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Opinion No. 03-040

Taxation of Lottery Winnings

QUESTIONS

1. Would it be constitutional to impose a tax on winnings from the Tennessee lottery?

2. Would such a tax satisfy equal protection requirements if it were applied to lottery winnings but not to other prize winnings, gambling winnings, found money, rewards, or ordinary earned income?

OPINIONS

1. Yes. Acting under its powers enumerated in Article II, Section 28 of the Tennessee Constitution, the General Assembly could declare participation in the Tennessee lottery to be a taxable privilege, and it could measure that tax by a percentage of winnings from the lottery.

2. Yes. Imposing such a tax on lottery winnings but not on other winnings or income would be constitutionally permissible and would not violate equal protection.

ANALYSIS

(1)

The instant questions focus on the nature and legality of taxing lottery winnings. While such a tax has not previously been addressed in Tennessee because of the constitutional prohibition of a State lottery, the recent amendment to Article XI, Section 5, authorizing the General Assembly to implement a carefully-prescribed type of lottery, makes consideration of this question appropriate.

The General Assembly has virtually unlimited power to declare, define, and tax privileges. Article II, Section 28 of the Tennessee Constitution recognizes that "[t]he Legislature shall have power to tax merchants, peddlers, and privileges, in such manner as they may from time to time direct . . . ." Since the founding of the State, the courts have recognized the extremely broad discretion of the legislature to design the system of taxation in Tennessee. *See Mabry v. Tarver,* 20 Tenn. (1 Humph.) 98 (1839); *Jenkins v. Ewin,* 55 Tenn. (8 Heisk.) 456 (1872); *Ogilvie v. Hailey,* 141 Tenn. 392, 210 S.W. 645 (1918).

In *Hooten v. Carson,* 186 Tenn. 282, 209 S.W.2d 273 (1948), the Supreme Court, in upholding the newly-adopted sales tax, found "the law [to be] well settled that the State in the exercise of its sovereign power may impose a privilege tax upon any and all business transactions to the end that the general public be protected from unfair trade practices . . . ." 186 Tenn. at 288-89. Further, in that same year the Court in *Knoxtenn Theatres v. Dance,* 186 Tenn. 114, 208 S.W.2d 536 (1948), upheld a privilege tax on the purchase of tickets for admission to a theater, picture show, or other place of amusement, stressing that the pursuit of pleasure may be taxed as a privilege. 186 Tenn. at 119.

Under these authorities, the General Assembly quite clearly could declare the purchase of a lottery ticket or share, or general participation in the State-sponsored lottery, to be a taxable privilege. Such participation has elements of both a business transaction and an amusement, and its existence is dependent upon authorization by the State. Thus, it meets the most stringent view of what may be characterized as a privilege and taxed as such.

If the legislature should declare purchase of a lottery ticket or share to be taxable as a privilege, it then would have discretion to determine how the tax on that privilege is to be imposed and measured. The courts have recognized the "authority for the legislature to measure the tax by any reasonable standard." *Bank of Commerce & Trust Co. v. Senter,* 149 Tenn. 569, 585, 260 S.W. 114 (1924). The Supreme Court in *Bank of Commerce* approved the corporate excise tax as a privilege tax on doing business in Tennessee in the corporate form, measured by a percentage of the net income of the corporation. And just as earnings from the privilege of doing business in the corporate form are a reasonable and permissible measure for the corporate excise tax, the winnings resulting from the privilege of buying a lottery ticket are a reasonable and permissible measure for a tax on that privilege.

Thus, it is clear from well-established Tennessee precedents that the General Assembly could impose a tax measured by a percentage of winnings from the Tennessee lottery. It could do this by declaring participation in the lottery to be taxable privilege, and basing the tax on the amount of one's winnings.

The instant question refers to "the imposition of a Hall Income Tax on lottery winnings." The sort of privilege tax described above is grounded in a completely different legal theory than the Hall Income Tax. Such a tax on lottery winnings would not be a mere expansion of the Hall Income Tax. The Hall Income Tax is based on the language of Article II, Section 28 of the Constitution that states, "the Legislature shall have power to levy a tax upon incomes derived from stocks and bonds that are not taxed ad valorem." As a result, the Hall Income Tax reaches only stock dividends and bond interest, as the legislature has defined those terms. *See* Tenn. Code Ann. §§ 67-2-101 & -102. Lottery winnings do not fall into these categories, and thus a tax on those winnings cannot be premised on an expansion of the Hall Income Tax, at least as that term has heretofore been used in Tennessee.

