The Unexpected Tax Consequences of "Extreme Makeover: Home Edition"

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I. INTRODUCTION

Not many people argue with the idea of helping families in need. Most in today's society have a soft spot for helping the less fortunate and wish they could do more to help others. This is where "Extreme Makeover: Home Edition" comes in. "Home Edition" is a reality television series that involves a "run-down house, a deserving family, several opinionated designers, [and] seven days."[1]

Home Edition seeks to differentiate itself from other home improvement shows by choosing families that "have fallen on tough times."[2] The crew sends the family on a seven-day all expense-paid vacation while it lavishly rebuilds the entire home, a process that would usually take more than four months.[3] The rebuilding process

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1. *Extreme Makeover Home Edition* home page, *at* http://abc.go.com/primetime/xtremehome/show.html (last visited Dec. 2, 2004).

2. Charlie McCollum, *'Extreme' to Focus on Deserving Families*, CHICAGO TRIBUNE, February 15, 2004, at 9, *available at* 2004 WL 69247494.

3. *Extreme Makeover Home Edition* home page, *at* http://abc.go.com/primetime/xtremehome/show.html (last visited Nov. 20, 2004); *See* McCollum,

includes every room, the exterior, and the landscaping and is made possible through the help of a team of eight designers, contractors, and several hundred workers.[4] Home Edition is able to supply the renovations because of the donations of material and labor. For instance, Sears, Roebuck and Co. pays more than $1 million for home products such as tools, appliances, and furnishings.[5]

Recently, questions have arisen as to the income tax consequences of these massive home improvements.[6] In response to the questions, Home Edition has responded by saying that the homeowners escape any federal taxation by entering into a lease.[7] The television show claims that the $50,000 value of the appliances and other furnishings are nontaxable as rent because the lease durations are less than fifteen days.[8] Moreover, it asserts that the renovations are free from income taxation as lessee improvements.[9] Skeptics say that this argument will not pass IRS scrutiny and the IRS has yet to comment on the issue.[10] Only time will tell how the IRS will react to this use of the tax code.

Part II of this article will give readers the background behind Home Edition by telling the stories of some of the families who have been helped by the television series. Next, part III will explore the potential tax consequences stemming from the proposed use of I.R.C. Section 280A(g). It will begin with the basic concept of the taxability of prizes and awards, explaining that it is a commonly accepted principal for prizes and awards such as game show winnings and lottery prizes to be subject to the federal income tax. Next, it will explain why this situation does not fit within the exceptions to I.R.C. Section 74, the Section that includes certain prizes and awards in gross income.

Part III will continue by discussing Section 280A(g), which excludes rent from gross income if the cumulative rental period is less than fifteen days. The Section does not distinguish based on the amount of rent paid, allowing astronomical rent amounts. Next, the article will introduce I.R.C. Sections 109 and 1019, which hold

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supra note 2.

4. *Id.*

5. McCollum, *supra* note 2, at 9.

6. Anthony DeBarros, *The Tax Makeover Can Be Extreme, Too*, TIME, October 15, 2004, at E10, *available at* 2004 WL 58567054; Daniel McGinn, *Television: Tax Trouble for ABC's 'Extreme' Winners?*, NEWSWEEK, May 17, 2004, at 12, *available at* 2004 WL 62585100; Jose L. Sanchez Jr., *Extreme Homecoming 2,000 People Welcome Penngrove Family to New $1.5 Million House*, PRESS DEMOCRAT, July 16, 2004, at A1, *available at* 2004 WL 57986899.

7. Sanchez Jr., *supra* note 6, at A1.

8. McGinn, *supra* note 6, at 12. Under I.R.C. § 280A (g) (Westlaw 2004), a taxpayer does not have to include in gross income the amount of rent he receives if the dwelling is rented for less than fifteen days.

9. *Id.* Under I.R.C. § 109 (Westlaw 2004), a lessor does not have to include in its gross income, the value of improvements made by a lessee.

10. DeBarros, *supra* note 6, at E10.

that improvements made by a lessee are not taxable to the lessor. Instead, the value of capital improvements is realized as a capital gain upon the sale of the property.

Because many parties disguise transactions as leases, the next part of the article will discuss the "substance versus form" argument and apply it to two different situations. The first is when a taxpayer "leases" property to a business in which it is a shareholder, but courts hold that the rent is in actuality nothing more than constructive dividends to the shareholder. The second situation is when a transaction is structured as a sale-and-leaseback, but in reality is a financing arrangement. By looking at the economic basis of the transactions, it becomes clear that the parties often use the lease for the purpose of income tax avoidance.

Next, the article will discuss the requirement for rental deductions—that the taxpayer be involved in the activity for a profit. Although Section 280A is subject to a "for profit" requirement because it allows income tax deductions, a profit motive is not necessary under Section 280A(g) because the taxpayer is not allowed to take rental deductions under the subsection. Thus, although the profit motive analysis is typically used in connection with rental deductions, it is unavailable here.

The article will then compare leases and licenses and explain that it is likely Home Edition had a license and not a lease, thereby rendering the families unable to claim the gifts and capital improvements as income tax free. In conclusion, the article will explain that if a court does a substance versus form analysis, it may find that the parties had no economic reason to enter the lease except for tax savings, thereby exposing the families to excessive amounts of unexpected federal income tax—an expense that few, if any, of them can afford.

II. BACKGROUND: ONE DESERVING FAMILY

"Good morning, Pope family!"[11] This is what the Pope family woke up to at 4:30 a.m., July 8, 2004, when the Home Edition crew arrived to renovate the Pope farmhouse.[12] Shelby Pope, a 12-year-old, wrote the ABC show's producers telling them why her home should be made-over.[13] Shelby, who has polymorphous light eruption (sun poisoning), had to spend much of her time in a small bedroom with her window covered.[14] The project, taking seven days and involving more than 2,000 people, increased the value of the property by hundreds of thousands of dollars and added a covered pool and wine cellar.[15] The landscaping, windows, indoor lighting, and pool will be more conducive to Shelby's light allergy.[16]

11. Jose L. Sanchez Jr., *It'll Be a Dream Home; Family on Vacation While Crew Rebuilds House In 5/12 Days*, PRESS DEMOCRAT, July 9, 2004, at A1, *available at* 2004 WL 57986584.

