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News and Commentary

Tax Reality Bites

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By Jeffrey H. Kahn

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Introduction

For the past few years, the hottest trend in television programming has been so-called "reality" television. Although this type of programming certainly is not new,¹ all the major television network stations are attempting to capitalize on the success of shows like Survivor and Meet My Folks.² Many networks have chosen to offer reality programming with an element of romance or, at least, dating. For example, ABC scored a hit with The Bachelor, a reality television show where one bachelor attempted to find true love by choosing among several female candidates. Like all popular trends, the networks have attempted to one up each other (and attract viewers) by adopting intriguing variations to the formula. Thus, Fox's Joe Millionaire had a similar premise, but its unique variation was that the female contestants were told that the bachelor was a millionaire -- when in fact he was not. The show was one of the biggest hits of the 2003 season.

For Love or Money

The most recent step in this reality television "evolution" is NBC's For Love or Money. As with The Bachelor and Joe Millionaire, the program focused on one bachelor and several women vying for his love. Here, the novel variation was that the women were told that whoever "won" (that is, whomever the bachelor picked as his final choice) could choose either to stay with the bachelor or to reject the bachelor and receive a substantial dollar prize, which, for convenience, I will refer to as $1 million.³ On the season finale of For Love or Money, the bachelor, Rob, chose Erin; but it was not to be, as Erin elected to take the $1 million. But, NBC had yet another scenario for its faithful viewers. At the end of the show, the finale flashed ahead to three weeks after Erin had elected to take the cash prize, and showed NBC inviting her to be a contestant on For Love or Money 2. For Love or Money 2 will turn the tables on the sexes; the lone bachelorette will choose among 15 bachelors vying for her attention. The last man standing would receive the option to either stay with the bachelorette or take $1 million. If Erin, as [P. 419] the bachelorette, could convince
her final choice to pick her over the $1 million, she would receive $2 million. If the bachelor picked the $1 million over Erin, she would lose everything.

Erin elected to take a chance and gamble that she could convince the bachelor of her choice to choose her over the money. With dramatic flair, the finale of the first season of *For Love or Money* concluded with Erin handing her "$1 million" check back to the host of the show. As of this writing, *For Love or Money* 2 is still airing episodes; thus, we do not yet know whether Erin will win her prize.

The finale of the first season of *For Love or Money* drew roughly 12.9 million viewers. Erin should hope that an Internal Revenue Service agent was not one of them. While I have no knowledge of the specifics of the legal arrangement between the show's producers and Erin, from the facts that were made public, it appears highly likely that, under basic tax principles, she will have to include the prize money from the first series in her income and thus be taxed on it even if she ultimately loses it in the second series.

NBC did not expressly tell viewers whether Erin elected to take the present value of $1 million or the $1 million annuity. With dramatic license, the finale of the first series presented that, three weeks after she elected to take the money, she returned her "$1 million" check to participate in the second series; but it is clear that Erin would not have received a check anywhere nearly as large as $1 million under either prize scenario. The fact that she appeared in the finale with a check in hand suggests that she chose the present value option, but it is not conclusive. Therefore, I will discuss the tax consequences of both options since her choice is not clear.

**Present Value of One Million Dollars**

Generally, individual taxpayers use the cash receipts and disbursements method of accounting, often referred to simply as the "cash method." Under this method of accounting, taxpayers are taxed on income when they receive cash or its equivalent. An important component of this system is the doctrine of constructive receipt. The oft-quoted explanation of the doctrine of constructive receipt is that "a taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it." Reg. section 1.451-2(a) states:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw has been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The courts have followed this line of reasoning in cases involving uncashed checks. For example, in *Fromson v. United States*, the taxpayers had filed a patent infringement case against a manufacturer and were awarded a judgment that was not entirely to their satisfaction. The manufacturer tendered a check to the taxpayers on Dec. 29, 1986. The taxpayers
erroneously believed that if they cashed the check, they would forfeit their rights to appeal the judgment and so the taxpayers returned the check uncashed. The company sent the check back to the taxpayers on Dec. 31, 1986, and, after filing their appeal on Jan. 22, 1987, the taxpayers cashed it. The taxpayers contended that the check was income to them in 1987 when they cashed it. Holding for the government, the Court of Federal Claims ruled that the check was income to the taxpayers when they received it in 1986 because there were no restrictions or limitations on their cashing it.

