State lottery — use of unclaimed prize money and proceeds of privilege tax

QUESTIONS

1. House and Senate versions of a proposed bill to implement the lottery each establish a pool of unclaimed lottery prize money. The House and Senate versions provide for the following four different uses, the last of which is only in the Senate version:

   A. Expenses of incarceration for lottery-related felonies;

   B. Treating compulsive gambling problems or providing educational programs regarding compulsive gambling problems; and

   C. Lottery prizes or future prize promotions.

   D. After-school programs “in accordance with the provisions of Article XI, Section 5 of the Constitution of Tennessee.”

   May unclaimed prize money constitutionally be used for these purposes?

2. May the General Assembly appropriate unclaimed lottery prize funds in any manner other than allowing the Tennessee Education Lottery Corporation to use it as future prizes, special prize promotions, or for educational programs as enumerated in Article XI, Section 5 of the Tennessee Constitution?

3. If a privilege tax is attached to lottery winnings, would the appropriation of the proceeds of such tax be limited by Article XI, Section 5 of the Tennessee Constitution?

OPINIONS

1. A. Although it can be argued that the costs of incarcerating individuals convicted of lottery-related felonies are incurred as an indirect result of the operation of a state lottery, they are not expenses or losses directly incurred in realizing lottery revenues. For this reason, lottery revenues, including unclaimed lottery prizes, may not constitutionally be used to pay to incarcerate individuals convicted of lottery-related felonies.
B. Similarly, although it can be argued that some compulsive gambling problems may be related to establishing a state lottery, neither treating compulsive gambling problems nor providing educational programs regarding compulsive gambling problems is an expense or loss directly incurred in realizing lottery revenues. For this reason, lottery revenues, including unclaimed lottery prizes, may not constitutionally be used for treating compulsive gambling problems or for providing educational programs regarding compulsive gambling problems.

C. Lottery revenues, including unclaimed lottery prizes, may, clearly, be used for lottery prize money and prize promotions. These are expenses directly incurred in realizing lottery revenues.

D. Lottery revenues, including unclaimed lottery prize money, may be used for after school programs only if the funds are used to “supplement, not supplant, non-lottery educational resources for educational programs and purposes.” The Senate version of the bill regarding after school programs does not clearly contain this requirement. Further, the bill provides no way to ascertain that the financial assistance program has been fully funded and that moneys in the unclaimed prize fund may, therefore, be appropriated for the other purposes listed in Article XI, Section 5. These defects render this provision for the use of unclaimed lottery prize money, as currently drafted, unconstitutional.

2. Like other lottery revenues, unclaimed lottery prize money may be used to pay expenses or losses incurred in realizing lottery revenues. These may include expenses other than prizes or prize promotions, but must be incurred in realizing lottery revenues. Any remaining revenues must be used for the educational purposes and in accordance with the restrictions contained in Article XI, Section 5 of the Tennessee Constitution.

3. There are no particular constitutional limitations on the use of revenues derived from a privilege tax on lottery winnings. The Legislature may prescribe a particular distribution or use for those revenues. That distribution or use need not be limited to the uses the Tennessee Constitution permits for lottery proceeds.

ANALYSIS

This opinion concerns proposed bills implementing a state lottery. The first question concerns the use of the unclaimed lottery prize money pool for four different purposes under House and Senate versions of a bill to establish a state lottery. Section 2 of both the House and Senate versions, proposed Tenn. Code Ann. § 4-51-123(b)(4), provides:

(A) A holder of a winning cash ticket or share from any lottery game conducted by a drawing shall claim a cash prize within one (1) year after the drawing in which the cash prize was won. If a multistate or multisovereign lottery game requires, by rule or
regulation, a period of time less than one (1) year for redemption of a winning ticket, such period shall apply for that lottery game.

(B) In any Tennessee lottery game in which the player may determine instantly if he has won or lost, such player shall claim a cash prize within ninety (90) days, or for a multistate or multisovereign lottery game within one hundred eighty (180) days, after the end of the lottery game.

(C) If a valid claim is not made for a cash prize within the applicable period, the cash prize shall constitute an unclaimed prize for purposes of this section.

Subsection (g) of the same proposed statute in the Senate version provides in relevant part:

(1) Unclaimed prize money shall not constitute lottery proceeds. The provisions of Title 66, Chapter 29 shall not apply to unclaimed prize money of the corporation.

