. 26, 2005).

greater risks."[92] The value of the annuity in the hands of the decedent—the value that the courts say is relevant—is impacted by the marketability restriction. In this case, there is no need to rely solely on the "basic economic tenet that an asset subject to marketability restrictions is worth less than an identical asset without marketability restrictions."[93] Through a lens of practicality, the annuities, *in the hands of the decedents*, were worth the present value of the rights the annuities encompassed.[94]

While the various factors of a discount rate are extremely important for determining the appropriateness of the Secretary's tables,[95] selecting a discount rate based on timing is also important. If the Service uses the correct factors in building its discount rates, but inappropriately utilizes a discount rate in effect at an illogical time, then the valuations produced by the tables are inevitably flawed.

2. *Date of Jackpot vs. Date of Death*

If the tables apply, selecting the proper discount rate is paramount for the tables' valuation. Discount rates change over time as speculation warrants alternative predictions and future payments become more certain.[96] Although not a given, discount rates calculated by alternative parties for the same period of time and for the same type of underlying stream will usually be substantially similar if they include the same or similar factors. However, because the Service updates its discount rates monthly,[97] it is important to ensure that the tables use a discount rate in effect at the appropriate time.

In *Negron*, the Sixth Circuit correctly demonstrated that the selection of a discount rate depends on the purpose for utilizing a present value calculation.[98] In that case, the discount rates "yielded different results because they served different purposes."[99] Two discount rates are applicable in valuating these annuities: date of jackpot and date of death. The purpose of a date of jackpot discount rate is to calculate "the value of the unpaid annuity as if it had been a

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[92] *Negron*, 553 F.3d at 1019.

[93] *Id.* (citing *Donovan*, 2005 WL 958403, at *4).

[94] Determining the rights depends on whether the executor can make an election. For a discussion of the rights that these estates own, see *infra* Part IV.C.

[95] This is because it is important that the Secretary's tables account for the factors that are relevant in this problem, including, but not limited to, marketability restrictions.

[96] *See* JEFF MADURA, INTERNATIONAL FINANCIAL MANAGEMENT 404 (9th ed. 2008) ("A different discount rate should therefore be applied to each period in accordance with its corresponding risk."). This is because "cash flows . . . are less certain in the distant future than they are in the near future." *See id.*

[97] "During each calendar month, the Secretary shall determine the Federal . . . mid-term rate . . . which shall apply during the following calendar month." I.R.C. § 1274(d)(1)(B) (2006).

[98] *See Negron*, 553 F.3d at 1016.

[99] *Id.*

lump sum from the beginning."[100] Alternatively, the purpose of a date of death discount rate is to value "the annuities as an ongoing annuity or a continuing stream of periodic payments."[101]

The Service uses a discount rate in effect at the date of death.[102] The tables utilize a date of death discount rate because they calculate present value based on an annuity's valuation date,[103] which is the date of death.[104] These valuation rules apply in the case of estates.[105] The tables include actuarial factors that are designed to compute the present value in various factual situations.[106] Because the focus of the tables is to assign a present value at the date of death, the valuation tables are updated monthly using an interest rate "equal to 120 percent of the Federal midterm rate in effect under [the Code] for the month in which the valuation date falls."[107] Therefore, the tables are tied to a medium term rate that is regularly updated to market rates of interest.[108] In addition to the interest rate component, the tables reflect "the mortality data most recently available from the United States Census."[109]

Because these payments are properly considered annuities,[110] the date of death discount rate used by the Service is correct. The purpose that should be respected is the one that mirrors reality, and treating the annuities as annuities is the realistic approach. The reality of this situation is simple: a lottery winner who elected annuity payments rather than a lump sum dies before all annuities are paid, and the estate is left with the residual annuity. As demonstrated above, an executorial lump sum election does not destroy the reality that the estate owns an annuity.[111]

The utilization of a date of jackpot discount rate would be incorrect because it would distort reality. A date of jackpot scheme would treat the winner's death as an event that warranted a substitute for the winner's original election.

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[100] *Id.*

[101] *Id.*

[102] Thus, the Service values these annuities as a continuing stream of periodic payments. *See id.*

[103] Temp. Treas. Reg. § 20.2031-7T(d) (as amended in 2009); I.R.C. § 7520(d).

[104] I.R.C. § 2031(a).

[105] Temp. Treas. Reg. § 20.7520-1T(a) (as amended in 2009).

[106] Treas. Reg. § 20.2031-7(a) (as amended in 2009).

[107] I.R.C. § 7520(a)(2).

[108] *See* § 1274(d)(1). "During each calendar month, the Secretary shall determine the Federal . . . mid-term rate . . . which shall apply during the following calendar month." § 1274(d)(1)(B). This section applies to annuity payments for lottery winnings. § 1274(c)(1)(B) ("[T]his section shall apply to any debt instrument given in consideration for the sale or exchange of property if . . . some or all of the payments due under such debt instrument are due more than 6 months after the date of such sale or exchange."). The determination of the rate is based on the average market yield on outstanding marketable obligations of the United States. § 1274(d)(1)(C)(i)–(ii).

[109] Treas. Reg. § 20.7520-1(b)(2) (as amended in 2009).

[110] For an analysis of why these payments are annuities, see *supra* Part III.A.

[111] *See supra* Part III.A.

Therefore, if the Service utilized a date of jackpot discount rate in this situation, it would convert the annuity into a lump sum through a backdated, posthumous, and inappropriate purpose, which is incorrect because it is not actually what transpired.[112]

Furthermore, a date of jackpot discount rate is not properly designed to carry out the purpose of treating the annuity "as if it had been a lump sum from the beginning."[113] If this is the purpose of a date of jackpot discount rate, the amount included in the estate would be the amount the winner would have realized had he or she elected the lump sum at the date of jackpot less all annual payments received before death. But this calculation would not account for the reality that would have ensued. True, the winner—had he or she elected the lump sum in the beginning—would have been forced to abide by the rates in effect at that time; but the date of jackpot discount rate does not account for the fact that the winner never had the hope of investing the lump sum payment to earn higher than anticipated returns.[114]

Potential arguments that a date of jackpot discount rate is correct because it serves a different purpose are also incorrect because they are really arguments that the Service should value an annuity for a reason *other than* establishing its present value.[115] Perhaps the most *technical* argument that can be made to

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[112] With respect to Ohio, this argument is further strengthened by pointing to the Ohio Lottery's policy of providing the winner a second chance at electing to take a lump sum payment. OHIO ADMIN. CODE ANN. § 3770:1-8-04(C)(4) (2011) ("In the event that prizes may be paid as an annuity .... [t]he prize winner(s) shall have sixty calendar days from the date of the redemption for payment ... to opt for the discounted cash value of the prize award ...."). Therefore, in order to receive annuity payments of lottery winnings, a decedent would not only have had to decline to elect the cash option at the point of wager, but also waive his or her right to receive the lump sum payment within sixty days of winning the prize.