If Erin elected to take the present value option, and if she received the check before electing to embark on the second series of the program, it does not appear that there were any restrictions on her cashing the check during the three-week period (or whatever part of that period preceded her acceptance of the offer to appear in the second series) following her rejection of Rob that would have prevented income recognition. There are two possible restrictions that warrant consideration.

First, by accepting the check, it appears likely that Erin is contractually barred from dating or marrying Rob, assuming that the contract is valid and does not violate public policy. This is not the type of restriction that would block income recognition before the check was cashed. Courts have held that the mere receipt of a check does not cause income recognition if the cashing of the check would cause the taxpayer to forfeit a legal right that the taxpayer possesses. In other words, although the receipt of a check will be income if the conversion of the check to money involves no more than a ministerial act, a significant cost associated with cashing the check will prevent recognition until the check is cashed or used to acquire something.

An illustration of a restriction that would bar income recognition for the receipt of a check is where the cashing of the check would be an acceptance by the payee of a settlement of a claim or a waiver of a right to appeal. However, not every loss of a benefit is a restriction that prevents income recognition. An example of that in the constructive receipt area is that a taxpayer must take into account the interest that is added to his savings account even though the withdrawal of that interest would deprive the taxpayer of future interest that would be earned if the amount were left in the savings account.

Let us assume that Erin agreed not to date or marry Rob when she elected to take the money. Cashing the check would not deprive her of any right that she then possessed. Her contractual obligation to delete Rob from her radar screen arose before and not because of cashing the check. But what if after receiving the check, Erin changed her mind and decided that she would prefer to pursue a relationship with Rob? Does that possibility prevent the receipt of the check from being income? The answer clearly is negative. If Erin subsequently married Rob, that would be a breach of her contract, assuming that the contract was valid and did not violate public policy. The producers' remedy might be no more than to obtain a return of the money (or check), but her option to breach the contract would not be affected by cashing the check. This is no different than any other commercial transaction.

A second restriction is that by accepting the check, she would forfeit her right to appear on the second series of the show and to seek to double the amount of her prize. This restriction would be apposite only if Erin was informed of that circumstance before receiving and accepting the check. But, again, that restriction does not apply to cashing the check. If the choice were given to Erin before she took the check, then electing to take the check would have been the act that forfeited her opportunity to appear in the second series. If the choice were offered to her three weeks after she received the check, as purportedly was the case, she had already recognized
the income before the restriction came into existence. In any event, as discussed below, Erin's election to appear on the second series was a use of the monetary prize for her own consumption purposes and so caused her to recognize income. Later, I will discuss the possibility that Erin knew of all the circumstances before receiving the check and that the transfer and return of the check were part of a charade.

A person's refusal to accept a prize does not cause the recognition of income. There is no requirement that a person accept income they do not wish to have; it cannot be forced on them. But, that is not the case here. Erin did not refuse her prize; to the contrary, she used it to purchase her appearance on a nationally televised show, with all of the publicity that entails, and the opportunity to compete for an even larger prize.

If Erin wins the "$2 million" on the second series of the show, will she be taxed on the dollar value of that prize and also be taxed on the "$1 million" prize that she won on the first series? To the extent that she paid that first prize to gamble on receiving the "$2 million" prize, a part of the "$2 million" is a return of the amount she bet and so is not income to her. However, it is arguable that a portion of her first prize was paid for the gamble and a portion was paid for the opportunity to appear on national television for weeks. Perhaps, an apportionment must be made so that all of the first prize is taxable, and a lesser amount of the second prize is excluded. A more lenient analysis would permit all of the first prize to be allocated to the gamble; and so the aggregate amount taxed would be the amount of the second prize since the amount of the second prize that is excluded from income would then equal the amount of the first prize.