(2) A portion of unclaimed prize money, not to exceed two hundred thousand dollars ($200,000) annually, shall be directed to the Department of Mental Health and Developmental Disabilities for the treatment of compulsive gambling disorder and educational programs related to such disorder. The Department of Mental Health and Developmental Disabilities shall prepare an annual report for the board and select committee concerning its efforts in the treatment of compulsive gambling. A portion of unclaimed prize money, not to exceed twenty-five thousand dollars ($25,000) annually, shall be directed to the Department of Correction for the incarceration of any person convicted pursuant to the provisions of Title 39, Chapter 17, Part 6; provided that on any June 30, any funds unexpended by the department for such incarcerations shall not revert to the general fund but shall remain available in subsequent fiscal years to fund incarcerations under Title 39, Chapter 17, Part 6.

(3) Any unclaimed prize money in excess of the funds transferred in accordance with the provisions of subdivision (2) shall be directed as follows:

(A) Fifty percent (50%) to the Department of Education for after school programs. Such programs to be in accordance with the provisions of Article XI, Section 5 of the Constitution of Tennessee; and
(B) Fifty percent (50%) to be added to the pool from which future prizes are to be awarded or used for special prize promotions.

Subsection (h) of proposed Tenn. Code Ann. § 4-51-123 in the House version provides:

(1) Unclaimed prize money shall not constitute net lottery proceeds or, for the purposes of § 4-51-111, lottery proceeds. The provisions of title 66, chapter 29 shall not apply to unclaimed prize money of the corporation.

(2) (A) Beginning in fiscal year 2004-2005, a portion of unclaimed prize money, not to exceed seven hundred thousand dollars ($700,000) annually, shall be directed to the University of Memphis Tennessee Center for Responsible Gambling for the treatment of compulsive gambling disorder and educational programs related to such disorder. The University of Memphis Tennessee Center for Responsible Gambling shall prepare an annual report for the board and select committee concerning its efforts in the treatment of compulsive gambling.

(B) Except as otherwise provided in this subdivision, a sum sufficient from unclaimed prize money shall be directed annually to the department of correction for the incarceration of any person convicted pursuant to the provisions of title 39, chapter 17, part 6; provided that on any June 30, any funds unexpended by the department for such incarcerations shall not revert to the general fund but shall remain available in subsequent fiscal years to fund incarcerations under title 39, chapter 17, part 6. In fiscal year 2003-2004, the corporation shall transfer eight thousand five hundred dollars ($8,500) to the department of finance and administration for such costs.

(3) Any unclaimed prize money in excess of the portions directed in accordance with the provisions of subdivision (2) may be added to the pool from which future prizes are to be awarded or used for special prize promotions.

Under Tenn. Code Ann. §§ 66-29-101, et seq., property that has remained unclaimed for a certain period of time must be turned over to the Treasurer and is held indefinitely pending claims by the rightful owner.

Article XI, Section 5 of the Tennessee Constitution provides in relevant part:
The legislature shall have no power to authorize lotteries for any purpose, and shall pass laws to prohibit the sale of lottery tickets in this state, except that the legislature may authorize a state lottery if the net proceeds of the lottery’s revenues are allocated to provide financial assistance to citizens of this state to enable such citizens to attend post-secondary educational institutions located within this state. The excess after such allocations from such net proceeds from the lottery would be appropriated to:

1. Capital outlay projects for K-12 educational facilities; and
2. Early learning programs and after school programs.

Such appropriation of funds to support improvements and enhancements for educational programs and purposes and such net proceeds shall be used to supplement, not supplant, non-lottery educational resources for educational programs and purposes.

(Emphasis added). Thus, Article XI, Section 5 restricts the allocation of the “net proceeds of the lottery’s revenues.” The “lottery’s revenues” are the initial pool of funds governed by the amendment. That pool is then reduced to the “net proceeds of the lottery’s revenues” by subtracting the amount of expenses incurred to offer the lottery. This Office has noted that, as commonly used, the term “net proceeds” refers to what remains of the gross proceeds after all expenses and losses incurred in realizing them are deducted. Op. Tenn. Atty. Gen. 03-007 (January 22, 2003). There, we concluded that “net proceeds” as used in Article XI, Section 5 of the Tennessee Constitution are the funds remaining from the gross proceeds from the state lottery after all expenses and losses incurred in realizing them are deducted. We also noted that the legislature has some discretion in defining what constitutes an expense of the state lottery. That opinion concluded, however, that proceeds from the state lottery may not be used to fund the regulation of charitable lotteries, since this would not be an expense incurred in realizing the gross proceeds from the state lottery.

