Law v. Commissioner, 86 T. C. 1065 (1986)

A partnership that acquires only a contractual right to participate in a motion picture's gross receipts, rather than the film itself, may depreciate its basis in that contract right.

Summary

In Law v. Commissioner, the Tax Court addressed the tax treatment of a limited partnership, Deka Associates, Ltd. , that purported to acquire a motion picture, "Force 10 From Navarone," for distribution in the U. S. and Canada. The court determined that Deka did not acquire a depreciable interest in the film but rather a contractual right to a percentage of the film's gross receipts. Consequently, Deka was allowed to depreciate its basis in this contractual right, which was limited to the cash paid and an acquisition fee, using the straight-line method. The court also found that a nonrecourse note given as part of the purchase price was not genuine indebtedness and thus could not be included in the depreciable basis. Furthermore, the court held that the partnership was engaged in the activity for profit and that the petitioner was entitled to an investment tax credit based on his capital at risk.

Facts

Navarone Productions sold the distribution rights to "Force 10 From Navarone" in the U. S. and Canada to American International Pictures (AIP) for a production advance and a share of net receipts. AIP then assigned these rights to its subsidiary, Wetherly Productions, which sold them to Lionel American Corp. Lionel immediately resold the rights to Deka Associates, Ltd. , a limited partnership, for $560,000 cash and a $5,040,000 nonrecourse note. Deka's interest in the film was structured as a participation in AIP's gross receipts. The partnership claimed depreciation deductions based on the total purchase price, including the nonrecourse note.

Procedural History

The Commissioner of Internal Revenue disallowed the partnership's depreciation and other deductions, leading to a deficiency notice. The petitioners, William J. and Helen M. Law, challenged the Commissioner's determinations in the U. S. Tax Court. The court heard the case alongside Tolwinsky v. Commissioner, as both involved similar issues with TBC Films' motion picture partnerships.

Issue(s)

1. Whether Deka Associates, Ltd. acquired a depreciable interest in the motion picture "Force 10 From Navarone. "
2. If not, whether Deka is entitled to depreciate its basis in a contractual right to participate in the film's gross receipts.
3. What constitutes Deka's depreciable basis and the allowable method of depreciation.

4. Whether Deka's nonrecourse note to the seller represented genuine indebtedness.
5. Whether the partnership was engaged in an activity for profit.
6. Whether the petitioner is entitled to an investment tax credit.

Holding

1. No, because Deka did not acquire substantial rights in the motion picture but only a participation in the proceeds of its exploitation.
2. Yes, because Deka could depreciate its contractual right to participate in the film's gross receipts.
3. Deka's depreciable basis was limited to $560,000 cash paid and an $84,520 acquisition fee, and it could use the straight-line method of depreciation.
4. No, because the nonrecourse note and the level II payments were sham transactions lacking economic substance.
5. Yes, because the partnership had a reasonable prospect of making a profit.
6. Yes, because the petitioner had an ownership interest in the film for purposes of the investment credit based on capital at risk.

Court's Reasoning

The Tax Court applied the substance-over-form doctrine, determining that Deka acquired only a contractual right to participate in AIP's gross receipts rather than the motion picture itself. This was due to AIP retaining complete control over the film through the distribution agreement. The court rejected the inclusion of the nonrecourse note in the depreciable basis, as it was not a genuine debt but a paper transaction designed to increase tax benefits. The court allowed depreciation of the contractual right using the straight-line method, as the declining balance method is not permitted for intangible assets. The court found the partnership was engaged in the activity for profit based on the reasonable prospect of profit and the success of similar investments. Finally, the court held that the petitioner had an ownership interest in the film for investment credit purposes because he was at risk for his capital contribution.

Practical Implications

This decision impacts how tax professionals should approach the depreciation of contractual rights in motion pictures and similar assets. It underscores the importance of determining whether a taxpayer has acquired ownership or merely a participation interest. The ruling also emphasizes the scrutiny applied to nonrecourse financing arrangements, particularly in transactions designed to generate tax benefits. Practitioners should be cautious in structuring such deals, ensuring they have economic substance. The case also affects the application of the investment tax credit, reinforcing that a taxpayer's capital at risk can qualify as an ownership interest, even without legal title or a depreciable interest in the asset. Subsequent cases involving similar structures have often cited Law v. Commissioner to distinguish between genuine and sham transactions.

