Tolwinsky v. Commissioner, 86 T. C. 1009 (1986)

A contractual right to payments contingent on the success of a motion picture is depreciable if it is exhausted over time.

Summary

Nathan Tolwinsky, a limited partner in Hart Associates, Ltd. , invested in the partnership which acquired the motion picture 'The Deer Hunter' from EMI. The partnership's investment was structured as a series of transactions involving intermediaries Great Lakes and Lionel. The court found that Hart did not acquire ownership of the film but rather a contractual right to contingent payments. This right was deemed depreciable, but the partnership's basis for depreciation was limited to the cash paid and the acquisition fee, excluding a nonrecourse note that lacked economic substance. The court also disallowed deductions for interest, management fees, and other expenses, and denied an investment tax credit due to the absence of an ownership interest in the film.

Facts

EMI produced 'The Deer Hunter' and entered into a production-financing-distribution agreement with Universal Pictures. EMI then assigned its rights to British Lion and sold the film's U. S. and Canadian rights to Great Lakes, which sold them to Lionel, who then sold them to Hart Associates. Hart's acquisition included a cash payment and a nonrecourse note. The film was distributed by Universal and was successful at the box office. Hart claimed depreciation and other deductions based on its purported ownership of the film, which the IRS challenged.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Tolwinsky's federal income taxes for 1978 and 1979. Tolwinsky petitioned the Tax Court. The Commissioner amended his answer to challenge the nature of Hart's interest in the film, the depreciation deductions, and the investment tax credit. The case was tried and decided by the Tax Court, which issued its opinion in 1986.

Issue(s)

1. Whether Hart acquired a depreciable interest in the motion picture 'The Deer Hunter'?
2. If Hart did not acquire a depreciable interest in the film, did it acquire a depreciable interest in the contractual right to contingent payments?
3. What is Hart's depreciable basis in the contractual right?
4. Is Hart entitled to deductions for interest, management fees, and other expenses?
5. Was Hart engaged in an activity for profit?
6. Is Tolwinsky entitled to an investment tax credit with respect to the film?

Holding

1. No, because Hart did not acquire all substantial rights in the film; EMI and Universal retained control over its exploitation.
2. Yes, because the contractual right to contingent payments is subject to exhaustion over time.
3. Hart’s depreciable basis is limited to the cash paid to EMI and the acquisition fee paid to TBC Films, excluding the nonrecourse note.
4. No, because the interest on the nonrecourse note was not deductible, and the management fees were capital expenditures.
5. Yes, because Hart had a reasonable prospect of making an economic profit.
6. No, because Hart did not have an ownership interest in the film for investment tax credit purposes.

Court’s Reasoning

The court applied the economic substance doctrine, finding that the transactions between EMI, Great Lakes, Lionel, and Hart were structured to shift tax benefits without genuine business purpose. Hart did not acquire ownership of the film because EMI and Universal retained all substantial rights. The court determined that Hart’s interest was a contractual right to contingent payments, which was depreciable under the straight-line method. The court rejected the inclusion of the nonrecourse note in Hart’s basis, as it was not a genuine debt. The court also found that the management fees were not deductible as they were capital expenditures. The court concluded that Hart was engaged in an activity for profit based on the potential for economic gain from the film. Finally, the court denied the investment tax credit because Hart did not have an ownership interest in the film.

Practical Implications

This decision impacts how tax professionals should analyze similar transactions involving the purchase of income interests in creative works. It clarifies that contractual rights to contingent payments can be depreciated if they are exhausted over time, but the basis for such depreciation must reflect genuine economic investment. The ruling emphasizes the importance of economic substance over form in tax planning, particularly in the context of nonrecourse financing and the use of intermediaries. It also affects the structuring of film investments, as it highlights the limitations on claiming depreciation and investment tax credits without actual ownership. Subsequent cases have followed this decision in distinguishing between ownership and income interests in intellectual property.

