

Taxation of Lump Sums of Money

By Kristina Vasold

We all would like to receive a large lump sum of money or a prize, but many people do not consider the tax consequences that result. Payment of income taxes is required on most lump sums of money. Some money or prizes will have the withholding taxes already taken out when the prize is paid, but others may not and the taxes will have to be calculated on the taxpayer's income tax return. Examples of lump sums of money or prizes that a taxpayer may receive are awards, sweepstakes winnings, lottery winnings, gambling winnings, gifts, damages awarded in a lawsuit, and life insurance proceeds.

Prizes and Awards

Generally, prizes and awards should be reported on Form 1040 (or other form of Form 1040, such as 1040NR) under "other income." I.R.C. §74(a). Prizes and awards need not be reported if: (1) are received in recognition of past accomplishments in religious, charitable, scientific, artistic, educational, literary, or civil fields; (2) the winner is selected without action on his part; (3) the winner is not expected to perform any future services; or (4) the payer transfers the prize or award to a charitable organization or governmental unit in the name of the recipient. I.R.C. §74(b). Also if the prize is refused, it does not need to be reported.

If a prize or award is not for services performed and its value equals \$600 or more, the taxpayer should receive Form 1099-MISC for the value of the prize, and the taxpayer must report this amount as other income on Form 1040. The entity that gave the taxpayer the prize or award should give or send you Form 1099-MISC. A Form 1099-MISC is not required if the prize or award is less than \$600. Prizes and awards paid by the taxpayer's employer needs to be reported on Form W-2 by the employer and then the taxpayer must include that value as W-2 income on Form 1040. If there is an option of a lump sum or an annuity payable over at least 10 years, and the option is selected no later than 60 days after the winner becomes entitled to the prize, the payment of the winning is considered made when it is actually received by the taxpayer. Thus, Form 1099-MISC must be filed each year to report the amount actually paid that year if the winner selects an annuity payment.

The fair market value of the merchandise is taxable if the prize is a valuable object, such as a car. Form 1099-MISC should be received by the taxpayer and the taxpayer must add that amount to the "other income" line of Form 1040. The fair market value is the price at which the property would change hands between the buyer and seller, if neither was required to buy or sell, and both had knowledge of all the necessary facts.

Sweepstakes, Lotteries, and Raffles

All sweepstakes, lottery, and raffle winnings must be recorded as other income on the income tax return. If the prize is merchandise then it must be reported by the taxpayer at the fair market value of the prize less the wager, or if the winnings are cash, then it must be reported by the taxpayer at the value of the money minus the wager. The entity giving the taxpayer the winnings is required to file a Form W-2G if the sweepstakes and lottery winnings are \$600 or

more and are at least 300 times the amount of the wager. I.R.C. §3402(q)(3). If there was not a wager, then the value should be included on Form 1099-MISC. Form 1099-MISC or Form W-2G should be sent to the recipient of the winnings from the entity making the payment. If the winnings less the wager exceed \$5,000, the entity giving the taxpayer the winnings must withhold federal income tax at a rate of 25 percent at the time the winnings are released. If the winner does not supply the payer with an ITIN (Individual Taxpayer Identification Number), then the payer must backup withhold at a rate of 28 percent. An ITIN can be the taxpayer's social security number or a number that is assigned to the taxpayer from the IRS. Backup withholding is also required for winnings of \$600 and over, but less than \$5,000. Backup withholding will be done at the time of giving the winner the money or the merchandise in order to ensure that the government will receive part of the taxes from this amount. The taxpayer should then include this withholding on their tax return and will receive a refund for any overpayment.

Gambling Winnings

The taxing procedure for gambling winnings may be different for nonresidents of the United States (see below).

U.S. Residents

All gambling winnings must be reported on the "other income" line of Form 1040. Gambling losses can be deducted up to the amount of the winnings as an itemized deduction, if itemized deductions are claimed. I.R.C. § 165(d). These amounts may have to be proven with receipts, tickets, or statements.

The entity that paid the winnings issues a Form W-2G, if \$1,200 or more is won on bingo or slots, or if \$1,500 or more (reduced by the amount of the wager) is won on keno. For any other gambling activity, a Form W-2G is required if the winnings equal \$600 or more and the payout is at least 300 times the amount of the wager.

