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New Jersey Tax Court Decides Equitable Principles Bar State from Imposing Gross Income Tax on Winnings from Lottery Drawings Pre-2009 Law Change

In three separate but related cases, the New Jersey Tax Court held that the state could not impose Gross Income Tax on New Jersey lottery winnings from drawings that occurred prior to a 2009 law change. *Milligan v. Director, Division of Taxation*, Dkt. Nos. 007048-2011, et al. *Leger v. Director, Division of Taxation*, Dkt. No. 007706-2011 and *Harrington, et al. v. Director, Division of Taxation*, Dkt. No. 009529-2011, et al. In 2009, in an effort to generate state tax revenues, the New Jersey legislature sought to tax certain New Jersey lottery winnings. On June 29, 2009, *N.J.S.A.*§ 54A:6-11 was amended to impose Gross Income Tax on New Jersey lottery winnings from any prize in excess of $10,000. L.2009, c.69. The amendment also provided that it would "take effect immediately and apply to taxable years beginning on or after January 1, 2009."

In *Milligan*, the plaintiffs (husband and wife) won a $46 million lottery prize in 2000 and elected to take installment payments of approximately $1.7 million per year for 26 years. The Milligans were informed by the Division of State Lottery that the annual installment payment would be net of federal income tax only. In 2010, the Milligans included their annual lottery installment payment in their 2009 New Jersey Gross Income Tax return. Shortly thereafter, they filed an amended 2009 New Jersey Gross Income Tax return, which excluded the annual installment and sought a refund of tax paid on the annual installment. The Director disallowed the amended return and denied the refund claim. The taxpayers timely protested the denial and ultimately filed a complaint in the Tax Court.

In *Leger*, the plaintiffs (husband and wife) won a $3.5 million Pick 6 Lotto prize in December 2008. Due to personal family matters, the Legers did not know they had won until sometime in March 2009. After consulting with his long-time financial advisor, Mr. Leger elected to take the lump sum payment option. In May 2009, Mr. Leger received a check for approximately $1.9 million from the Division of State Lottery, which was the lump sum payment option less federal income tax withholding. After that, Mr. Leger's financial advisor became aware of the June 29, 2009, law change. He advised Mr. Leger to make an estimated tax payment to New Jersey prior to December 31, 2009, to cover the Gross Income Tax on the lottery winnings. The Legers filed their 2009 New Jersey Gross Income Tax return in April 2010, and included the lottery winnings in their gross income. Shortly thereafter, they filed an amended 2009 New Jersey Gross Income Tax return, excluding the lottery winnings and requesting a refund of the tax assessed on the lottery winnings. The Director disallowed the amended return and refund claim. The taxpayers timely protested the denial and ultimately filed a complaint in Tax Court.

In *Harrington*, the plaintiffs (10 individuals) won the New Jersey Mega Millions lottery prize of approximately $216 million on March 3, 2009. They elected to take the lump sum option payment in the amount of approximately $140 million. Each plaintiff was entitled to approximately $14 million. Each plaintiff received a check from the Division of State Lottery for approximately $10.5 million, which was net of federal income tax withholding. In 2010, the plaintiffs filed their 2009 New Jersey Gross Income Tax returns and included therein the amount of their share of the lottery winnings. Shortly thereafter, they filed amended 2009 New Jersey Gross Income Tax returns excluding the lottery winnings and requesting a refund of the overpaid tax. The Director disallowed the amended returns and refund claims. The plaintiffs timely protested the denial and initially filed complaints in the Superior Court Law Division alleging certain constitutional and contract claims against the Director. The cases were transferred to the Tax Court and amended complaints were filed.

In all three cases, the Tax Court found that at the time the plaintiffs purchased their lottery tickets, the New Jersey Division of State Lottery advertised that New Jersey lottery winnings were not subject to Gross Income Tax. In addition, at the time all of the plaintiffs turned in their winning tickets, they were advised that the payments to them would be net of federal income taxes only. For these reasons, the Tax Court concluded that the "square corners" doctrine precluded the assessment of Gross Income Tax on the plaintiffs' lottery winnings from a prize awarded before the June 29, 2009 amendment. The square corners doctrine is an equitable concept that basically precludes the assessment of a tax where the taxpayer made financial decisions relying on representations by state officials regarding how tax laws would be applied. The Tax Court also found that to the extent that a plaintiff relied on the Gross Income Tax exclusion of lottery winnings in planning his or her financial affairs after s/he received those winnings (which was especially true in *Leger*), it was a manifest injustice for New Jersey to impose Gross Income Tax on those winnings. The "manifest injustice" doctrine is another equitable concept designed to prevent unfair results that do not necessarily violate constitutional principles.

These three decisions affirm the Tax Court's willingness to apply both the square corners and the manifest injustice doctrines.