12. *Id.*

13. *Id.*

14. *Id.*

15. Sanchez Jr., *supra* note 6, at A1.

16. *Id.*

The Pope's Sonoma County home had a pre-makeover value of $285,766, and although it has not yet been reassessed, the project's general contractor estimates that its value is now $1.5 million.[17] To help defray the increased property taxes and utility bills, the improvements included solar panels, a new well, and a septic system.[18]

A dream was granted for a mother and her three daughters in Kingston, Washington when Home Edition enabled them to move from a shed into a brand new home.[19] After Roxanne Dore's husband passed away, her home was destroyed by a fire, and the insurance was not adequate to rebuild.[20] Dore and her children were forced to move into a utility shed with no running water and only an outhouse available.[21] Through the work of hundreds—mostly volunteers—a six bedroom, seven bathroom home worth $500,000 was erected.[22] The property taxes are estimated to be $6,500 annually, starting in 2006.[23]

Brian Woffard's home in Encinitas, California had 1,212 square feet and an assessed value of $246,410 before it was renovated into 4,337 square feet with seven bedrooms and a gym.[24] Because his home was reassessed at $572,879, the widowed father of eight will receive a property tax bill of more than double the previous amount, up from $2,700 to $6,000.[25]

Other episodes of Home Edition have included installing an elevator in the home of a young man who had recently been restricted to a wheelchair and rebuilding an entire street in Los Angeles after a flood.[26] Possibly the most heartwarming was that of the Vardon family in Oak Park, Michigan who was chosen after the fifteen-year old son Stefan submitted an essay about his family.[27] He is the communicator of the family because his mother and father are both deaf, and his brother, Lance, is blind

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17. *Id.*

18. Sanchez Jr., *supra* note 11, at A1.

19. Brian Calvert, *Some 'Extremely' Happy Folks in Kingston*, November 11, 2004, *at* http://www.komotv.com/news/printstory.asp?id=33925 (last visited Nov. 13, 2004).

20. Nancy Bartley, *Kingston Cheers as Winners of TV Show See New Home*, SEATTLE TIMES, *available at* http://seattletimes.nwsource.com/html/localnews/2002094194_makeover18m.html (last visited Nov. 18, 2004).

21. *Id.*

22. *Id.*

23. *Id.*

24. Roger M. Showley, *Property Tax Bill Comes Due For Woffard*, THE SAN DIEGO UNION-TRIBUNE, October 17, 2004, at I2, *available at* 2004 WL 59007747.

25. DeBarros, *supra* note 6, at E10.

26. *"Home Edition" Will Take its Show On the Road*, ST. LOUIS POST-DISPATCH, July 16, 2004, at E01, *available at* 2004 WL 84636099.

27. *Extreme Makeover Home Edition* home page, *at* http://abc.go.com/primetime/xtremehome/bios/families/the_vardon_family.html (last visited Nov. 20, 2004).

and autistic.[28] Larry Vardon, a welder, felt he was not able to provide his special family with everything it needed.[29]

Home Edition chose the Vardon family because of its special needs and to make the 980 foot home more spacious.[30] Lance's parents were worried because on more than one occasion they had awakened to find Lance's bed empty and him outside the house.[31] Among the gadgets installed to make it easier for the family to communicate and keep Lance from wandering were: a security system alerting the family when people come and go, a GPS device attached to Lance's clothing to show his location, a vibrating bed to awaken Larry and Judy if Lance leaves during the night, cell phones that ring/vibrate and allow the family members to email each other, a machine that allows Lance to type a message in Braille and converts it to text, and security cameras and computer monitors in every room.[32] Not only did the construction company spend more than $200,000 on renovations while another donor supplied more than $10,000 in furniture, but Stefan was awarded a $50,000 college scholarship.[33] To greet the Vardons upon their return from their week-long trip were 6,000 people waving their hands silently in the air, the sign language signal for applause.[34] After seeing the couple react to their new home, there was not a dry eye in sight.[35]

III. UNEXPECTED CONSEQUENCES

Home Edition undoubtedly makes a difference in the hearts of the families it provides with new homes. It provides a beautiful home to each deserving family, while involving the community and television viewers. Unfortunately, there may be potential unpleasant ramifications from this goodwill. The families are given new homes, appliances, furnishings, and sometimes even automobiles, collectively worth hundreds of thousands of dollars. With this accession to wealth comes questions about the tax consequences. The property tax increases are unavoidable, and the next part of the article introduces the potentially horrifying income tax consequences.

28. Andrea Bogos, *TV Show Makes Dream Home a Reality*, THE DETROIT NEWS, August 18, 2004, at 4, *available at* 2004 WL 88704042.

29. Kara G. Morrison, *High-tech Home Helps Disabled Parents*, THE DETROIT NEWS, November 9, 2003, at 1, *available at* 2004 WL 95226552.

30. Bogos, *supra* note 28, at 4.

31. Morrison, *supra* note 29, at 1.

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

A. *Taxability of Prizes and Awards*

It has long been understood that a prize or award is not exempt from income tax as a gift under I.R.C. § 102.[36] In *Robertson v. United States*, the taxpayer submitted a composition to a symphonic contest and later claimed that the $25,000 award was a nontaxable gift.[37] In response, the Court held that the discharge of a contractual obligation cannot be a gift.[38] Although the donor receives no economic benefit from the services, the award is taxable to the donee.[39]

In 1954, I.R.C. § 74 was enacted to clarify this rule and to overrule two cases that had held a prize and award to be tax-exempt.[40] Section 74 also impliedly prevents prizes from being tax-free gifts because, even if the requirements of Section 102 are met, it may fail Section 74(b) or (c).[41] Under Section 74, "gross income includes amounts received as prizes and awards" unless the income falls under an exception.[42] This taxability includes, but is not limited to, "amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types."[43] The exceptions in Section 74 consist of a prize or award transferred to a charity, certain employee achievement awards, and qualified scholarships excluded by Section 117.[44]

The first exception is granted when a prize is a result of "religious, charitable, scientific, educational, artistic, literary, or civic achievement" if (1) the recipient did not personally enter the contest, (2) the recipient does not have an obligation to perform substantial future services in order to receive the award, and (3) the prize or award is transferred to a charitable organization described in Section 170(c).[45] Although many taxpayers have attempted to use the civic exception to avoid taxation, the exception is not without boundaries.[46] The court in *Simmons v. United States* stressed that the civic exception is not limitless, and although "civic" is not defined in

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36. Robertson v. United States, 343 U.S. 711, 713 (1952); 26 U.S.C. § 102 (1986).