[113] Negron v. United States, 553 F.3d 1013, 1016 (6th Cir. 2009).

[114] "[I]f you take the lump sum payout, you are personally financially responsible for investing for the future and maintaining this money." BILL KAROSHI, HOW TO WIN THE LOTTERY ... BY NOT PLAYING 37 (2008). For a comprehensive discussion of all the considerations after a lottery is won, see generally Kristin Davis, *I'm Rich! (Now What?)*, KIPLINGER'S PERS. FIN., Nov. 2000, at 92. "If you're a smart investor, cash is probably the right choice because it's likely you can earn a higher return on the lump sum than with the interest rate built into the annuity." *Id.* at 95. In fact, a lump sum election actually allows the winner to more readily utilize the jackpot to create wealth without ever diminishing the principal because the amount realized up front is greater. *See* ROBERT DOYEN & MEG SCHNEIDER, MAKING MILLIONS FOR DUMMIES 163 (2009) ("[F]inancial experts recommend investing your lottery proceeds and spending only the earnings, not the principal, of those investments.").

[115] With respect to states like Ohio that allow the executor to make an election, one possible theory is that the treatment by state lotteries in this situation should be considered a penalty for changing elections. However, the discussion of whether this is a penalty must be bifurcated. First, there is a mathematical argument that it is not a penalty. In this situation, the utilization of a date of jackpot discount rate resulted in an amount realized that was less than the proper taxable amount according to the Service. However, a date of jackpot discount rate could result in the exact opposite result if the rate in effect at the date the prize

justify a date of jackpot discount rate is that the backdated treatment serves a mistake-correcting purpose. Under this theory, if the winner would have known that he or she would die before all installment payments were made, then the winner would have elected to take a lump sum payment and, therefore, the estate should be able to have the decedent's initial "mistaken" election reversed. But for whatever reason—and in accordance with state law—the winner bypassed opportunities to choose a lump sum payment. Conceivably, the winner felt incapable of managing a large lump sum and altruistically wanted his or her financially incompetent descendents to have more manageable annual payments over a longer period of time.

Since a date of death discount rate is correct, both an estate and the Service should valuate the annuities using market rates in effect when the lottery winner dies. Because the tables utilize a date of death rate,[116] they are properly designed to valuate the annuities *that they capture*. Utilizing a date of jackpot discount rate will not appropriately valuate these annuities. An estate that utilizes a date of jackpot discount rate will not calculate the correct present value. Estates that are unable to make a lump sum election are unlikely to argue this point.

However, estates that can and do elect a lump sum distribution argue that a date of jackpot discount rate should be used because it yields the amount realized. In *Negron*, the estates reported the amount realized as a result of an executor-elected lump sum payment, based on a date of jackpot discount rate.[117] By indicating this amount on the estate tax returns, Negron—the executrix—established that, in her opinion, the value of the two annuities should be the

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was won was requisitely lower than the date of death rate used by the Service. Since a date of jackpot discount rate does not automatically result in this problem, it is inappropriate to define the treatment by the state lotteries as a penalty for changing elections. Second, there is a monopolistic argument that it is a penalty. Because the executor can only receive a lump sum from the lottery, the lottery—operating as a monopoly—forces the result to dissuade estates from the lump sum since it is likely that an executor would only elect the lump sum if the lump sum payment would be greater than the amount of a single annuity payment. In this sense the date of jackpot discount rate is a penalty because it forces the estate to realize an amount related to an initial lump sum amount, which will be lower than the sum of the remaining annuity payments. I believe that, because the crux of the estate's desire is to obtain the most money possible, the mathematical argument trumps the monopolistic argument because executors will still prefer a calculation that results in a greater amount realized even if the state lottery only imposes a date of jackpot discount rate to create potential problems with the Service. Therefore, because the monopolistic approach does not preclude an executor from rationally making the election (because the election can result in more money to the estate if the rate used by the Service is disproportionately high when compared to the date of jackpot discount rate), I do not feel that it is appropriate to classify this treatment as a penalty since it is *not guaranteed* to have a negative result for the estate. Also, the payment might actually be the opposite of a penalty. It could be designed to benefit estates that would not be able to pay estate taxes without an immediate infusion of money.

[116] *See* I.R.C. § 2031(a) (2006).

[117] *Negron*, 553 F.3d at 1014.

amount realized.[118] In that case, the Ohio Lottery affixed the amount that could be realized if Negron elected a lump sum.[119] Therefore, Negron argued that the Ohio Lottery's lump sum calculation determined the value of the annuity. In deciding *Negron*, the Sixth Circuit concluded that the "lump sum calculation was simply *an alternate method of valuing* lottery winnings and does not make the IRS method unreasonable."[120]

Both the Sixth Circuit and Negron erred in concluding that the Ohio Lottery's utilization of a date of jackpot discount rate was for the purposes of valuing the lottery winnings. Rather, the Ohio Lottery used a date of jackpot discount rate to set the amount the estate was eligible to receive should the executrix make the election.[121] The Sixth Circuit incorrectly posited that the calculation was designed to determine "the *present value* of the remaining lottery payments [by] using a discount rate of 9.0% from the state valuation tables in effect on . . . the date the lottery prize was won."[122] Considering the Sixth Circuit's conclusion that the purpose of a date of jackpot discount rate is to treat the annuity as if it had been a lump sum from the beginning,[123] it is only appropriate to read the language of the Ohio Revised Code that authorizes payment of "the remainder of the prize winner's prize award . . . in the form of a discounted lump sum,"[124] in light of the *actual distribution* should the executor make the election: the amount is equal to what an original lump sum amount would have been less the annual payments received.[125] Thus, there is no attempt by the Ohio Lottery to determine the *present value*,[126] because the

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[118] *See id.*

[119] *See id.* This is the value that was based on an original lump sum election or, in other words, a date of jackpot discount rate. *See id.*

[120] *Id.* at 1016 (emphasis added).

[121] *See id.* at 1014.

[122] *Id.* (emphasis added).

[123] *Negron*, 553 F.3d at 1016.

[124] OHIO REV. CODE ANN. § 3770.07(D)(2)(b)(5) (West 2006). In Ohio, the "formula for setting the discounted cash value [is] determined by the director in accordance with the game rule governing the game in which the prize is won." OHIO ADMIN. CODE § 3770:1-8-04(C)(4) (2007). Ohio's "formula" utilizes a discount rate in effect on the date the prize was won. *Negron*, 553 F.3d at 1016 (citing OHIO ADMIN. CODE § 3770:1-8-01(B)(3)(b)). "The discount rate to be used in determining the discounted lump sum cash settlements [to estates] . . . shall be the cash option discount rate available *at the time the prize was won . . . .*" § 3770:1-8-01(B)(3)(b) (emphasis added).