Inquiry is also made concerning whether imposition of a tax on lottery winnings would constitute

an income tax. This depends entirely on what one means by an income tax. Some might consider the excise tax, Tenn. Code Ann. §§ 67-4-2001 *et seq.*, to be an income tax, since it now amounts to 6½ % of net earnings of corporations and other specified entities doing business in Tennessee. Tenn. Code Ann. § 67-4-2007. Technically speaking, however, the excise tax is not a direct income tax, but a privilege tax that is measured by income. Whether a particular levy is an income tax or not lies in the eye of the beholder, and depends on whether one affixes that term based on the measure of the tax or on its legal incidence.

Of course, the General Assembly could attempt to impose a direct income tax on lottery winnings, without characterizing the levy as a privilege tax. This might enable the tax to have a different scope and to reach, for instance, winnings by Tennessee residents from other states' lotteries. Premised in such a way, such a tax would present the constitutional question of whether a direct tax on income, or a tax on the privilege of receiving income or earnings, is permissible in Tennessee. *See Evans v. McCabe,* 164 Tenn. 672, 52 S.W.2d 159 (1932); *Jack Cole Co. v. MacFarland,* 206 Tenn. 694, 337 S.W.2d 453 (1960). While this Office believes that such a tax is permissible, *see* Op. Tenn. Att'y Gen. No. 99-217 (Oct. 28, 1999), it would present issues beyond those that are necessary for one to address in considering a privilege tax on purchasing lottery tickets, measured by the winnings from the Tennessee lottery.

(2)

The next question is whether a tax on or measured by lottery winnings would satisfy equal protection standards if the tax did not reach other prize winnings, gambling winnings, found money, rewards, or ordinary earned income. The clear answer is that such a tax would not violate the equal protection provisions of the fourteenth amendment to the U.S. Constitution, or Article I, Section 8, and Article XI, Section 8, of the Tennessee Constitution.

In structuring their tax systems, the states' powers to make classifications are at their broadest. A mere rational basis is sufficient to sustain classifications in the objects or amounts of taxation, so long as the tax does not discriminate against a suspect class or infringe on a fundamental right, neither of which is a concern in taxing lottery winnings. The Supreme Court articulated these general principles of equal protection law in *Doe v. Norris*, 751 S.W.2d 834, 840-42 (Tenn. 1988), as follows:

> The concept of equal protection espoused by the federal and our state constitutions guarantees that "all persons similarly circumstanced shall be treated alike." Conversely, things which are different in fact or opinion are not required by either constitution to be treated the same. "The initial discretion to determine what is 'different' and what is 'the same' resides in the legislatures of the States," and legislatures are given considerable latitude in determining what groups are different and what groups are the same. *Id.* In most instances the judicial inquiry into the legislative choice

> is limited to whether the classifications have a reasonable relationship to a legitimate interest.

Consequently, legislation containing particular classifications is not in violation of the Tennessee or federal constitution if "any possible reason can be conceived to justify the classification, or if the reasonableness be fairly debatable . . . ." *Estrin v. Moss*, 221 Tenn. 657, 430 S.W.2d 345, 349 (1968); *Nolichuckey Sand Co. v. Huddleston*, 896 S.W.2d 782, 789 (Tenn. Ct. App. 1994). It is well-settled that the rational basis test particularly applies in the realm of taxation, where the legislature's prerogatives and priorities in setting public policy must be given broad leeway. *See Brentwood Liquors Corp. v. Fox*, 496 S.W.2d 454, 457 (Tenn. 1973); *City of Tullahoma v. Bedford County*, 936 S.W.2d 408, 412 (Tenn. 1997); *Stalcup v. City of Gatlinburg*, 577 S.W.2d 439, 443 (Tenn. 1979). As "the right to tax is essential to the existence of government, and is particularly a matter for the Legislature," a plaintiff seeking to challenge the constitutionality of a Tennessee revenue statute "bears a heavy burden." *Nolichuckey Sand Co. v. Huddleston*, 896 S.W.2d 782, 788 (Tenn. Ct. App. 1994), *quoting Vertrees v. State Board of Elections*, 141 Tenn. 645, 214 S.W. 737, 740 (1919).

There are numerous reasons why the legislature could deem it proper to tax lottery winnings and not other forms of gambling winnings or earnings. Foremost among these reasons for special taxation of the Tennessee lottery and its winnings is its character as a State-sponsored gambling enterprise. Obviously, the State can attempt to derive special revenue from such an enterprise that it sponsors and promotes. Because of the extensive State involvement with the lottery, it is reasonable for its winnings to be treated differently from other winnings, or from ordinary earned income. Moreover, lottery winnings can readily be identified as a more appropriate object of taxation than earned income, in light of the State's strong interest in promoting the work ethic and productive endeavors.

Consequently, it is clear that the General Assembly may tax winnings from the Tennessee lottery, even if it chooses not to tax other types of winnings and earnings. Neither the United States Constitution nor the Tennessee Constitution prohibits such reasonable classifications in our tax laws.

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