37. *Robertson*, 343 U.S. at 711-13.

38. *Id.* at 713.

39. *Id.* at 714.

40. I.R.C. § 74 (Westlaw 2004); S. REP. NO. 1622, *reprinted in* 1954 U.S.C.C.A.N. 4621, 4642 (1954) (overruling Washburn v. C.I.R., 5 T.C. 1333, 1335 (1945) (holding radio show contest Pot 'O Gold prize exempt) and McDermott v. C.I.R., 150 F.2d 585, 587 (D.C. Cir. 1945) (holding Ross Essay Contest award exempt)).

41. BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS § 5.05 (2d ed. 2004) (but noting that *Simmons v. U.S., infra* note 46, considered the taxpayer's argument that a prize could be tax-free, without applying Section 74).

42. I.R.C. § 74.

43. Treas. Reg. § 1.74-1(a)(1) (Westlaw 2004).

44. I.R.C. § 74.

45. *Id.*

46. Simmons v. United States, 308 F.2d 160, 163 (4th Cir. 1962) (holding that taxpayer's $25,000 prize for catching a unique fish was not in recognition of a civic achievement).

the Code section, it must "enhance the public good."[47] This Section is intended to be limited, excluding such awards as the Nobel or Pulitzer Prize.[48]

The Internal Revenue Service also illustrated the difficulty of fitting within the exception by ruling that awards a family received for being chosen as an "average family" did not meet the exception in Section 74.[49] Consistent with the narrow view of the exception, courts have held that awards received by professional sports athletes are not made in recognition of a "civic" or "artistic" achievement.[50] In *Hornung v. Commissioner*, the taxpayer was a professional football player who received a car from a sport magazine for being chosen as the most valuable player in the National Football League's championship game.[51] The court found that the magazine's motive was to promote its business, and there was not the necessary "detached and disinterested generosity" in order for the award to be a gift.[52] Additionally, the court noted that Section 74 was enacted in order to eliminate the question of gift exclusions when dealing with prizes or awards.[53] Lastly, the court, following *Simmons v. U.S.* and the legislative history of Section 74, held that Section 74(b) did not apply because professional football is not "educational, artistic, scientific, or civic" according to the ordinarily understood meanings of the words.[54]

The second exception under Section 74, for certain employee achievement awards, is met if the employer's cost is deductible under Section 274(j).[55] If the employer's cost exceeds the deductible amount, the amount included in the recipient's gross income is the greater of the excess of the cost or value of the award.[56] Because the cost of the collective awards to a recipient generally may not exceed $400 and must be tangible personal property, cash is not exempted by this Section.[57]

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47. *Id.*

48. *Id.*; S. REP. NO. 1622, *reprinted in* 1954 U.S.C.C.A.N. 4621, 4642 (1954).

49. Rev. Rul. 58-354, 1958-2 C.B. 36. (Holding that awards resulting from a conference held to select a family with an average living routine were not made in recognition of "religious, charitable, scientific, educational, artistic, literary, or civic achievement").

50. Hornung v. Comm'r, 47 T.C. 428, 435-37 (1967); Wills v. Comm'r, 411 F.2d 537, 542-43 (9th Cir. 1969).

51. *Hornung*, 47 T.C. at 429-30. (noting that *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1959) stands for the proposition that a gift results from "detached and disinterested generosity").

52. *Id.* at 433, 435.

53. *Id.* at 435.

54. *Id.* at 436-37.

55. I.R.C. § 74; I.R.C. § 274(j) (2000).

56. I.R.C. § 74.

57. I.R.C. § 274(j)(2)(A). If a qualified plan award, the limitation is $1,600. I.R.C. § 274(j)(2)(B); I.R.C. § 74(j)(3)(A).

The taxable value of a prize or award that is not made in money, but instead consists of goods or services, is its fair market value.[58] The cost of the prize is not determinative; rather the fair market value is the price for which the taxpayer can sell the goods to a willing buyer.[59] In *McCoy v. Commissioner*, the taxpayer won an automobile with a cost to the distributing company of $4,452.54.[60] The taxpayer drove the car for ten days and traded it for $1,000 cash and a station wagon with a dealer's price of $2,600.[61] He included $3,600 in his adjusted gross income for the year and received a deficiency notice stating that he had additional income of $852.54, the difference between the purchase price and selling price.[62] The court held that the value of the car was $3,900 at the time of receipt by taxpayer because the value was reduced substantially in the ten days the taxpayer owned and used the car.[63] Thus, neither the purchase price nor the selling price was determinative.[64]

How can a person escape being taxed on a prize or award? If a taxpayer wins an unwanted prize, he can decline the award.[65] Otherwise, as shown by Section 74, the prize or award is taxable if the recipient economically benefits from it.[66]

B. *Rental under Section 280A(g)*

Because the Home Edition "prizes" do not qualify under the exceptions to Section 74, one may wonder why the lucky families are not facing tremendous income tax liabilities stemming from their new homes and furnishings. According to one of Home Edition's producers, David Goldberg, the homeowners are able to legally avoid including the flat screen televisions and other appliances in their gross income by declaring the value as rent.[67] He explains that when property is leased for less than fourteen days, no federal income tax is due on the rental income.[68] The show leases the families' homes for ten days and pays them $50,000 rent, rather than cash, in appliances and furnishings.[69] Although Goldberg says the television show

58. Treas. Reg. § 1.74-1(a)(2) (1960).

59. McCoy v. Comm'r, 38 T.C. 841, 843-44 (1962).

60. *Id.* at 842.

61. *Id.*

62. *Id.* at 842-43.

63. *Id.* at 844.

64. *McCoy*, 38 T.C. at 844.

65. Rev. Rul. 57-374, 1957-2 C.B. 69.

66. I.R.C. § 74(c); Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (changed Section 74 to include the requirement that the prize or award must be totally relinquished to charity to be excluded as recipient's gross income); Bruce I. Kogan, *The Taxation of Prizes and Awards—Tax Policy Winners and Losers*, 63 WASH. L. REV. 257, 286-87 (1988).