[125] The distribution is displayed in the example within Part I. If the original lump sum amount would have been $\$X$, but the winner elected annual payments in the amount of $\$Y$, the lump sum distribution to the estate would be equal to: $\$X - (\$Y * n)$, where n is the number payments received prior to death.

[126] Even if the Ohio Lottery was trying to provide a valuation, its valuation would be incorrect. In this case, the decedent won a jackpot at some time in the past that was worth a specific amount that would have been determined using calculations in effect at that time. But the treatment by the lottery would be erroneous because it would not actually calculate what the decedent had. The "property right at issue [was] a legally enforceable, virtually risk-free right to receive annual payments that cannot be assigned to a third party." *Negron*,

"remainder" is the difference exemplified in the distribution calculation and the "discounted lump sum" is a reference to the original discounted lump sum amount.[127]

Determining the proper logic of a discount rate does not completely satisfy this inquiry; in fact, it might actually be a red herring. While we know that the date of death discount rate used by the Service is the correct approach, it is paramount to understand that the Service's calculation only applies if the Secretary's tables grasp the annuity. Thus, if the tables do not apply, all of the focus that the courts place on valuation dates merely hides the larger problem.

IV. STATUTORY AND REGULATORY FRAMEWORK: DETERMINING THE APPROPRIATE CALCULATION

When an estate owns an annuity,[128] there are two basic routes under the Code and Regulations. The appropriate route is based on the characterization of the underlying annuity because, even though § 7520 requires imposition of annuity tables, prescribed by the Secretary, for the purpose of determining "the value of *any* annuity,"[129] the Regulations clarify that standard annuity factors under § 7520 apply only to "*ordinary annuity interests*."[130] Thus, the first route is to apply the annuity tables if the estate owns an ordinary annuity interest. However, special factors apply to "*restricted beneficial interests*,"[131] and an annuity defined as an "*other beneficial interests*."[132] This means that there is a second route, departing from the annuity tables in the event of an exception. Therefore, if these annuities should travel down the second route, we know that "any" does not mean "all."

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553 F.3d at 1020. Therefore, the estate had an annuity. *See* Treas. Reg. § 20.2039-1(b) (as amended in 1995). Thus, the value of the annuity is what is relevant for *valuation of an estate*, and not the value of what an initial lump sum payment would have been. But it is important to remember that the state lottery's calculation *still plays a role in determining the present value of the annuity*. While it does not determine the value itself, the lump sum option amount is a factor that must be considered when discounting for marketability. In essence, at death, the absolute marketability restriction is lifted and the estate can cash out the annuity for a lump sum payment. This lump sum payment amount is predetermined by the state lottery. Because it is a factor to consider when assessing a value to be imposed on the annuity, the state lottery's calculation still serves a purpose in valuation, but it does not represent the annuity's value. For a discussion of the factors of valuation, see *supra* Part III.B.1.

[127] *See* OHIO REV. CODE ANN. § 3770.07(D)(2)(b)(5).

[128] In this problem the estate does own an annuity. For a demonstration of this fact, see *supra* Part III.A.

[129] I.R.C. § 7520(a) (2006) (emphasis added).

[130] Treas. Reg. § 20.7520-3(b)(1)(i)(A) (as amended in 1995) (emphasis added). An ordinary annuity interest is defined as "the right to receive a fixed dollar amount at the end of each year . . . [for a] defined period." *Id.*

[131] § 20.7520-3(b)(1)(ii) (emphasis added).

[132] § 20.7520-3(b)(1)(iii) (emphasis added).

The Code and Regulations default to ordinary annuity treatment.[133] "This results in the presumptive correctness of the IRS annuity tables and [a] considerable burden for those seeking departure from their use."[134] Therefore, unless an exception is applicable, the tables should be applied—along with their valuation logic—regardless of what an estate might have already realized through an executor-elected lump sum. However, because the lottery annuities at hand arguably fit into both exceptions, the tables should not be used at all. Instead, the annuity should be valuated using all of the facts and circumstances.

A. *Regulatory Exception One: Restricted Beneficial Interest*

A restricted beneficial interest exists when a party owns "an annuity . . . that is subject to any contingency, power, or other restriction."[135] "In general, a standard section 7520 annuity . . . factor may *not* be used to value a restricted beneficial interest."[136] Even though lottery payments have significant marketability restrictions, which seem to qualify them at a textual level as a restricted beneficial interest,[137] the Service argues that lottery winnings paid to estates are ordinary annuity interests and, therefore, the annuity tables should be used in these cases.[138]

To date, courts agree with the Service that these payments are not restricted beneficial interests.[139] The Sixth Circuit identified the appropriate basis for

[133] *See generally* I.R.C. § 7520(a); Treas. Reg. § 20.7520-3(b)(1)(i)(A).

[134] Negron v. United States, 553 F.3d 1013, 1017 (6th Cir. 2009) (citing Shackleford v. United States, 262 F.3d 1028, 1032 (9th Cir. 2001)).

[135] § 20.7520-3(b)(1)(ii).

[136] *Id.* (emphasis added).

[137] *See* § 20.7520-3(b)(1)(ii) (defining a restricted beneficial interest as "an annuity . . . that is subject to *any* contingency, power, or other restriction" (emphasis added)).

[138] *See, e.g.*, *Negron*, 553 F.3d at 1014; *Shackleford*, 262 F.3d at 1031.

[139] According to the Sixth Circuit, the "Fifth Circuit is the only circuit court to have considered whether a decedent's right to receive structured settlement payments, similar to non-assignable lottery payments, was a 'restricted beneficial interest' [under the Code]." *Negron*, 553 F.3d at 1019 (citing Anthony v. United States, 520 F.3d 374, 378 (5th Cir. 2008)). The Fifth Circuit stated that "a restriction within the meaning of the regulation is one which jeopardizes receipt of the payment stream, not one which merely impacts on the ability of the payee to dispose of his or her right thereto." *Anthony*, 520 F.3d at 383 (quoting Estate of Gribauskas v. Comm'r, 116 T.C. 142, 165 (2001)). Essentially, the Fifth Circuit concluded that the Regulation formalized the already-existent judicial interpretation that the exception to the annuity tables involved a restriction that undercut one of the assumptions at the root of the tables' logic, marketability not being one of the relevant assumptions. *Id.* at 380–83. The district court in Massachusetts agrees: "The 'restriction' on marketability of lottery earnings is not one which justifies characterizing the proceeds as a 'restricted beneficial interest' under the regulations." Estate of Donovan v. United States, No. Civ.A. 04-10594-DPW, 2005 WL 958403, at *3 (D. Mass. Apr. 26, 2005). Technically, the Sixth Circuit did not reach a conclusion on the matter, stating only that the lower court did not need to evaluate whether the restricted beneficial interest exception applied. *Negron*, 553

interpreting whether an exception to the blanket rule of § 7520(a) applies: "The Treasury explained that 'these regulations [in § 20.7520-3] generally adopt principles established in case law and published IRS positions. There is no indication that Congress intended to supersede this well-established case law and administrative ruling position when it enacted section 7520.'"[140]