The withholding and backup withholding rules that apply to sweepstakes and lotteries also apply to gambling winnings, except bingo, keno, and slot machine winnings which taxes are not generally withheld. I.R.C. §3402(a). If the winnings less the wager exceed \$5,000 and if the winnings are at least 300 times the wager, the entity giving the taxpayer the winnings must withhold federal income tax at a rate of 25 percent. If the winner does not supply the payor with an ITIN, then the payer must backup withhold at a rate of 28 percent. Backup withholding is also required if winnings are \$600 and over, but less than \$5,000. If backup withholding is required, the entity making the payment to the winner will withhold the amount of tax at the time of giving the winner the money or the merchandise. The taxpayer should then include this withholding on his tax return and will receive a refund for any overpayment.

Nonresident Aliens

There is no income tax or reporting of nonbusiness gambling winnings on blackjack, baccarat, craps, roulette, or big-6 wheel won in the United States by a nonresident for tax

purposes. For all other gambling winnings that are not effectively connected with a U.S. trade or business and is not exempted by a tax treaty, nonresident aliens are subject to 30 percent withholding tax. I.R.C. §871(a)(1). The tax treaty for the country of residence should be reviewed for all other types of gambling. Certain foreign countries have treaty benefits that exclude gambling income from the U.S. taxable income of their residents. Those countries include Austria, Czech Republic, Denmark, Finland, France, Germany, Hungary, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Netherlands, Russian Federation, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Tunisia, Turkey, Ukraine, and the United Kingdom. A foreign person must fill out Form W-8BEN to let the withholding agent know that the winner is a foreign person, so withholding may not be applicable. The entity providing the winnings must report the winnings and the tax withheld on Forms 1042 and 1042-S. The recipient must report the amount of the winnings and amount of the tax withheld from Form 1042 or 1042-S on his Form 1040NR.

Gifts

A gift is not included as gross income of the taxpayer. I.R.C. § 102. Although the donor of money or property is subject to gift tax on a gift. A gift is taxable to the donor once the donor does not have control over the gift anymore. The gift is not taxable if the donor has not transferred gifts totaling a present value of over the exclusion amount (\$11,000 in 2005, \$12,000 in 2006) to any one person in the taxable year. I.R.C. §2503(b). If the total gifts to any one person are over the exclusion, then the donor must file a gift tax return (Form 709). Form 709 must be filed even if no tax is payable on the amount of the gift. If married, both spouses can give separate gifts up to the annual limit to the same person without the gift being taxable (\$22,000 in 2005, and \$24,000 in 2006). The annual limit does not apply to gifts to the donor's spouse, gifts to a political organization for its use, gifts to charities, or tuition or medical expenses the donor paid directly to an education or medical institution for someone else's benefit.

Damages Won from a Lawsuit or Settlement

Compensatory damages are damages to reimburse the injured person for the loss suffered. Compensatory damages received to remedy personal physical injuries or personal physical sicknesses are not taxed, even if you are not the injured party. I.R.C. §104(a). Emotional distress is not considered a physical injury or sickness, therefore, the amount paid for medical care attributable to emotional distress is not excluded from tax. *Id.* Compensatory damages received based on a claim of emotional distress linked to a physical injury or sickness, are excludable from tax.

Punitive damages are damages awarded in addition to actual damages when the defendant acted recklessly or with bad intent. All punitive damages are taxed and should be reported on Form 1040 (or other type of Form 1040) as other income. Court costs and legal fees should not be subtracted from this amount. Form 1099-MISC should be received that will report punitive damages to the IRS.

Insurance Proceeds

Life insurance proceeds that are payable because the insured died are excludable from the recipient's gross income. I.R.C. §101(b)(1). If the proceeds were paid after the death of the insured under an interest option or in installments, any amount received over the total amount payable at the time of the insured's death is not excludable from the beneficiary's income tax. I.R.C. §101(d)(1). Transferring of the insurance policy during the insured's life will cause the beneficiary to lose all or part of the exclusion. Certain accelerated death benefits received by terminally or chronically ill insureds are excludable from the beneficiary's income tax.

Helpful Resource Information:

IRS Publication 554 Older Americans' Tax Guide (life insurance information)

IRS Publication 939 General Rule for Pensions and Annuities

IRS Publication 950 Introduction to Estate & Gift Taxes

IRS Publication 901 U.S. Tax Treaties

IRS Form 1099-MISC and Instructions

IRS Form W-2

IRS Form W-2G

IRS Form 1042

IRS Form 1042-S

IRS Form W-8BEN

IRS Form 709