67. Sanchez Jr., *supra* note 6, at A1.

68. *Id.*

69. McGinn, *supra* note 6, at 12.

contacted many tax experts, other people are skeptical that this treatment will not pass Internal Revenue Service scrutiny because the intent is not to rent, but rather to renovate.[70] Home Edition is concerned enough with potential implications that it provides each family with a tax attorney.[71]

Generally, an individual's gross income includes any accession to wealth, including the receipt of rental income.[72] If rental income is included as gross income, the taxpayer may also deduct certain expenses that are attributable to the rental income.[73] However, Section 280A(g) of the Internal Revenue Code provides an exception when the taxpayer rents the dwelling for less than fifteen days during the year.[74] If the dwelling is rented for less than fifteen days, no deduction for rental expenses is allowed, and the rental income, otherwise includable under Section 61 as gross income, is ignored.[75] Because this de minimis exception allows a taxpayer to exclude large amounts of rent from his or her gross income, the House of Representatives has unsuccessfully tried to pass bills to repeal Section 280A(g).[76]

The de minimis exception of Section 280A(g) is meant to exclude rental income if the dwelling is rented for less than fifteen days.[77] Whether the payments are below the fair rental value of the residence is irrelevant.[78] In *Roy v. Commissioner*, the taxpayer insisted that $12,000 in rental income was de minimis rental income, even though the storage space was rented for the whole year.[79] The court reasoned that because Section 280A(g) does not require the dwelling be rented at fair market value, the amount of rent was not a factor in determining whether the Section applied.[80] Instead, the number of days rented is determinative.[81]

Although $50,000 seems like a large amount for renting a house for less than ten days, Section 280A(g) does not place a dollar limitation on its exclusion. The Legislature has recognized that there is potential for taxpayers to take advantage of this Section, but, ultimately, nothing has been done about it. Thus, the Home Edition families' use of this Section may work.

70. DeBarros, *supra* note 6, at E10.

71. McCollum, *supra* note 2, at 9.

72. I.R.C. § 61(a)(5) (Westlaw 2004); Han v. Comm'r, 83 T.C.M. (CCH) 1824 (2002) (citing Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 427 (1955)).

73. I.R.C. § 280A(c), (e) (Westlaw 2004).

74. I.R.C. § 280A(g).

75. *Id.*

76. H.R. REP. NO. 105-148, at 678 (1997); H.R. REP. NO. 102-668, at 22 (1992); H.R. CONF. REP. NO. 104-350, at 1495-96 (1995).

77. Roy v. Comm'r, T.C.M. 1998-125 (1998).

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

C. *Lessee Improvements*

Even if Home Edition rents the families' homes for more than fourteen days, thereby disqualifying the $50,000 payments for the Section 280A(g) exception, the capital improvements will be nontaxable to the lessor homeowners.[82] Under Section 109, "gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee."[83] The flip side of this rule is that under Section 1019, the lessor is unable to increase the property's basis on account of the improvements made by the lessee.[84] Thus, the consequence is that taxation of the improvements is deferred until the lessor disposes of the property.

The reasoning behind Sections 109 and 1019 is that whatever the lessor inherits at the end of the lease is often depreciated, specialized, or obsolete.[85] When the improvements, instead, serve as a substitute for rent, they constitute gross income to the lessor.[86] The intent of the parties, indicated by the four corners of the lease and contractual circumstances, determines whether the improvements constitute rent.[87]

Even before Section 109 was enacted, lessee improvements were not included in lessor income, and they alternatively did not constitute rent unless that intent was "plainly disclosed."[88] In *M.E. Blatt v. United States*, the taxpayer leased real estate for use as a movie theater.[89] The lessor agreed to pay for certain improvements in order to make it a functional theater, and the lessee paid for the remaining amount.[90] The improvements paid for by the lessee consisted of a ventilation system, architect's fees, draperies, a chair, electric signs, and other goods.[91] The Commissioner of Internal Revenue argued that the improvements were income to the extent they had value at the lease's conclusion; and the trial court held that the improvements paid for by the lessee instantly became property of the lessor and constituted additional rent payments.[92]

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82. I.R.C. § 109 (Westlaw 2004).

83. *Id.*

84. I.R.C. § 1019 (Westlaw 2004). Alternatively, if the improvement amount was included in lessor's gross income, the basis of such property should be adjusted accordingly. Treas. Reg. § 1.1019-1 (Westlaw 2004).

85. MILTON R. FRIEDMAN, PRACTISING LAW INSTITUTE, FRIEDMAN ON LEASES § 22.5 (4th ed. 1997).

86. I.R.C. § 109; Treas. Reg. § 1.61-8(c) (Westlaw 2004).

87. Treas. Reg. § 1.61-8(c) (Westlaw 2004).

88. M.E. Blatt Co. v. United States, 305 U.S. 267, 277, 279 (1938).

89. *Id.* at 274.

90. *Id.* at 274-75.

91. *Id.* at 278.

92. *Id.* at 274, 276.

Before the Supreme Court, the taxpayer insisted that no realization of gain takes place when a lessee improves the property, and, instead, the added value constitutes a capital addition.[93] The IRS contended that the improvements are income to the lessor at a certain time, and the best theory is upon the construction of the improvements.[94] The Court held that the parties must clearly intend that capital improvements constitute rent, and there was not an adequate showing.[95] Even when the improvements are required by the lease agreement, they will not be characterized as rent when uncertain as to amount and time.[96] Instead, the amount of rent must be fixed, as must be the time for payment.[97]

The Court reasoned that there was no realized income to the lessor because the value of the building was increased.[98] Additionally, the Court noted that if the value were income to the lessor, it would not be valued at the time of construction.[99] Although the lessor technically owned the items, the lessor had no right to use them during the term; and at the end of the lease, some items would be worthless.[100]

The Supreme Court, in one significant case, *Helvering v. Bruun*, held that when the lessee voluntarily demolished and reconstructed the lessor's building, the gain was realized at the time the lease terminated.[101] The lessor/taxpayer argued that the added value only served as capital gain when the owner disposed of the property, but the Court reasoned that to qualify for such a gain, the amount need not be cash or result from a sale.[102] Accordingly, a new building was attached to the lessor's property, which added value and constituted a realized taxable gain.[103] Despite the outcome of this case, it was overruled in the Internal Revenue Act of 1942 when Congress enacted Section 22(b)(11).[104] Thus, the *Blatt* rule remains intact today.