The Service's position on the § 20.7520-3 restricted beneficial interest exception is set out in Technical Advice Memorandum 96-16-004. The Service established that the actuarial tables were to be used "even though the annuity payment may *not be assigned without judicial approval*."[141] The decedent's estate argued that because the state restricted the ability of a lottery winner to assign payments, the annuity was a restricted beneficial interest, disabling the application of the annuity tables.[142] The Service disagreed with the estate's analysis, stating that "the term 'restriction' references *other* limitations similar to contingencies . . . or powers . . . *such that receipt of the annuity payments by the beneficiary becomes questionable*."[143]

Thus, the Service placed emphasis on *only* the ability to receive future payments, even though the Regulation itself does not reflect this sentiment.[144] Furthermore, the Service continued, other portions of the Regulations make "it clear that 'contingency, power, or other restriction' references only limitations that impact on the payment of the annuity."[145] Because "the right of the annuitant to receive any and all annuity payments has not been restricted or

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F.3d at 1021. Consequently, the Fifth Circuit's conclusion—but not necessarily its logic—echoes the Service's position in the Technical Advice Memorandum. *See infra* notes 140–47 and accompanying text.

[140] *Negron*, 553 F.3d at 1017 (citing T.D. 8630, 1996-1 C.B. 339). The Service's view in these cases is consistent with its views as expressed in both a Private Letter Ruling and a Technical Advice Memorandum. Ja Lee Kao, *Valuing Future Lottery Winnings for Estate Tax Purposes:* Estate of Shackleford v. United States, 52 TAX LAW. 609, 611 (1999) (citing I.R.S. Priv. Ltr. Rul. 96-13-016 (Dec. 27, 1995); I.R.S. Tech. Adv. Mem. 96-16-004 (Dec. 29, 1995)).

[141] I.R.S. Tech. Adv. Mem. 96-16-004 (emphasis added). It is important to note that of the four cases creating this split, *Cook* is the only case that allowed assignment through judicial order. Cook v. Comm'r, 349 F.3d 850, 851 (5th Cir. 2003). The other three circuits dealt with absolute restrictions on marketability.

[142] I.R.S. Tech. Adv. Mem. 96-16-004.

[143] *Id.* (second emphasis added).

[144] *Id.* The Regulation *only says* that a restricted beneficial interest is "an annuity . . . that is subject to any contingency, power, or other restriction." Treas. Reg. § 20.7520-3(b)(1)(ii) (as amended in 1995).

[145] I.R.S. Tech. Adv. Mem. 96-16-004 (referencing § 20.7520-3(b)(2)). "A standard section 7520 annuity factor may not be used to determine the present value of an annuity for a specified term of years . . . unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period." § 20.7520-3(b)(2)(i). What is absent from the Technical Advice Memorandum is concrete acknowledgement that there is a non-marketability factor built into the annuity tables. However, it is important to remember that the Service is advocating that the proper calculation for these restricted annuities is within the Secretary's tables.

limited in any way" when the restriction applies only to marketability, the law "prohibiting a lottery winner from assigning lottery winnings *without prior judicial approval* is not a restriction on the annuity such that the annuity would constitute a restricted beneficial interest."[146] While in some states lottery winnings are not assignable regardless of whether the estate receives judicial approval,[147] the Service's position also applies when even a judge cannot make way for assignment because the lack of marketability does not limit the ability to receive payments.[148]

The first major problem for some courts relying on the Service's opinion in the Technical Advice Memorandum is that, under the facts used by the Service, the lottery winnings could be assigned with judicial approval.[149] In cases like *Negron*, the marketability restrictions are absolute.[150] Fundamentally, the payments in *Negron* seem much more "restricted" than the payments in the Technical Advice Memorandum.[151]

The second major problem is the Service's articulation of an example of a restricted beneficial interest.[152] In the example the Regulation states:

> *Limited invasion of corpus.* The decedent, A, bequeathed property to a trust under the terms of which all of the trust income is to be paid to A's child for life and the remainder is to be distributed to A's grandchild. The trust authorizes the child to withdraw up to $5,000 per year from the trust corpus. In this case, the child's power to invade trust corpus is limited to an ascertainable amount each year. Annual invasions of any amount would be expected to progressively diminish the property from which the child's income is paid. Consequently, the income interest is not considered an ordinary income interest for purposes of this paragraph, and the standard section 7520 income interest factor may not be used to determine the present value of the income interest.[153]

This example appears to be stating that if the beneficiary can withdraw money from the trust, the corpus could dwindle away (even if the amount that can be withdrawn is limited), which could ultimately leave the trust without a sufficient corpus to make future annuity payments.[154] Therefore, taking payments *now* destroys the prospect of annuities *later*.

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[146] I.R.S. Tech. Adv. Mem. 96-16-004 (emphasis added).

[147] *See, e.g.*, OHIO REV. CODE ANN. § 3770.07 (D)(1) (West 2004).

[148] *See* I.R.S. Tech. Adv. Mem. 96-16-004.

[149] *See id.*

[150] *See, e.g.*, § 3770.07 (D)(1).

[151] This does not help to resolve the issue in *Cook* because those annuities could be assigned through judicial order. Cook v. Comm'r, 349 F.3d 850, 851 (5th Cir. 2003).

[152] Treas. Reg. § 20.7520-3(b)(1)(ii) (as amended in 1995) (citing two examples).

[153] § 20.7520-3(b)(2)(v), ex. 4.

[154] *See id.*

The example is markedly similar to the situations in *Cook* and *Negron*. In *Cook*, the payments could be assigned through judicial order,[155] and in *Negron*, the executor was able to elect a one-time lump sum payment.[156] It can be argued that the option of payment through sale—regardless of whether it is to a third party through a judicial order or the state lottery through an election—destroys the prospect of future annuity payments. The "power to invade" the right to the remaining annuity payments is "limited to an ascertainable amount," that would be expected not only to "progressively diminish" the remaining annuity payments, but also to completely cancel out the remaining annuity payments.[157] Nevertheless, this argument does not apply to situations in which there is no opportunity for a sale through judicial order or executorial election.

But the example itself is also questionable because it is not necessarily a situation in which "receipt of the annuity payments by the beneficiary becomes questionable."[158] Even though the child's right is limited to $5000 per year, the example presumes that "the right of the annuitant to receive any and all annuity payments has . . . been restricted or limited,"[159] because "invasions of *any amount* would be expected to *progressively diminish* the property from which . . . income is paid."[160] But the Regulation purports this progressive diminishing would occur without establishing the value of the underlying corpus.[161] For example, assuming withdrawals were limited to $5000 per year, is there actually a threat to the receipt of "any and all annuity payments"[162] if the corpus is valued at $100 million?[163]

This example is also pushed to the limits of reality in terms of ascertainable life expectancy. The example contains the overzealous statement that the invasions can be in "any amount" and still be "expected to progressively diminish the property."[164] Drawing on the earlier hypothetical of a $100 million corpus, it is without argument that a limited invasion of $1 per year would not actually threaten the right to receive a single annuity payment.[165] While the

[155] *Cook*, 349 F.3d at 851.

