Wildman v. Commissioner, 78 T. C. 943 (1982)

A cash basis taxpayer partnership cannot claim depreciation deductions for a film under the income forecast method without receiving income in the taxable year.

Summary

Max E. Wildman and Joyce L. Wildman were limited partners in New London Co. , a partnership formed to acquire and distribute the film "Sea Wolf. " The partnership claimed a depreciation deduction of $1,001,739 and an investment tax credit based on a $4 million cost basis for the film. The Tax Court ruled that no depreciation was allowable under the income forecast method because the partnership, operating on a cash basis, had not received any income in 1975. Additionally, the court held that the partnership's $3,540,000 nonrecourse note was not includable in the film's basis as it unreasonably exceeded the film's fair market value. The court also disallowed the investment tax credit due to the retroactive application of IRC section 48(k)(4), which limits credits to qualified U. S. production costs.

Facts

Max E. Wildman invested $50,000 in New London Co. , a limited partnership formed in December 1975 to acquire and distribute the film "Sea Wolf. " The partnership purchased the film for $460,000 cash and a $3,540,000 nonrecourse note. It also paid $20,000 to general partners, $33,000 in legal fees, and $2,500 in promotional expenses. The film was released in December 1975, and the partnership reported a depreciation deduction of $1,001,739 and claimed an investment tax credit. The partnership was a cash basis taxpayer and received no income from the film's exhibition in 1975.

Procedural History

The Commissioner of Internal Revenue disallowed the partnership's claimed deductions and credit, resulting in a deficiency determination of $77,381. 90 against the Wildmans. The Wildmans petitioned the U. S. Tax Court, which upheld the Commissioner's determination, ruling in favor of the respondent on all issues.

Issue(s)

1. Whether the partnership is entitled to a depreciation deduction for the film under the income forecast method for the taxable year 1975?
2. Whether the partnership can include the $3,540,000 nonrecourse note in the cost basis of the film for depreciation purposes?
3. Whether the partnership is allowed to change its method of depreciation without the respondent's consent?
4. Whether the partnership engaged in the activity for profit?
5. Whether the retroactive application of IRC section 48(k)(4) to disallow the investment tax credit is unconstitutional?

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6. Whether the payments made to general partners, for legal fees, and for promotional expenses are deductible?

Holding

1. No, because the partnership, as a cash basis taxpayer, received no income in 1975, resulting in a zero numerator for the income forecast method.
2. No, because the $3,540,000 nonrecourse note unreasonably exceeded the fair market value of the film, and thus could not be included in the film's basis.
3. No, because the partnership chose an acceptable method of depreciation initially and cannot change without consent.
4. Yes, because the partnership was conducted in a businesslike manner with a profit motive.
5. No, because the retroactive application of IRC section 48(k)(4) is constitutional and disallows the investment tax credit due to lack of qualified U. S. production costs.
6. No, because all payments were for capital expenditures and must be capitalized.

Court's Reasoning

The Tax Court applied the income forecast method of depreciation, which matches deductions with income derived from the film. Since the partnership received no income in 1975, it was not entitled to a depreciation deduction. The court followed *Siegel v. Commissioner*, 78 T. C. 659 (1982), which held that income under the income forecast method must reflect gross income reportable by the taxpayer under its accounting method. The $3,540,000 nonrecourse note was excluded from the film's basis because it unreasonably exceeded the film's fair market value, as per *Estate of Franklin v. Commissioner*, 64 T. C. 752 (1975). The partnership could not change its method of depreciation without consent, following *Silver Queen Motel v. Commissioner*, 55 T. C. 1101 (1971). The court found the partnership engaged in the activity for profit, considering the businesslike manner of operations and the film's potential for profit. The retroactive application of IRC section 48(k)(4) was deemed constitutional, limiting investment tax credits to qualified U. S. production costs. Payments to general partners, for legal fees, and for promotional expenses were held to be capital expenditures, requiring capitalization as per IRC section 263 and *Woodward v. Commissioner*, 397 U. S. 572 (1970).

Practical Implications

This decision reinforces the principle that cash basis taxpayers must receive income in the taxable year to claim depreciation under the income forecast method for films. It also clarifies that nonrecourse notes cannot be included in the cost basis if they exceed the fair market value of the asset. Tax practitioners should be cautious when advising clients on depreciation methods and the inclusion of nonrecourse debt in asset basis. The case underscores the importance of U. S. production costs for investment tax credits and the constitutionality of retroactive tax legislation. For

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film partnerships, this ruling emphasizes the need to carefully document and justify expenses as deductible business costs rather than capital expenditures. Subsequent cases have cited *Wildman* in addressing similar issues, reinforcing its significance in tax law related to film investments.

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