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93. *Blatt*, 305 U.S. at 276.

94. *Id.*

95. *Id.* at 277-78. (In *Brown v. C.I.R.*, 220 F.2d 12 (1955), the Seventh Circuit Court of Appeals cited *Blatt*. There, the lease included a provision where an amount expended by the lessee would be credited as rent. Thus, the court held that that the payments were clearly characterized as rent in the lease).

96. *Id.* at 277.

97. *Id.*

98. *Blatt*, 305 U.S. at 279.

99. *Id.* at 280.

100. *Id.*

101. Helvering v. Bruun, 309 U.S. 461, 467 (1940).

102. *Id.* at 467, 469.

103. *Id.* at 469.

104. Cunningham v. Comm'r, 28 T.C. 670, 679 (1957). Section 22(b)(11) is almost identical to the now current Section 109, stating that "gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee."

The courts have also made it clear that even if no rent is paid, lessee improvements do not necessarily constitute rent.[105] In *Cummingham v. Commissioner*, the lessor rented property to a company in which she was a principal owner.[106] The parties agreed that the lessee company would erect a building, pay all pertinent taxes, and at the end of six years the lease would terminate with the building reverting to the lessor.[107] The court noted that, under *Bruun*, the improvements would be taxable income.[108] However, Congress later enacted Section 22(b)(1) to limit taxable income to that which constituted rent.[109] Even though no rent was paid, the parties did not intend that the improvements constitute rent at the time of the building's construction or the lease's termination.[110] In fact the improvements were specific to the lessee company and would have little value to anyone except if in a similar business.[111] Thus, following *Blatt*, none of the improvements were included in the lessor's gross income.[112]

The characterization of the improvements also affects taxation. Generally, if the lessee makes improvements, it is also entitled to take depreciation on its capital improvements.[113] If the lessee's improvements are deemed rent and not a capital expenditure, the lessor is entitled to take depreciation on the improvements.[114] This is beyond the scope of this article and will not be further discussed.

D. *A Disguised Lease?*

Taxpayers often attempt to disguise transactions as leases in order to take advantage of tax benefits.[115] In response, courts look at the "objective realities of a transaction rather than to the particular form the parties employed."[116] Thus, the parties' written documents are not binding if reality leads to an opposite result.[117] This analysis is applied in the following sections of the article.

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105. *Id.* at 682.
106. *Id.* at 671-72.
107. *Id.* at 673.
108. *Id.* at 679.
109. *Cunningham*, 28 T.C. at 679.
110. *Id.* at 682.
111. *Id.* at 681.
112. *Id.* at 680-82.
113. McGrath v. Comm'r, 84 T.C.M. 310 (2002) (noting the factors taken into consideration when characterizing improvements as rent in *M.E. Blatt Co. v. United States*, 305 U.S. 267 (1938)).
114. *Id.*
115. STEFAN F. TUCKER, TAX PLANNING FOR REAL ESTATE TRANSACTIONS, § 23.10 (2004).
116. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).
117. *Id.*

1. Constructive Dividends

If a lease is made between a shareholder and a controlled corporation, constructive dividends will be deemed to be paid to the lessor for the lessee improvements unless the lease represents a bona fide business transaction and fair rental value is paid.[118] In other words, although lessee improvements generally are not included in the lessor's income either upon the construction or the termination of the lease, the rule fails to apply when the lease agreement is a sham.[119] In *Spera*, the taxpayer leased property to his wholly owned corporation for $1,200 per year.[120] Additionally, the corporation was obligated to pay the taxes, common area maintenance, and snow removal fees associated with the property and had the option of constructing a building.[121] The corporation erected a building, and the taxpayer used the third floor as his residence.[122]

In deciding whether the corporation lessee's construction expenses constituted constructive dividends to the lessor or whether the lease should be honored for tax purposes, the court said that the first step is to decide whether the lease had any economic reality.[123] The court is not bound by the form of the transaction, rather the substance governs.[124] The court held that there was no economic reality behind the lease arrangement because the terms of the lease were not commercially reasonable, and the parties did not intend to abide by its terms.[125] Not only did the lease cover the rental of property with a value of $4,000 to be rented for fifty years, totaling $60,000, but the lease did not provide for an increase in rent for the optional fifty year lease extension.[126] Furthermore, the parties did not adequately determine the fair market value of the land or determine the market rate for similar property in the area, the corporation did not pay rent, and the corporation did not pay taxes or other expenses.[127]

Because there was no economic reality behind the lease agreement, Section 109 did not apply, and the lessee improvements were not tax-free under Section 109 and *Blatt*.[128] Instead, the court found that the corporation's expenditures were intended to

118. Bardes v. Comm'r, 37 T.C. 1134, 1148-50 (1962).
119. Spera v. Comm'r, 75 T.C.M. (CCH) 2540 (1998).
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Spera*, 75 T.C.M. (CCH) 2540.
125. *Id.*
126. *Id.*
127. *Id.*
128. *Id.*

benefit the taxpayer, and the payments were taxable to him as constructive dividends.[129]

The tax court followed the same reasoning in *Weigel v. Commissioner* where the sole stockholder of a company leased property to the company for $5,000 per month.[130] When the corporation stopped leasing the property, the stockholder leased it to a third party for $4,500 per month.[131] The lessee company made improvements to the property, and the Commissioner argued that the improvements constituted a taxable dividend to the lessor stockholder.[132] Although the property was acquired solely for lease to the corporation, the court found that it was leased to the corporation under commercially reasonable terms.[133] Namely, the stockholder leased to the wholly owned corporation for several years until it was forced out of business, the improvements were made for the benefit of the corporation's business, and the rent corresponded with that of similar parcels in the area.[134] Thus, the court found that there was a bona fide business transaction between the parties and that the stockholder did not have to recognize dividend income.[135]