[156] Negron v. United States, 553 F.3d 1013, 1014 (6th Cir. 2009)

[157] § 20.7520-3(b)(2)(v), ex. 4.

[158] I.R.S. Tech. Adv. Mem. 96-16-004 (Dec. 29, 1995).

[159] *Id.*

[160] § 20.7520-3(b)(2)(v), ex. 4 (emphasis added).

[161] *See id.*

[162] I.R.S. Tech. Adv. Mem. 96-16-004.

[163] Without considering the amount of income distributed each year, the beneficiary could make the limited withdrawals from a corpus of this size for 20,000 years (i.e., $100,000,000/$5000). If, in addition to the limited withdrawals, $1 million in income was distributed each year, the corpus would be in existence for a mere 99.5 years (i.e., $100,000,000/$1,005,000).

[164] § 20.7520-3(b)(2)(v), ex. 4.

[165] Without considering the amount of income distributed each year, the beneficiary could make the limited withdrawals from a corpus of this size for 100,000,000 years (i.e., $100,000,000/$1). If, in addition to the limited withdrawals, $1 million in income was distributed each year, the corpus would be in existence for a mere 100 years (i.e.,

limitation is not related to marketability, acknowledgement by the Service that this type of limitation constitutes a restricted beneficial interest undermines its position in its Technical Advice Memorandum.

When combined with the questionable example, the textual problem for the Service and courts that side with the Service's intent is amplified. If the Treasury sincerely meant that the intent of the Regulations is to "generally adopt principles established in case law and published IRS positions,"[166] then it should be important to Congress to ensure that the Regulations accurately articulate the "case law and published IRS positions"; such action by Congress would ensure that courts do not hold the Service to the confusing and inappropriately under- and overstated text even when the Service has articulated a countervailing intent.[167] Because of the ambiguity in the definition of restricted beneficial interest, even a court that is committed to interpreting the text accurately would need to look beyond the Regulation.[168]

However, this does not necessarily mean that the court would be willing to look outside the text as the whole; rather, the strictest of courts could analyze this issue with reference to other sections. For starters, it may make sense to look first at the second regulatory exception.

B. *Regulatory Exception Two: Other Beneficial Interest*

An "other beneficial interest" exists if the components of the tables are inapplicable in determining the value of an annuity.[169] The components referred to by the Regulations are the interest rate and mortality components under § 7520.[170] If the components are inapplicable in determining the value of the annuity, its "actual fair market value . . . (determined without regard to section

$100,000,000/$1,000,001). The fact that a limited invasion of $1 combined with an annual income of $1 million only buys you 0.5 more years than a limited invasion of $5000 combined with an annual income of $1 million demonstrates the irrelevance of the amount of the limited invasion in a direction counter to the irrelevance suggested by the Regulation. *See id.* (stating that any amount constitutes a threat to the corpus).

[166] Negron v. United States, 553 F.3d 1013, 1017 (6th Cir. 2009) (citing T.D. 8630, 1996-1 C.B. 339).

[167] "It is the *law* that governs, not the intent of the lawgiver." Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws, in* A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 3, 17 (Amy Gutmann ed., 1997).

[168] A strictly textual analysis can break down when there is more than one reasonable interpretation of the text. In this situation, Justice Scalia advocates an interpretation that does the "least violence to the text." Green v. Bock Laundry Mach. Co., 490 U.S. 504, 529 (1989) (Scalia, J., concurring). Thus, if warranted, a textual interpretation can result in applying the "best answer" level on the funnel of abstraction. *See generally* William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990).

[169] § 20.7520-3(b)(1)(iii).

[170] *See id.*

7520) is based on *all of the facts and circumstances* . . . applicable to the property interest."[171]

The circuit split essentially revolves around this exception. While neither the Fifth Circuit nor the Sixth Circuit concluded that a regulatory exception was applicable,[172] the Second and Ninth Circuits agreed that transfer restrictions reduced fair market value.[173] The Ninth Circuit stated that the annuity tables "did not accurately reflect economic reality,"[174] and because the "right to transfer is one of the most essential sticks in the bundle" of property rights,[175] "the statutory restrictions on transfer reduced the fair market value of the right to receive future lottery payments,"[176] and the court departed from the tables to determine the fair market value.[177] The Fifth and Sixth Circuits discredit this analysis. Neither circuit believes that marketability restrictions should be considered when valuing a lottery prize.[178] In this sense, both sides of the split unnecessarily relied on theoretical stances instead of evaluating the Code and Regulations.[179]

At this point in the Fifth and Sixth Circuits' analysis, the importance of resolving this problem peaks. The *Negron* court emphasized the Fifth Circuit's recitation of other annuities with marketability restrictions that are valued using the Service's annuity tables.[180] In *Cook*, the Fifth Circuit pointed out that "the value of survivor annuities payable under qualified plans (transfer of which is prohibited by ERISA); charitable remainder annuity trusts; and grantor retained annuity trusts (GRATS); which are not marketable, are determined by use of the tables."[181] According to the Fifth Circuit, because the non-marketability does not "'alter or jeopardize the essential entitlement to a stream of fixed

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[171] *Id.* (emphasis added).

[172] *See* Negron v. United States, 553 F.3d 1013, 1021 (6th Cir. 2009); Cook v. Comm'r, 349 F.3d 850, 856–57 (5th Cir. 2003).

[173] *See* Estate of Gribauskas v. Comm'r, 342 F.3d 85, 88 (2d Cir. 2003); Shackleford v. United States, 262 F.3d 1028, 1032 (9th Cir. 2001).

[174] *Shackleford*, 262 F.3d at 1033.

[175] *Id.* at 1032 (citation omitted) (internal quotation marks omitted).

[176] *Id.*

[177] *Id.* at 1033. The Second Circuit's analysis was tempered by stipulations that the estate's valuation was more accurate and, therefore, did not require the same level of analysis in concluding to depart from the tables. *Gribauskas*, 342 F.3d at 88. It is not readily apparent why the Commissioner was willing to stipulate in *Gribauskas*, but the Second Circuit considered it to be a notable revelation in its analysis. *See id.* at 87.

[178] Negron v. United States, 553 F.3d 1013, 1020 (6th Cir. 2009); Cook v. Comm'r, 349 F.3d 850, 857 (5th Cir. 2003).

[179] The Service, at least impliedly, maintains that the tables account for marketability restrictions in that the Service stated that the tables should be used in calculating the present value of the rights to future lottery payments. *See* I.R.S. Priv. Ltr. Rul. 96-13-016 (Dec. 27, 1995).