If the bachelor in the second show chooses to take the money, could Erin prevail in a contention that she used the prize from the first series to bet on her doubling her take, and so the loss of that amount was a loss incurred in a transaction entered into for profit and deductible under section 165(c)(2)? For the purpose of considering that issue, let us put aside the question of whether the amount of the first prize must be apportioned between the amount bet on winning a larger amount and the amount expended for the privilege of appearing on television. The first obstacle to that contention is that the loss on the amount "paid" to seek to win the larger prize was a loss from a "wagering transaction," and section 165(d) permits the deduction of such losses only to the extent of gains from "wagering transactions" that were obtained in the same tax year. Unless Erin has other gambling winnings in the year in which her loss occurs, she cannot deduct her loss. If her prize from the first show qualifies as a gain from a "wagering transaction," and if the gain occurred in the same tax year as when the loss occurred, then Erin could deduct her loss, and the gain and loss would be a wash. However, the income that Erin recognized from the prize that she earned on the first series does not appear to be wagering gain and thus her loss can be deducted only if she has other gambling winnings in that year. In one sense, Erin did gamble in the first series. She expended her time and probably purchased one or more dresses and incurred costs in enhancing her personal appearance. Can she be said to have spent that money in a wagering transaction to win the prize? The Tax Court has held that expenses incurred in appearing on a game show in which a monetary prize was earned are not wagers and so are not gambling losses. A television contest does not seem to be the kind of transaction that Congress likely had in mind when it adopted section 165(d). If it were, then gambling losses could be deducted to the extent of any prize or award the taxpayer obtained from a contest which the taxpayer had entered. As previously noted, the Tax Court has rejected the notion that such winnings are from wagering transactions.
Suppose, for example, that instead of opting to appear on the second series, Erin took the cash, went to a casino in Las Vegas, and put the amount she won on red at roulette. If the ball landed on black, would Erin be allowed to deduct her gambling loss on the ground that the prize she won on the television show was a wagering gain? Unless one is willing to accept that contention, and the author finds it farfetched, Erin will not be allowed to deduct her loss from the second series of the television show.

There is a contention open to Erin that would immunize her from a tax disaster if it were accepted. Erin could argue that her participation on both series of the show should be treated as a single integrated transaction, and that the several parts of that transaction should not be isolated and taxed separately. Erin would argue that only the gain resulting from the completed integrated transaction should be taxed. The difficulty with that contention is that there is no authority for integrating her participation in both series. In an analogous circumstance, the tax law has consistently held that the income earned in a tax year is taxed in that year even if the income is part of a transaction that ultimately yields a loss when it is completed in a later year. Those cases rest on the importance of maintaining the annual reporting of income, and that concept will not apply to the instant case unless the two series occur in different years. Nevertheless, the wagering aspect of Erin’s participation in the second series seems to make it a different and therefore separate transaction from the first series. Because the tax consequences to Erin of treating the two series separately are so severe, the IRS or a court might very well be moved to adopt an integrated transaction approach to prevent such a harsh result.

**40-Year Annuity**

What would be the tax consequences if Erin had chosen the 40-year annuity? In that case, if Erin had not elected to participate in the second series, she would have income only when she received each cash payment on the annuity and only for the amount of cash received. On the other hand, if Erin sold the annuity to someone else, she would have income equal to the amount she received minus her basis in the annuity (presumably zero). Would her relinquishment of the annuity to the show be a payment for the privilege of appearing on the second series of the show and for the opportunity to win a larger prize? For the same reasons as those discussed above in connection with the waiver of the present value option, the author concludes that an amount equal to the value of the annuity would be income to her at the time that she effectively transferred her rights in the annuity to purchase those opportunities.