As quoted above, both the House and Senate versions of the bill provide that unclaimed prize money will not constitute net lottery proceeds. This statement is not sufficient, however, to remove the constitutional limits on the use of these funds. Clearly, unclaimed lottery prizes would be included in the term “lottery’s revenues,” which, under Article XI, Section 5, must be allocated to specific educational purposes after expenses incurred to offer the lottery have been subtracted. Funds to pay the prizes will come from the proceeds of the sale of lottery tickets or shares. The fact that the prizes are not claimed does not change their status as “lottery’s revenues” within the meaning of Article XI, Section 5 of the Tennessee Constitution. Therefore, unclaimed lottery prizes, like other lottery revenues, must be allocated to the educational purposes specified in the constitution.
unless they are used to pay expenses and losses incurred in realizing gross proceeds from the lottery. Op. Tenn. Atty. Gen. 03-041 (April 11, 2003). The question then becomes whether the proposed purposes — payment of incarceration expenses for people convicted of lottery related crimes; treatment of compulsive gambling problems; prize money and prize promotions; and after school programs — are expenses and losses incurred in realizing gross proceeds from the lottery or fall within the permissible educational uses for lottery proceeds in Article XI, Section 5.

1. Uses of Unclaimed Prize Money
   A. Incarceration Expenses

   Section 8 of both the House and Senate versions of the bill adds new sections to the state criminal code, Tenn. Code Ann. §§ 39-17-601, et seq. Under the new statutory system, several offenses related to the sale of a lottery ticket or the operations of the lottery would be felonies. The question, then, is whether expenses to incarcerate individuals convicted of these felonies can be regarded as expenses or losses incurred in realizing gross proceeds from the lottery.

   The Oregon Supreme Court has addressed the meaning of the term “costs of administration” as used under the constitutional provision allowing a state lottery in Oregon. Ecumenical Ministries of Oregon v. Oregon State Lottery Commission, 318 Or. 551, 871 P.2d 106 (1994). In that case, Article XV, Section 4(3) of the Oregon Constitution provided in part that “[a]ll proceeds from the State Lottery, including interest, but excluding costs of administration and payment of prizes, shall be used for the purpose of creating jobs and furthering economic development in Oregon.” Section 4(4)(e) created a fund within the state’s general fund, “which is continuously appropriated for the purpose of administering and operating the Commission and the State Lottery.” The plaintiffs challenged several provisions of legislation implementing a state lottery, including a provision allocating three percent of net revenue of county video lottery games to the county as “administrative expenses” for “gaming law enforcement.” The Court noted that another part of Article XV required the lottery to pay “all of its expenses” out of the revenues it received. 871 P.2d at 114. The Court cited a dictionary definition of the term “administration.” Finally, the Court also examined a companion measure to the ballot measure amending the Constitution to allow a state lottery in 1984. The Court found that, considering all these sources, the terms “costs of administration” and “administering and operating” the Commission and the State Lottery as used in the State Constitution related to the “expenses” or “costs” of the internal implementation and management of the lottery. 871 P.2d at 115.

   The Court then concluded that expenditures for “gaming law enforcement” could not be considered an administrative expense of the lottery for which lottery revenues could constitutionally be used. The Court noted that gaming law enforcement was not limited to games operated by the State Lottery. The Court stated:

   We conclude that, even though “gaming laws” are laws that relate to the playing of games for stakes or prizes, including games operated by the State Lottery, expenditures for a county’s enforcement of such
laws are not an administrative expense of the lottery. That is because, although some gaming law enforcement complements the operation of the lottery, expenditures for gaming law enforcement are not expenses or costs of the internal implementation or management of the lottery.

871 P.2d 106, at 115-116 (footnote omitted). The Court further noted that its conclusion was not intended to affect expenditures by the State Lottery Commission for the purposes of maintaining security and ensuring the State Lottery’s own compliance with the laws governing operation of the lottery. Id., at 116, note 11.

The situation addressed in this opinion differs in some respects from the situation addressed in Ecumenical Ministries. Under the proposed bill, lottery revenues would be used to defray incarceration expenses for individuals convicted only of lottery-related felonies. Unlike the statute in Ecumenical Ministries, therefore, the proposed amendment is focused on offenses related to the lottery, and not to gaming laws in general. But the Oregon Supreme Court acknowledged that “some gaming law enforcement complements the operation of the lottery . . . .” 871 P.2d 106, at 116. Nevertheless, the Oregon Supreme Court found that “expenditures for gaming law enforcement are not expenses or costs of the internal implementation or management of the lottery.” Id. This statement indicates that the Court would have reached the same conclusion even if the statute had allowed counties to use lottery proceeds to pay expenses only to enforce criminal laws directly related to the operation of the State Lottery.