[180] *Negron*, 553 F.3d at 1020 (citing *Cook*, 349 F.3d at 856).

[181] *Cook*, 349 F.3d at 856 (citing Treas. Reg. §§ 1.664-2(c), 20.2039-2(c)(1)(v)(iii), 20.2039-2(c)(2)).

payments,'"[182] the Service's tables account for the proper determination of present value because the assumptions underlying the tables remain intact.[183] Not only are there other examples of non-marketable instruments that are valued by the Secretary's tables, but there are also other instances of taxation in excess of amount realized.[184]

But by not thoroughly evaluating the Code, the Fifth and Sixth Circuits actually created more of a conundrum. They opened the door to other annuities that are potentially valuated inappropriately under the Secretary's tables. Even though these circuits argued that the tables applied because the factual basis underlying their inception did not disprove assumptions underlying the tables,[185] and there are other instances of taxation in excess of realization,[186] the Code and Regulations do not base the determination to depart from the tables on disproving assumptions in the instances of an "other beneficial interest."[187]

As a result, none of the circuits' sufficiently analyzed this exception. The Regulations *explicitly* state that "all of the facts and circumstances" should be

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[182] *Id.* at 857 (citation omitted).

[183] *See id.*

[184] If the executor can make an election, the result can be taxation in excess of realization. *See, e.g.*, *Negron*, 553 F.3d at 1016. The Code carves out taxation in excess of amount realized through the grantor trust rules. "Ordinarily, the income of a trust is taxed either to the beneficiaries of the trust (if the income is distributed to the beneficiaries) or to the trust itself (if the income is accumulated by the trust)." SCHMALBECK & ZELENAK, *supra* note 14, at 822. However, the grantor trust rules actually impose tax on the grantor of the trust instead "if the grantor retains certain powers over the trust or certain economic interests in the trust." *Id.* at 818. Section 673 provides that a "grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest." I.R.C. § 673(a) (2006). The tax is imposed on such a grantor, "unless the reversion is worth no more than 5 percent of the value of the property at the time of the transfer." SCHMALBECK & ZELENAK, *supra* note 14, at 818. Thus, the grantor pays tax on an amount unrealized, not just an amount in excess of the amount realized. For a proposal suggesting change, see Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375, 413–21 (2001). The Code also imposes taxation in excess of amount realized under § 7872. Section 7872(a) states that "in the case of any below-market loan . . . which is a gift loan[,] the foregone interest shall be treated as transferred from the lender to the borrower, and retransferred by the borrower to the lender as interest." I.R.C. § 7872(a)(1)(A)–(B). In most instances, a loan will be a below-market loan if the interest rate is below the applicable federal rate (it need not be 0%). § 7872(e)(1)(A). The Code therefore imputes what the interest should have been, then retransfers the amount of interest to the lender as if the borrower had made an interest payment for that year. The result for the lender is, essentially, phantom investment income. There is a benefit to the borrower in some situations to help offset the lender's pain. Investment expense—imputed in the amount that the lender must recognize for the interest-free gift loan—can offset investment income if the borrower has investment income. § 163(d). Also, there are special rules for certain gift loans. *See* § 7872(d). For a synopsis of interest-free gift loans, see SCHMALBECK & ZELENAK, *supra* note 14, at 820–22.

[185] *Cook*, 349 F.3d at 856 (citing Treas. Reg. §§ 1.664-2(c), 20.2039-2(c)(1)(v)(iii), 20.2039-2(c)(2)).

[186] *See generally supra* note 184.

[187] Treas. Reg. § 20.7520-3(b)(1)(iii) (as amended in 1995).

taken into account—thus warranting departure—*if the interest rate component of § 7520 is inapplicable*.[188] The circuits should have turned to the Code's description of the interest rate component instead of simply pointing to other non-marketable annuities[189] or relying solely on the theoretical stance that marketability is an essential stick in the bundle.[190]

The Code suggests that there is *not* a non-marketability factor in the interest rate component. Section 1274 provides that the Federal mid-term rate, which is the interest rate component of the annuity tables prescribed under § 7520, is determined with reference to "*marketable* obligations of the United States."[191] This is troublesome because there are also non-marketable U.S. obligations (e.g., savings bonds), yet the Code does not include their prevailing rates in calculating the interest rate for an ordinary income annuity.[192] If only marketable obligations are factored into the interest rate, then *there cannot be a non-marketability factor in the annuity tables* prescribed under § 7520 since the only other factor is a mortality component. In the present issue, the lottery payments have severe marketability restrictions that limit assignability of future lottery payments.

Since the non-marketability of annuities is *not* an assumption underlying the IRS annuity tables, the interest rate component of the Secretary's tables is not applicable in determining the value of these annuities.[193] More notably, the interest rate component does not appear to be applicable in determining the value of the other annuities that the Fifth and Sixth Circuits used as support in concluding that the lump sum lottery payments should be valued under the tables.[194]

Because the interest rate component is not applicable, these annuities are other beneficial interests. Other beneficial interests are not ordinary annuities,[195] and only ordinary annuities are properly valuated under the tables.[196] As a result, the value of the annuities should be determined using "all of the facts and circumstances."[197]

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[188] *Id.*

[189] This is the approach adopted by the Fifth and Sixth Circuits. This approach did not accurately seek to determine if the tables accounted for marketability. Rather, it took past practices for granted.

[190] This is the approach adopted by the Ninth Circuit. It may be inappropriate to conclude that the Second Circuit adopted this approach since the Service stipulated to problems with valuation. *See* Estate of Gribauskas v. Comm'r, 342 F.3d 85, 87–88 (2d Cir. 2003). This approach did not sufficiently seek to discover whether the tables accounted for the fact that this particular stick in the bundle was an absentee.

[191] I.R.C. § 1274(d)(1)(C)(i)–(ii) (2006) (emphasis added).

[192] *See id.*

[193] *See* Treas. Reg. § 20.7520-3(b)(1)(iii).

[194] *See id.*

[195] *See id.*

[196] *See* § 20.7520-3(b)(1)(i)(A).

[197] § 20.7520-3(b)(1)(iii).