Even if the expenditures made by the lessee corporation bestow a "direct ascertainable, economic benefit[]," realized dividend income does not necessarily result.[136] In *Bardes v. Commissioner*, the lessor leased property to his closely held corporation, and the corporation subsequently made improvements.[137] Although the Commissioner contended that the improvement cost was constructive dividends, the court said that similar to *Blatt*, gains that benefit the lessor do "not amount to contemporaneous realization of gain within the meaning of the statute."[138]

Similarly, if the court finds the rent of a controlled corporation to be excessive, a portion will be deemed constructive dividends to the controlling shareholder lessor.[139] Additionally, the corporation is not able to take the excess "rent" payment as a deduction on its federal tax return.[140]

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129. *Spera*, 75 T.C.M. (CCH) 2540.
130. 72 T.C.M. (CCH) 1119 (1996).
131. *Id.*
132. *Id.*
133. *Id.*
134. *Id.*
135. *Weigel*, 72 T.C.M. (CCH) 1119.
136. Bardes v. Comm'r, 37 T.C. 1134, 1149 (1962).
137. *Id.*
138. *Id.* (quoting M.E. Blatt Co. v. United States, 305 U.S. 267 (1938)).
139. Limericks, Inc. v. Comm'r, 7 T.C. 1129, 1134-35 (1946).
140. Utter-McKinley Mortuaries v. Comm'r, 225 F.2d 870, 874 (9th Cir. 1955).

2. Sale/Leaseback

There are not many cases that discuss Section 109, but the following can be analogized to the substance versus form analysis performed by the courts in other cases in order to determine if a transaction is valid. As shown in *Frank Lyon Co. v. United States*, the courts actively apply the substance versus form doctrine to sale-and-leaseback transactions to determine whether in reality only a financing transaction exists.[141] There, the Frank Lyon Company ("Lyon"), a home furnishings business, purchased a building under construction from Worthen Bank & Trust Company ("Worthen"), and Lyon leased it back to Worthen.[142] Worthen was not able to keep title to the building, and consequently sold it to Lyon because Arkansas statutes and regulations hindered it from producing the necessary capital and obtaining the proper permission for construction.[143] Thus, Worthen was forced to enter a transaction that would allow it to use the building.[144]

Lyon secured financing from First National City Bank ("City Bank") and New York Life Insurance Company ("New York Life") for the construction and mortgage.[145] Worthen and Lyon entered into a lease that provided for a term of twenty-five years and options to extend for eight additional five year terms, included an option to purchase the property, and called for rent that was equal to the New York Life mortgage principal and interest payments due over the corresponding time period.[146] Additionally, Worthen was responsible for the expenses of the office building, such as repairs, taxes, and insurance.[147]

On Lyon's federal income tax returns, it deducted the interest paid to New York Life and City Bank, depreciation on the building, legal fees, and other expenses related to the sale and lease.[148] The Commissioner ruled that the expenses and income were not allowable because Lyon was not the owner of the building, and the transaction was a financing agreement where Lyon made a loan to Worthen and was merely an intermediary who transferred the principal and interest from Worthen to New York Life.[149]

The Government insisted that the instant transaction was a sham—citing *Helvering v. Lazarus & Co.*, where the Court found a sale-and-leaseback between a taxpayer and bank to be a mortgage loan in reality.[150] The Court in *Lyon* found the

141. Frank Lyon Co. v. United States, 435 U.S. 561 (1978).
142. *Id.* at 562.
143. *Id.* at 563-64.
144. *Id.* at 564.
145. *Id.* at 565.
146. *Lyon*, 435 U.S. at 564-66.
147. *Id.* at 566.
148. *Id.* at 568.
149. *Id.* at 568-69.
150. *Id.* at 574-75 (citing Helvering v. Lazurus & Co., 308 U.S. 252 (1939)).

situation distinguishable from *Lazarus* because there were only two parties there, not a multiple party transaction compelled by bank restrictions.[151] *Lazarus* would have applied if Worthen had made a mortgage agreement with New York Life and received a loan from Lyon, but instead Lyon undertook a substantial risk and was primarily liable for the obligation.[152]

The Government further argued that the sale-and-leaseback was a sham because: Frank Lyon was on Worthen's Board of Directors; the transaction was outside Lyon's normal business activity; the lease payments corresponded with the mortgage amount; the nature of several available options to Worthen supported the position; and Lyon received favorable tax benefits.[153] The Court pointed out that the economic reality of the transaction was illustrated by Worthen's inability to finance construction with the use of a typical mortgage, additional state and federal regulations, the requirements that the lease contain an option to purchase and the building be owned by an independent third party, and financial organizations' interest in participating in the transaction.[154] Additional factors were the competitive bidding and bona fide negotiations, Lyon's sole liability to City Bank and New York Life, the risk of Worthen's potential default or failure, the fact that three parties were involved in the transaction, the fact that Worthen could choose not to exercise the option to buy after the lease term if the worth of the building was not adequate, and the lack of tax advantages relating to the transaction used.[155] In conclusion, the Court held that:

> [W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the [form] effectuated by the parties.[156]

The business purpose and economic effect tests were further clarified by the Fourth Circuit Court of Appeals in *Rice's Toyota World, Inc. v. Commissioner.*[157] There, Rice's Toyota World ("Rice") purchased a computer from Finalco in exchange for a recourse note and two nonrecourse notes.[158] Rice leased the computer back to Finalco for eight years with the rent contingent on Finalco's ability to sublease the computer.[159] This transaction took place as a result of Rice learning about sale-and-

151. *Lyon*, 435 U.S. at 575-76.
152. *Id.* at 576-77.
153. *Id.* at 581-82.
154. *Id.* at 582-83.
155. *Id.*
156. *Lyon*, 435 U.S. at 583-84.
157. 752 F.2d 89 (4th Cir. 1985).
158. *Id.* at 91.
159. *Id.*

leasebacks from a friend who had entered into a similar relationship with Finalco.[160] Rice claimed accelerated depreciation deductions and interest deductions on its federal tax returns, and the Commissioner disallowed the deductions because the sale-and-leaseback was a sham.[161]