The language of the Tennessee Constitution also differs from the language of the Oregon Constitution interpreted in Ecumenical Ministries. Article XI, Section 5 of the Tennessee Constitution, unlike the Oregon Constitution, does not expressly refer to “costs of administration” of the lottery. But it does provide that the “net proceeds of the lottery’s revenues” must be allocated for specific educational purposes. As discussed above, the term “net proceeds” refers to what remains of the gross proceeds after all expenses and losses incurred in realizing them are deducted. Article XI, Section 5, therefore, allows lottery revenues to be used to pay expenses and losses that were incurred in realizing those revenues. We think this term is virtually synonymous with the Oregon Supreme Court’s interpretation of “costs of administration” payable from lottery revenues under the Oregon Constitution. Similarly, although it can be argued that the costs of incarcerating individuals convicted of lottery-related felonies are incurred as an indirect result of the operation of a state lottery, they are not expenses or losses directly incurred in realizing lottery revenues. For this reason, lottery revenues, including unclaimed lottery prizes, may not constitutionally be used to pay to incarcerate individuals convicted of lottery-related offenses.

B. Treating Compulsive Gambling and Providing Educational Programs Regarding Compulsive Gambling

The second question is whether treatment of compulsive gambling problems by the Department of Mental Health and Developmental Disabilities or University of Memphis Tennessee
Center for Responsible Gambling and educational programs regarding compulsive gambling are expenses or losses incurred in realizing lottery proceeds. In *Ecumenical Ministries*, the Oregon Supreme Court found that expenditures for community mental health programs to treat gambling addiction were not a permissible “cost of administration” of the lottery under the Oregon Constitution. 871 P.2d at 116. The Court stated, “[a]lthough the need for such programs may result in part from the operation of the lottery, expenditures for mental health programs to treat gambling addiction also are not expenses or costs of the internal implementation or management of the lottery.” *Id.*

We think the same analysis applies to the use of lottery proceeds under Article XI, Section 5 of the Tennessee Constitution. It can be argued that some compulsive gambling problems may be related to the establishment of a state lottery. But the proposed expenditures would not be limited to the problems related to the state lottery. Further, we do not think that expenditures for treating compulsive gambling problems or for providing educational programs regarding compulsive gambling problems are expenses or losses incurred in realizing lottery proceeds. For this reason, lottery revenues, including unclaimed lottery prizes, may not constitutionally be used for treating compulsive gambling problems or for providing educational programs regarding compulsive gambling problems.

C. Lottery Prizes and Special Prize Promotions

The next question is whether unclaimed lottery prize funds may be used for lottery prizes and special prize promotions. Clearly, both these expenditures are expenses directly incurred in realizing lottery proceeds. Therefore, unclaimed lottery prize money may constitutionally be used for lottery prizes and special prize promotions.

D. After School Programs

Finally, under the Senate version, a portion of the unclaimed prize funds would be transferred to the Department of Education for after school programs, “[s]uch programs to be in accordance with the provisions of Article XI, Section 5 of the Constitution of Tennessee[.]” Obviously, this use is not an expense incurred in realizing lottery proceeds. Therefore, this use of the funds is unconstitutional unless it is carried out in accordance with that part of Article XI, Section 5 of the Tennessee Constitution regarding use of net proceeds of the lottery’s revenues. As quoted above, Article XI, Section 5 requires that net lottery revenues be used for three different educational purposes, including after school programs. Article XI, Section 5 imposes two other requirements on expending net lottery proceeds. First, these funds must be used to “supplement, not supplant, non-lottery educational resources for educational programs and purposes.” The Senate version of the bill regarding use of unclaimed lottery prize money for after school programs does not clearly contain this requirement. Second, Article XI, Section 5 creates a clear priority in favor of the first educational purpose, that is, “financial assistance to citizens of this state to enable such citizens to attend post-secondary educational institutions located within this state.” Op. Tenn. Atty. Gen. 03-015 (February 10, 2003). Once the financial assistance program established by the legislature is fully
funded, then any remaining net proceeds may be appropriated for the other purposes listed in Article XI, Section 5. *Id.* The Senate version regarding use of unclaimed lottery prize money for after school programs provides no way to ascertain that the financial assistance program has been fully funded and that unclaimed prize money may, therefore, be appropriated for the other purposes listed in Article XI, Section 5. These defects render this provision, as currently drafted, unconstitutional. Op. Tenn. Atty. Gen. 03-041 (April 11, 2003).