C. *Determining the Facts and Circumstances*

The facts and circumstances of this problem are variable, depending on whether an election is available to the executor. The statement that "all of the facts and circumstances . . . applicable to the property interest,"[198] should be used in valuating the exceptional annuity suggests that any right that *affects the value* should be considered.[199]

If the executor is not able to make a lump sum election, the facts and circumstances approach is simple. In these situations, as a matter of *fact*, the estate owns an annuity,[200] and there are two *circumstances* relevant to valuation: (1) marketability restrictions, and (2) receipt through continued annual payments. As a result, a valuator must discount the sum of the remaining annual payments through a calculation similar to that of the Service's annuity tables, and must *further discount* for the lack of marketability.[201]

If the executor is able to make a lump sum election, the facts and circumstances can be interpreted in two ways. First, as a matter of *fact*, the state lottery paid a predetermined, cognizable amount to the estate due to the *circumstances* surrounding the annuities that gave the executor the power to make the election. Under this approach, the result should be a taxable amount

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[198] *Id.*

[199] Compare this statement with Milo's evaluation of the facts and circumstances when deciding whether to make a lump sum election in Part I. Those facts and circumstances were all external to valuating what the estate owned. In other words, while they influenced Milo's decision to elect a lump sum, the value of the annuity did not depend on the needs of the beneficiaries of the estate. Thus, the only facts and circumstances that are relevant for valuation are the factors that define the annuity itself.

[200] For the discussion of why the estate owns an annuity, see *supra* Part III.A.

[201] It is important to distinguish this statement from the articulation by the Sixth Circuit in *Negron* that an alternate valuation method is available "does not make the IRS method unreasonable." Negron v. United States, 553 F.3d 1013, 1016 (6th Cir. 2009). In Part III.B.1, this Note demonstrates that marketability is relevant to consider when valuating these annuities, and in Part IV.B, this Note demonstrates that the annuity tables do not account for non-marketability. The fact that the tables do not account for non-marketability is what makes these annuities exceptional, and exceptional annuities are not to be valuated using the annuity tables. Even though the above statement may seem like an alternate valuation method, it is not an *alternate* valuation method; it is the *only* valuation method because the IRS's method is not available for valuating these exceptional annuities. *See* § 20.7520-3(b)(1)(iii). Also, the notion that a proper calculation here incorporates a present value calculation similar to the Service's calculation does not mean that this Note is arguing for application of the tables. Since the tables do not account for non-marketability, there is a second circumstance that must be evaluated, which will not result in the same valuation as the annuity tables. The fact that a portion of the calculation will be similar to the Service's calculation is simply a function of the fact that the annuity tables are, as demonstrated throughout Part III, properly designed to valuate annuities. The fact that these annuities are restricted does not destroy the fundamental correctness of the Service's tables; rather, it requires the incorporation of another factor that must also be considered since the annuity tables do not factor in non-marketability.

equal to the amount realized.[202] Second, as a matter of *fact*, the estate owns an annuity,[203] and there are three *circumstances* relevant to valuation: (1) marketability restrictions, (2) receipt through continued annual payments, and (3) receipt through an immediate lump sum. Under this approach, the result should be a taxable amount that reflects a discount for non-marketability and both the value of the immediate payment now and the present value of the sum of the deferred annual payments.[204]

The second approach is correct for valuation purposes because it comports with a proper present value calculation.[205] It also comports with present value under the Regulations. Even though the Regulations stress that the proper value is "the price at which the property would change hands between a willing buyer and a willing seller,"[206] they continue by stating that "[t]he fair market value of a particular item of property includible in the decedent's gross estate *is not to be determined by a forced sale price*."[207]

The second approach also comports with the appropriate lens for valuation. Since the relevant value is "the value of the property in the hands of the decedent,"[208] a present value calculation that factors in the facts and circumstances—that the executor could cash out the restricted annuities but only for a specific amount and only to the state lottery, or alternatively, that the executor could elect to continue annual payments with restrictions on a future sale—will acknowledge the ability to make the election and will not wait for the election to be made.

The first approach appears to mirror reality, but actually distorts reality. While it is true that the first approach would tax the amount that was actually, in fact, realized by the estate, it allows the executor to make an election before calculating what the decedent owned. Thus, it calculates a value outside of the hands of the decedent because it ignores that the value of the annuity was dependent on "*all* of the facts and circumstances,"[209] including the right to continue annual payments. In essence, the first approach allows this Note to progress to the final step while treating the payment as an annuity, and then applies original lump sum treatment to the payment, which ignores the fact that

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[202] If the Service imposes tax only on the amount realized, the portion of this query that seems inherently inequitable under these circumstances—taxation in excess of realization—is evaded. However, it is important to remember that taxation in excess of realization is not an impossible phenomenon if the circumstances make it appropriate. For more on this treatment, see SCHMALBECK & ZELENAK, *supra* note 14, at 820.

[203] For the discussion of why the estate owns an annuity, see *supra* Part III.A.

[204] It is likely that in this scenario—in which the immediate payment is typically less than the present value of the sum of the remaining annual payments—the appropriate taxable amount falls somewhere in between. *See* HAMILTON & BOOTH, *supra* note 59, at 19.

[205] For a comprehensive discussion on present value, see *supra* Part III.B.

[206] § 20.2031-1(b) (as amended in 1965).

[207] *Id.* (emphasis added).

[208] Negron v. United States, 553 F.3d 1013, 1019 (6th Cir. 2009).

[209] § 20.7520-3(b)(1)(iii) (as amended in 1995) (emphasis added).

the estate owned an annuity,[210] and confuses the amount of the lump sum for a calculated valuation by a state lottery.[211]

V. CONCLUSION

The Service's annuity tables are inapplicable when valuating lottery winnings encumbered by marketability restrictions because the tables do not account for non-marketability. Instead, a hybrid approach should be applied that not only draws from the logic of each of the existing authoritative interpretations,[212] but also completes a more thorough analysis of the available framework and valuation theory.

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[210] It ignores the fact that the estate owns an annuity because it does not account for the right to the future payments. This payment should get annuity treatment because it is an annuity. *See generally supra* Part III.A.

[211] In these situations, the state lotteries use a date of jackpot discount rate to calculate the amount they will offer to the executor, and not to establish what they think the annuity is worth *currently*. For this discussion, see *supra* Part III.B.2.