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**E electing to Appear on Sequel Before Getting Check**
What if, before receiving the check or the annuity, but after having been selected by Rob and having chosen the monetary prize, Erin were offered and accepted the opportunity to appear on the second series and double her prize. Perhaps, she was given a check only for dramatic purposes so that she could return it in full view of a television audience. In that event, the receipt of the check would be irrelevant since it had no substantive significance.\textsuperscript{23} The question is whether Erin’s vested right to receive the present value in cash or an annuity causes her income recognition even if she subsequently chose to forego that right to appear on the second series. In essence, Erin exchanged her right to the monetary prize for the right to appear on the second series, and that exchange would be a taxable transaction. Erin should therefore be taxable on the amount of the prize that she waived since she used it to purchase something she desired -- that is, she used it for her personal consumption.

But, even if this was not treated as a taxable exchange, and instead the transaction was characterized as if Erin merely chose the prize of the appearance on the second series, she would still have had income. Under this scenario, Erin still "won" the first series and was entitled to a prize. In this hypothetical, the prize would be that Erin appeared on the second series of \textit{For Love or Money}. The value of this prize should be taxable to Erin. Ordinarily, determining the value of such a prize would be difficult, if not impossible, and thus would probably not be taxable to the recipient. However, in this case, Erin apparently decided that the benefit of appearing for weeks on a nationally televised show -- together with the possibility of winning a larger amount -- was worth foregoing the dollars that she would otherwise receive. Thus, it is clear that the third option (appearing on the second series of \textit{For Love or Money}) was worth at least as much, to both Erin and the producers of the show, as the other two options. Valuation would not be difficult under this set of facts -- the prize of appearing on the second series should be valued the same as the two monetary prizes that Erin could have taken.\textsuperscript{24}

One final possibility is worth exploring. What if, before Rob's having made his selection, the producers had informed the women on the show that the selected woman would be given the option of accepting a monetary prize or appearing on a second series with the conditions that later were revealed to the viewing public? If that had been done, the disclosure would have to have been made to all the participating women, since Rob's choice would still be unknown at that time. In that case, and if, before being chosen, Erin had expressed her decision to appear on the second series, the transfer of the check to Erin and her later return of the check to the host would have been a charade undertaken to accentuate the dramatic element of her choice. While it is highly unlikely that such a disclosure was made at that juncture, the tax consequences of that scenario are worthy of discussion.

If a taxpayer enters into a contract to defer income before it is due, the taxpayer is not required to report that income until it is actually received.\textsuperscript{25} For example, in \textit{Robinson v. Commissioner},\textsuperscript{26} Sugar Ray Robinson, a boxer, signed a contract to engage in a fight for a world championship title. The contract granted Robinson the right to a specified percentage of the profits from the fight, but provided that Robinson's portion of the profits was to be paid to him over a period of years. Normally, fighters are paid in full immediately after the fight. However, for tax reasons, Robinson wanted his payment spread over a couple of years, and he contracted for that deferred payout before the fight took place (and thus before he had become entitled to his purse). Although the promoter was willing to contract to pay Robinson the entire amount upfront immediately after the fight, the promoter agreed in the contract to defer part of the payment. The IRS argued that the entire amount of Robinson's purse should be taxable to Robinson in the year of the fight under the doctrine of constructive receipt. The Tax Court disagreed and held that only the amount received by Robinson in the fight year was income to him in that year. The
result in that case would have been different, and the government would have prevailed, if the parties had first contracted to defer the payout of Robinson's purse after the fight had taken place and Robinson had become entitled to the full amount of the purse.