The court followed the two-pronged inquiry introduced in *Lyon*.[162] First, the court inquired as to the motives of the taxpayer under the business purpose prong and found that Rice's only motivation was to benefit from large income tax deductions.[163] Rice did not evaluate what the residual value of the computer would be after the lease was over in order to determine whether it would earn a profit.[164] Second, Finalco's promotional materials stressed the potential tax deductions and mentioned that the residual values were difficult to predict, Rice paid an enhanced price for the computer, and Rice intended to abandon the transaction before paying any tax on income.[165]

The economic substance inquiry involves an objective determination of whether the possibility of profit existed aside from tax savings.[166] As to this prong, the court agreed with the prior Tax Court decision that the residual value would not be sufficient to earn a profit.[167] After holding that the transaction lacked both economic substance and business purpose, the court disallowed the depreciation and interest deduction on the nonrecourse debt.[168] Because a court cannot prohibit a deduction stemming from a transaction with economic substance, even if motivated by tax consequences, the court allowed the deduction for recourse debt interest.[169]

3. Activity Engaged in For Profit?

The business purpose and economic effect tests have been applied to many different types of transactions in order to determine whether the transaction constitutes tax avoidance: Schedule C deductions relating to the sale of art;[170] interest on indebtedness;[171] "net leases" where the tenant retains certain responsibilities;[172]

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160. *Id.*

161. *Id.*

162. *Rice's Toyota World, Inc.*, 752 F.2d at 92-96.

163. *Id.* at 92-94.

164. *Id.* at 92.

165. *Id.* at 93-94.

166. *Id.* at 94.

167. *Rice's Toyota World, Inc.*, 752 F.2d at 94-95.

168. *Id.* at 95-96 (citing Gregory v. Helvering, 293 U.S. 465, 469-70 (1935) (Commissioner ignores the form used by the parties and taxes the transaction on its substance)).

169. *Id.* at 96.

170. Rose v. Comm'r, 868 F.2d 851 (6th Cir. 1989) ("[T]he essential inquiry is whether the transaction had any practicable economic effect other than the creation of economic tax losses.").

171. Knetsch v. United States, 364 U.S. 361 (1960); Bergman v. United States, 174 F.3d 928

differentiation of a lease from an employment contract to claim an investment tax credit;[173] and loss claimed from a failed motion picture.[174] Similarly, the deductions and expenses resulting from rental property are judged under a "for profit" standard.[175]

Courts have adopted the factors of Regulation 1.183-2 for determining whether a taxpayer has a profit motive in regard to an activity.[176] Additionally, "greater weight is given to objective facts than to the taxpayer's mere statement of his intent."[177] Rent set as "fair market value would normally suggest that the taxpayer had the requisite profit objective."[178] In *Bolaris v. Commissioner*, the Ninth Circuit Court of Appeals found a profit motive where the taxpayer rented his residence at fair market value, moved to a new residence, and the rental was not used for personal reasons.[179] Likewise, the Tax Court found a profit motive where the taxpayer researched the area where he built a ski lodge, operated the property in a business-like manner, the property appreciated, and the taxpayer did not use the lodge for personal enjoyment but incurred significant losses because of the competition, low snowfall, and a gasoline shortage.[180]

Although Section 280A(d) and (e) requires a profit motive in order to make certain deductions for rental use of the home, the de minimis exception of Section 280A(g) has no such requirement.[181] Thus, the "for profit" test does not directly apply to Home Edition's rental of homes.

(8th Cir. 1999); Bail Bonds By Marvin Nelson, Inc. v. C.I.R., 820 F.2d 1543 (9th Cir. 1987); Goldstein v. C.I.R., 364 F.2d 734 (2d Cir. 1966).

172. *In re* The Elder-Beerman Stores Corp., 207 B.R. 548 (S.D. Ohio 1997).

173. Newman v. C.I.R., 902 F.2d 159 (2d Cir. 1990).

174. Jacobson v. C.I.R., 915 F.2d 832 (2d Cir. 1990) (holding Tax Court erred in rejecting profit motive in economic substance inquiry because of a subjective dislike of film).

175. *See* I.R.C. § 183 (Westlaw 2004); I.R.C. § 280A(f)(3) (Westlaw 2004); Treas. Reg. § 1.183-2 (Westlaw 2004); Bolaris v. C.I.R., 776 F.2d 1428, 1432-33 (9th Cir. 1985); Jasionowski v. C.I.R., 66 T.C. 312, 318-19 (1976).

176. Treas. Reg. § 1.183-2(b). Factors are: (1) Manner in which the taxpayer carries on the activity; (2) The expertise of the taxpayer or his advisors; (3) The time and effort expended by the taxpayer in carrying on the activity; (4) Expectation that assets used in activity may appreciate in value; (5) The success of the taxpayer in carrying on other similar or dissimilar activities; (6) The taxpayer's history of income or losses with respect to the activity; (7) The amount of occasional profits, if any, which are earned; (8) The financial status of the taxpayer; (9) Elements of personal pleasure or recreation. *Id.*

177. Treas. Reg. § 1.183-2(a).

178. *Bolaris*, 776 F.2d at 1433 (quoting Bolaris v. Comm'r, 81 T.C. 840, 849 (1983)).

179. *Id.* at 1433-34.

180. Allen v. Comm'r, 72 T.C. 28, 35-36 (1979).

181. I.R.C. § 280A(d), (e), (g) (Westlaw 2004); Timothy M. Mulligan, *Tax Implications of the Rental Use of a Vacation Home: IRC Section 280A*, 88 DICK. L. REV. 109, 114 (Fall 1983-Summer 1984).

4. Does a Disguised Lease Exist Here?

In order to decide if a valid lease exists between the Home Edition parties, it is possible to analogize the situation to the disguised leases discussed previously. Although the lease may appear valid on its face, courts will perform a substance versus form analysis to decide whether to honor the lease for tax purposes. If a valid lease does not exist, Sections 280A(g) and 109 will be unavailable to the taxpayers, and both the $50,000 "rent" payment and the capital improvements will be taxable to the families.

The form of a lease is used by the Home Edition families, at least in part, for tax reasons. But, is there any substance to the lease? Earlier in the article, it was mentioned that tax planning can be part of a transaction, but there must be economic substance or a valid business purpose in order for the lease to be allowed for tax purposes.[182] This is a difficult issue because there is no precedent; but it appears that there is no economic substance or business purpose behind the Home Edition leases. For instance, as will be discussed in the next section of the article, similar circumstances would occur if a license were given to Home Edition instead of a lease. The only difference is that significant income tax implications would result.