2. Other Uses of Unclaimed Lottery Prize Money

The next question is whether the General Assembly may appropriate unclaimed lottery prize funds in any manner other than allowing the Tennessee Education Lottery Corporation to use it as future prizes, special prize promotions, or for educational programs as enumerated in Article XI, Section 5 of the Tennessee Constitution. Like other lottery revenues, unclaimed lottery prize money may be used to pay expenses or losses incurred in realizing lottery revenues. These may include expenses other than prizes or prize promotions, but must be incurred in realizing lottery revenues. Any remaining revenues must be used for the educational purposes and in accordance with the restrictions contained in Article XI, Section 5 of the Tennessee Constitution.

3. Restrictions on Use of Privilege Tax Proceeds

The last question is whether, if a privilege tax is attached to lottery winnings, appropriation of the proceeds of such tax would be limited by Article XI, Section 5 of the Tennessee Constitution. The House version of the bill levies a six percent privilege tax based on lottery winnings. Section 2, proposed sections 4-51-301 — 4-51-303 provide as follows:

4-5-301

(a) It is hereby declared to be a privilege, taxable by the state only, to participate in the Tennessee state lottery. For the exercise of such privilege, a tax is hereby levied, to be measured by winnings from such lottery, equal to six percent (6%) of gross winnings or prizes received by, accrued or credited to any person, partnership, trust, corporation, or other entity from such lottery, less the exemption provided in subsection (b).

(b) The tax imposed by this part shall not apply to the first six hundred dollars ($600) of lottery winnings otherwise taxable under this part.

4-51-302

(a) The Tennessee Education Lottery Corporation or other entity administering the Tennessee state lottery shall provide to the
commissioner of revenue the same information furnished to the federal internal revenue service on I.R.S. form W-2G relative to winnings of over six hundred dollars ($600) from a lottery.

(b) (1) The Tennessee Education Lottery Corporation or other entity administering the lottery shall withhold and remit to the commissioner of revenue six percent (6%) of lottery winnings over the exemption level provided in Section 4-51-301(b) at the same time federal tax withholding is required pursuant to I.R.S. Form W-2G.

(2) The commissioner of revenue shall furnish to the Tennessee Education Lottery Corporation or other entity administering the lottery necessary forms or tables to facilitate calculating and remitting the amount to be withheld.

4-51-303

Proceeds from the privilege tax levied by this part shall be earmarked and allocated first to the department of revenue in an amount sufficient to defray the costs of administration of this part. The remaining proceeds shall be earmarked and allocated fifty percent (50%) to early childhood education programs and fifty percent (50%) to health education programs.

This Office has concluded that the General Assembly could constitutionally impose a tax on the privilege of participating in the Tennessee lottery, measured by a percentage of winnings from the lottery. Op. Tenn. Atty. Gen. 03-040 (April 7, 2003). Article XI, Section 5 of the Tennessee Constitution restricts the allocation of the “net proceeds of the lottery’s revenues.” Thus, “the lottery’s revenues” are the initial pool of funds governed by the amendment. That pool is then reduced to the “net proceeds of the lottery’s revenues” by subtracting the amount of expenses incurred to offer the lottery. Therefore, to determine whether funds received from the imposition of a tax measured by lottery winnings would be restricted by the constitutional amendment, one must first determine whether the amount of taxes received would be included in the initial pool of funds governed by the amendment, namely “the lottery’s revenues.”

The import of the phrase “the lottery’s revenues” must be taken from its plain meaning and from the context in which it is used. The revenues raised from the lottery that has been authorized by Article XI, Section 5 would be distinct from any revenues raised from a separately authorized tax on the privilege of participating in the lottery. And these two sources of funds carry different legal consequences. The funds from the lottery itself, being derived from the sales price of the lottery tickets, would be received as a result of the adoption of the constitutional amendment and the subsequent implementation of a state lottery by the legislature. These are the monies that constitute the lottery’s revenues, and to which the constitutional restrictions on use apply. On the other hand,
any taxes received by the State from a privilege tax measured by lottery winnings would be calculated based upon the amount of those winnings, and would be received because of a separate decision by the legislature to impose a tax on the privilege of participating in the lottery. The monies received from this tax are not the lottery’s revenues as contemplated by the Constitution. Rather, they would be the revenues and proceeds of a separate tax levied on the privilege of participating in the lottery. These tax collections, therefore, stand on a different constitutional footing than do the actual receipts from conducting the lottery itself. As a result, there are no particular constitutional limitations on the use of revenues derived from a privilege tax measured by lottery winnings. The Legislature may prescribe a particular distribution or use for those revenues. That distribution or use need not be limited to the uses the Tennessee Constitution permits for lottery proceeds.

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