[212] There appear to be three different *authoritative* interpretations of the framework. First, the Service argues that the tables correctly establish the value of future lottery payments and, through implication, suggests that the tables account for marketability restrictions. I.R.S. Priv. Ltr. Rul. 96-13-016 (Dec. 27, 1995) ("If [a winner dies] with any of the lottery installment payments outstanding, the value of the remaining payments (as determined in accordance with the principles in § 2031 and 7520) . . . ."). Furthermore, the Service posits that the restricted beneficial interest exception does not apply because "limitation" should be read in light of the words "contingency" and "power," and, as a result, a "limitation" is only in regard to the ability to receive future payments from the stream. I.R.S. Tech. Adv. Mem. 96-16-004 (Dec. 29, 1995). Second, the Ninth Circuit and the Second Circuit agree that because marketability restrictions reduce the fair market value of the right to receive future lottery payments, the tables assign a value that does not reflect economic reality, thereby suggesting that the tables do not account—at least appropriately—for marketability factors, and that these annuities are not ordinary income annuities. *See* Estate of Gribauskas v. Comm'r, 342 F.3d 85, 87 (2d Cir. 2003); Shackleford v. United States, 262 F.3d 1028, 1031–32 (9th Cir. 2001); *see also* Michael Schmidt, Note, Negron v. United States*: The Sixth Circuit Improperly Applied the Eighth Circuit's Unreasonable and Unrealistic Results Exception Resulting in Its Conclusion that the IRS Annuity Tables Must Be Used to Value an Annuity with a Marketability Restriction*, 43 CREIGHTON L. REV. 945, 947–48 (2010). Third, the Fifth Circuit and the Sixth Circuit agree that the tables account for marketability restrictions, but that marketability restrictions should not be considered when valuing a lottery prize. *Negron*, 553 F.3d at 1020; Cook v. Comm'r, 349 F.3d 850, 856–57 (5th Cir. 2003). However, the tables still provide the appropriate valuation because "the value of the decedent's interest at the time of death is readily ascertainable and fairly reflected by the present value of the remaining payments using the IRS annuity tables." *Negron*, 553 F.3d at 1020; *see also Cook*, 349 F.3d at 857. Also, because the tables are applicable, these annuities are ordinary income annuities, thereby eliminating the two regulatory exceptions to the tables. *See* Anthony v. United States, 520 F.3d 374, 383 (5th Cir. 2008); *see also Negron*, 553 F.3d at 1019. There are also alternative approaches to valuation. *See, e.g.*, Kyla C.E. Grogan, Note, *Lucky for Life: A More Realistic and Reasonable Estate Tax Valuation for Nontransferable Lottery Winnings*, 79 WASH. L. REV. 1153, 1153 (2004) (arguing that courts should modify the tables' value with a limited-

The Service's "preference for convenience and certainty over accuracy in the individual case,"[213] is a realistic approach intended to efficiently solve complicated valuations. The tables are correctly designed to reflect the economic reality of annuities because, in calculating present value, the Service imposes a date of death discount rate. However, by creating exceptions to the annuity tables, the Service concedes that, in certain situations, convenience and certainty must give way to accuracy. Therefore, the existence of exceptions serves as an acknowledgement that the annuity tables do not assign an acceptable value to every type of annuity. But, because the Service interprets the text of the exceptions narrowly, the amount of error in valuation that is acceptable is relatively undefined. In essence, the Service's quest for convenience and certainty focuses on a comparison between the characteristics of an annuity and regulatory definitions when evaluating whether an exception applies, rather than comparing the difference between the value assigned by the tables and that of an alternative valuating party.

Restricted lottery annuities fit within at least one of the Service's exceptions because of the existence of marketability restrictions, and, when an exception applies, the utilization of the tables for valuation purposes is not permitted. While these annuities might fit within the "restricted beneficial interest" exception, the inapplicability of the interest rate component of the tables necessitates that these annuities be classified as "other beneficial interests." The Service sensibly determined that, because an interest rate is fundamental in discounting for present value, if the interest rate component of the annuity tables did not comport with the applicable annuity, the tables were not designed to calculate an acceptable value. And while the four circuits and the Service acknowledged that this exception exists, they did not complete the analysis because they did not seek to discover whether the interest rate component applied. The fact that these annuities are encumbered with marketability restrictions renders the interest rate component inapplicable because the interest rate component assumes marketability of the underlying stream. As a result, "any" does *not* mean "all." Practically, "any" means "ordinary annuity interests."

Marketability has value, and any restriction on marketability decreases the value of an annuity. Since these lottery annuities are encumbered by severe marketability restrictions, the tables assume value that is not present in this problem. To date, courts and the Service have confused this fact as the reason why departure from the tables is or is not warranted. It is clear that the courts that hold that marketability restrictions do not warrant departure from the Service's preference for convenience and certainty over accuracy *just because*

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percentage marketability discount by balancing the stability of payment structure and marketability restrictions).

[213] *Cook*, 349 F.3d at 854 (citing Bank of Cal. v. United States, 672 F.2d 758, 760 (9th Cir. 1982)).

the right to sell an income stream has value are correct.[214] To hold otherwise would undermine the reasonable policy stance that efficiency is generally more desirable than complete accuracy when valuating annuities. But, a complete hybrid approach demonstrates that the aforementioned courts are nevertheless incorrect in their conclusion to apply the tables because non-marketability implicates a regulatory exception, and *this regulatory exception*—and not non-marketability itself—mandates departure from the tables. Thus, while these courts state fundamentally correct logic in their conclusions, their conclusions are not fundamentally correct because the courts fail to analyze the interest rate component.

To properly valuate this type of exception to the tables, the Regulations mandate that the calculation must take all of the facts and circumstances into account. Consequently, this valuation scheme allows for a non-marketability factor even though the default annuity tables would not discount for the inability to sell. As designed, our tax system should attempt to tax value that is present in reality and not in theory. But the line between reality and theory is blurred in this situation because the concept of calculating the present value of an annuity is inescapably theoretical. In this regard, it is vital to properly define reality to fulfill the purpose of calculating present value: to assign a value in the hands of the decedent. This value is determined by analyzing the rights of the annuity before anyone alters the rights. Postponing valuation until after an executor acts disregards the value of the right to continue annual payments.

Applying the hybrid approach is not without its challenges. A calculation of this type is complicated. The Service acknowledged the complexity of these calculations by designing default tables. However, the Service did not preclude complex calculations altogether because it allowed the facts and circumstances calculation for exceptional annuities. In this regard, complex calculations are not impossible. Even though these calculations require an intensive fact-based inquiry, the chance of a flood of litigation involving lottery payments is nominal. But, the problem for the courts and the Service is that *these lottery payments might be a tipping point.*

Most vitally, this hybrid approach demonstrates that the annuity tables do not appear to accurately represent non-marketable annuities at all. In laying out all of the non-marketable streams that are valued under the tables, the Fifth Circuit's analysis adds fuel to this fire. It was inappropriate for the Fifth Circuit to conclude that restricted lottery winnings should be valued under the tables since many similar annuities were, because the Fifth Circuit deemphasized the importance of utilizing that which had the answer: the Code and Regulations. But, while such assumptions may violate policy considerations, it is less of an egregious leap of logic to conclude that if the lottery winnings at hand are not

[214] The marketability restrictions do make the annuity less valuable and, therefore, the annuity tables assign too great a value to these annuities. But, the default policy is to apply the annuity tables even if an alternative valuation scheme calculates a different value. Thus, these courts are essentially saying that a discrepancy in value alone is insufficient to warrant departure. This statement is in line with the default application of the annuity tables.

appropriately valued under the tables, everything the Fifth Circuit cited as support may not be properly valued either. The implications of this hypothesis would be an administrative nightmare for the Service, because it flies in the face of efficiency in valuation. But, as this hybrid approach stressed, the characteristics attached to each individual annuity must be analyzed before the applicability of the tables can be determined. In this regard, the notion that other non-marketable annuities are not properly valuated by the tables must remain a hypothesis sitting in limbo, as it awaits further analysis.