IV. LEASE V. LICENSE

Although the contract between the parties will be examined under the law in the state in which it was formed and in which the property is located, this article will cover the basic principles of leases and licenses.[183] "The difference between a license and a lease is that the lease gives to the tenant the right of possession against the world, while a license creates no interest in the land, but is simply the authority or power to use it in some specific way."[184] Usually a license is revocable by the licensor, but not assignable.[185] Although a lease can be unassignable, if the grantee conveys or assigns its rights in the agreement, a lease will exist.[186] Furthermore, possession to the exclusion of the owner indicates the existence of a lease.[187] Possession is judged using an objective standard and not using the language of agreement.[188]

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182. *Rice's Toyota World, Inc.*, 752 F.2d at 89, 94, 96.

183. Wallis v. Pan Am. Petroleum Corp., 384 U.S. 63, 71 (1966); Bondy v. Harvey, 62 F.2d 521, 522 (2d Cir. 1933).

184. Lee v. North Dakota Park Serv., 262 N.W.2d 467, 471 (N.D. 1977) (quoting Joplin Supply Co. v. West, 194 Mo. App. 78, 130 S.W. 156, 161 (Mo. Ct. of App. 1910)).

185. *Id.* (citing Lehman v. Williamson, 533 P.2d 63, 65 (Colo. App. 1975)).

186. Alexander v. Gardner, 96 S.W. 818, 819 (Ky. App. 1906).

187. *Lee*, 262 N.W.2d at 471; *In re* SCC Assoc. II Ltd. P'ship, 158 B.R. 1004, 1013 (N.D. Cal. 1993).

188. Golden West Baseball Co. v. Anaheim, 25 Cal. App. 4th 11, 32 (1994).

When distinguishing a lease, the court will look to see if the agreement has economic substance consistent with the definition of a lease.[189] For example, a lease is presumed in California when rent is paid from the one in possession to the owner.[190] However, rent serves as a characteristic of a lease when it is "to be paid at particular times during a specified term."[191]

Although the parties' intent determines whether a license or a lease exists, the intent is determined according to the circumstances in which the agreement was made.[192] The term of the agreement is not a decisive point as to whether the agreement is a license or a lease but may be taken into consideration.[193] In distinguishing between a lease and a license, the parties' intent prevails, but a court does not have to follow the parties' characterization of the transaction.[194] Accordingly, in *Alexander v. Gardner*, a landlord/tenant relationship was implied where the tenant of three years built structures, parked machines on the property, and made roads necessary for him to enjoy the property while his interest was assignable.[195]

The "Location Agreement" completed by each family when applying for Home Edition, gives an indication of how the transaction should be characterized.[196] By signing the Agreement, the owner releases the company from liability and agrees to the assignment of the company's rights.[197] Additionally, the property owner, if chosen, permits the company to "re-enter upon and again utilize the premises for such purpose."[198] The Agreement also provides that, if chosen, the property owner will complete a new agreement to grant the company additional rights to enter the property, record scenes, and renovate the property.[199] Aside from the owner giving the company the right to assign the interest in property, the rest of the provisions in the Agreement are consistent with a license. However, it is impossible to make a firm judgment without seeing the terms of the Agreement the parties sign before the actual renovation.

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189. *In re SCC Assoc. II Ltd. P'ship*, 158 B.R. at 1013.

190. Smith v. Royal Ins. Co., 111 F.2d 667, 670 (9th Cir. 1940).

191. *In re* Safeguard Self-Storage Trust, 2 F.3d 967, 972 (9th Cir. 1993) (quoting Beckett v. City of Paris Dry Goods Co., 96 P.2d 122, 124 (Cal. 1939)).

192. *Lee*, 262 N.W.2d at 467, 470-71; Union Cent. Life Ins. Co. v. Audet, 21 P.2d 53, 55 (Mont. 1933); *Golden West Baseball Co.*, 25 Cal. App. 4th at 21.

193. *Lee*, 262 N.W.2d at 472.

194. *Id.* at 474 ("The title of an instrument is not controlling."); Keller v. Southwood N. Med. Pavilion, Inc., 959 P.2d 102, 107 (Utah 1998).

195. Alexander v. Gardner, 96 S.W. 818, 819 (Ky. App. 1906).

196. *Extreme Makeover Home Edition* home page, *at* http://abc.go.com/primetime/xtremehome/application6.pdf (last visited Nov. 17, 2004).

197. *Id.*

198. *Id.*

199. *Id.*

On the other hand, it is possible to look at the circumstances surrounding the transaction. Here, the key is that a lease involves possession against the whole world, a right that Home Edition likely does not have. If the family chooses to come back early from its trip, does Home Edition have a right to exclude them? Rather, under the Agreement, Home Edition has the right to use the property *in a specified way.*[200] It appears that the Agreement and the circumstances surrounding it are consistent with Home Edition being a licensee rather than a lessee. Similar to a plumber, roofer, or any other contractor, Home Edition has the right to enter the property only to perform improvements on the property.

V. CONCLUSION

This is an unexplored area, but the families who have received such goodwill from Home Edition have reason to be wary. Aside from the known property tax ramifications, there remain tens of thousands of dollars of potential income tax burdens lurking in the shadows. The families' lawyers (in reality, the show's lawyers) have assured them that there is nothing to worry about; but the situation is not black and white. Although income stemming from the rental of property for less than fifteen days is tax-free, as are lessee improvements of rental property, the tax advantages are only applied to a valid lease.

If the IRS alleges a deficiency in taxes paid, the court may use a substance over form analysis and find that the parties had no reason to fashion the transaction as a lease, aside from the obvious tax advantages. In fact, using a license rather than a lease would have allowed the parties the same opportunities, minus the income tax savings. If the courts declare these leases invalid, the families will not be able to take advantage of the Code sections discussed in this article.

Another outcome is that Home Edition will have a hard, if not impossible, time finding families that are willing to have their homes renovated only to pay huge tax bills. The television series prides itself on helping needy families. Hopefully its good deeds can continue. The IRS has a difficult decision before it; does it start collecting the potentially deficient taxes, thus enforcing the spirit of the tax code, or does it allow this goodwill to continue?

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200. *Id.*