Erin could argue that if she made the choice to appear on the second series before she won the right to the cash payment or the annuity, then it should not be considered constructive receipt of either of those latter two options. However, in opposition, the IRS could argue with considerable merit that, even in the circumstance of this unlikely scenario, Erin received a prize consisting of the right to appear on the second series, and the receipt of that prize is income to her. As noted above, while valuation of such a prize normally would be very difficult or even impossible, since Erin was also offered two alternative prizes, it is reasonable to presume that all three alternatives were of approximately equal value, and so the readily ascertainable value of the monetary prizes can be taken to be the value of the option Erin selected.

**Conclusion**

There are strong grounds for taxing Erin on the amount of the monetary prize that she won on the first series of *For Love or Money*, even if she should lose that amount on *For Love or Money 2*. The principles on which that conclusion is grounded raise interesting issues and are worth discussing. But Erin's tax plight, should she lose her prize on the second series, might provoke strong feelings of sympathy; and it is possible that the IRS or a court would be unwilling to tax her on the original prize. As discussed above, the most plausible and principled ground for not taxing Erin in that case is that her participation in the two series should be treated as an integrated transaction.

There is a stronger case for applying that integrated transaction approach to other game or quiz shows where a contestant completes his appearance in one sitting. In many game shows, the contestants win monetary amounts in stages (typically by answering questions); but, if the contestants continue to participate after winning an amount, they risk losing what they have won. For example, assume a contestant has won $1,000 by answering a question correctly and then risks the $1,000 in an attempt to win $5,000 by answering a second question. Assume that the contestant answers the second question incorrectly and loses everything. The same analysis that is applied in this article could apply to that contestant as well. That is, the contestant could be taxed on the $1,000 as prize money (note that he had no wager at risk when he answered the first question) and then treated as having lost it in a wagering transaction. However fragile the integrated transaction approach may be as a general matter, it does fit more comfortably into a program of that format, where there is a series of questions or steps to overcome, than it does in the *For Love or Money* setting, where the second series is separated by time from the first and by a significant difference in structure -- that is, the first series did not involve any wagers, but a wager plays a major role in the second series.

In the next few weeks, we will learn whether Erin made the right choice in gambling her winnings from the first series. This author is rooting for Erin in *For Love or Money 2* to complete a trifecta: (1) find true love, (2) win $2 million, and (3) avoid an unpleasant deficiency letter from the IRS. NBC couldn't ask for a happier ending than that.

by Jeffrey H. Kahn
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FOOTNOTES

1 MTV's first season of The Real World -- perhaps, the original reality television program -- was filmed in 1991, although even earlier television programs like The Gong Show or The Dating Game could also be considered reality television.

2 Reality television is so popular that, in early 2004, Reality Central, a 24-hour reality television channel, will debut.

3 According to the credits that ran after the finale, the winner who elected to take the money and run could choose either (1) $1 million spread out over 40 years or (2) the present value of those payments.

4 Again, it is likely that the $2 million would be spread out over 40 years, so the present value is much less.

5 Nevertheless, as we will see later, if Erin manages to convince the final bachelor to pick her over the money, she may still face a tax issue. If the bachelor chooses the money over Erin, she faces an even more daunting tax problem.

6 The present value of $1 million spread out over 40 years (using by way of illustration a 4 percent discount rate, compounded annually) is about $495,000.


8 See Boris Bittker and Lawrence Lokken, 4 Federal Taxation of Income, Estates and Trusts, para. 105.3.3 (2nd ed. 1992) (hereinafter cited as "Bittker and Lokken").


10 Of course, if the provision barring Erin from marrying Rob is invalid or if the contract did not include such a prohibition, there was no restriction of that nature on Erin's cashing the check.

11 Bittker and Lokken, supra note 8.

12 See, e.g., Bones v. Commissioner, 4 T.C. 415 (1944).

13 Reg. section 1.451-2(a)(2).

14 In Rev. Rul. 57-374, 1957-2 C.B. 69, the IRS stated simply, "Where an individual refuses to accept an all-expense paid vacation trip he won as a prize in a contest, the fair market value of
the trip is not includible in his gross income for Federal income tax purposes."

15 Thus, if a person were gambling in Las Vegas on Dec. 31 and by midnight he had winnings of $10,000, but lost all of it by 2:00 A.M. on Jan. 1, technically he would not be able to offset the two and could deduct the $10,000 loss only if he had winnings in that year.

16 Gambling losses that are deductible under section 165(d) are not subject to the 2-percent-of-adjusted-gross-income floor for miscellaneous itemized deductions and are not subject to the overall limitation on itemized deductions. Sections 67(b)(3), 68(c)(3). Since gambling losses are not miscellaneous itemized deductions, they are not subject to the alternative minimum tax. Section 56(b)(1)(A)(i).

17 Section 74 states that gross income includes amounts received as prizes and awards. It appears that the $1 million won in the first series would be covered under this section and would not be winnings from gambling or wagers. In Whitten v. Commissioner, the Tax Court held that the prize won by a contestant on Wheel of Fortune was not gambling winnings. 70 T.C.M. 1064, Doc 95-9794 (15 pages), 95 TNT 209-14 (1995).

18 Whitten v. Commissioner, supra note 17.

19 Id.


21 If the annuity was completely funded and not subject to any restrictions, she would have income under the economic benefit doctrine equal to the present value of the annuity at the time that it was awarded. However, for purposes of this article, I am assuming that the annuity is merely the show’s unfunded, nonnegotiable promise to pay her $1 million over 40 years and thus would not be subject to immediate taxation for the present value since an unfunded, nonnegotiable promise is not cash or its equivalent and therefore is not income to a cash-method taxpayer. Bittker and Lokken, supra note 8, para. 105.3.2. See also Martin v. Commissioner, 96 T.C. 814 (1991).

22 In the case of arm’s-length exchanges, the tax law conclusively presumes that the exchange is of items of equal value so that if the value of only one side of an exchange can be reasonably determined, the other side is deemed to be of the same value. United States v. Davis, 370 U.S. 65 (1962); Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184 (Ct. Cl. 1954). In the instant case, there is no difficulty in determining the fair market value of what Erin gave up to appear on the show. The fair market value of appearing on the show is deemed to be equal to the fair market value of the annuity that she returned.

(Footnote continued on next page.)

(Footnote 22 continued.)

To the extent that the annuity was relinquished in pursuit of the gamble to win a greater prize, the instant facts are not similar to those of Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990), where the Court of Appeals, correctly but with dubious reasoning, held that a gambler did not have cancellation of indebtedness income when a casino accepted a much lower amount than
he owed.

23 I will ignore the question of whether, after receiving the check, Erin lawfully could have reneged on her agreement and refused to return it. I will assume that she could not prevail if she attempted to do that.

24 What if Erin picked Rob over the monetary prize? Does the position adopted in this article lead to the conclusion that picking Rob would cause Erin to recognize income equal to the $1 million monetary prize that she rejected? The answer is that she would not have recognized income. Unlike her appearance on the second series, Erin already had the privilege to have any relationship she wished with Rob, and so the show could not provide her any additional rights or privileges in that regard. In no manner could Erin be said to have purchased a right or privilege by waiving her monetary prize. To the contrary, the situation would be that Erin would simply have rejected the monetary prize, and so she would not recognize any income.

25 See, e.g., Veit v. Commissioner, 8 T.C. 809 (1947), and Kimbell v. Commissioner, 41 B.T.A. 940 (1940).


27 Consider the tax consequences if the contestant answers the second question correctly thereby winning $5,000 but loses it all by answering a third question incorrectly. While it might appear at first glance that the contestant has the same problem as the one described in the article, upon reflection it seems more likely that only $1,000 of the $5,000 to which the contestant became entitled when he correctly answered the second question was prize income. The remaining $4,000 arguably is gambling winnings from which $4,000 of the $5,000 gambling loss can be deducted.

END OF FOOTNOTES