Durkin v. Commissioner, 87 T. C. 1329 (1986)

Partnerships that acquire contractual rights to motion picture proceeds, rather than ownership of the films themselves, may depreciate those rights over time.

Summary

In Durkin v. Commissioner, the U. S. Tax Court addressed the tax implications of partnerships investing in motion pictures through a series of transactions involving Paramount Pictures Corp. , Film Writers Co. (FWC), and two partnerships, Balmoral and Shelburne. The court ruled that the partnerships did not acquire ownership of the films but rather contractual rights to the proceeds from their distribution. These rights were depreciable over time, but the court specified adjustments needed in the method of calculating depreciation. Additionally, the court disallowed deductions for certain payments to general partners and limited the basis for investment tax credits. The case illustrates the complexities of structuring investments in intellectual property for tax purposes and the importance of distinguishing between ownership and contractual rights in such assets.

Facts

In 1977 and 1978, Balmoral and Shelburne partnerships, organized by Capital B Corp. and Bernard M. Filler, purchased rights to several motion pictures from FWC, which had initially acquired them from Paramount Pictures Corp. The transactions involved cash, short-term recourse notes, and long-term recourse notes that would become nonrecourse upon certain conditions. The partnerships entered into distribution agreements with Paramount, retaining copyright but transferring all substantial rights for distribution and exploitation to Paramount. The partnerships claimed tax deductions for depreciation and investment credits based on their investment in these films.

Procedural History

The Commissioner of Internal Revenue issued deficiency notices to the partners of Balmoral and Shelburne, disallowing their claimed deductions and credits. The case proceeded to the U. S. Tax Court, which examined the nature of the partnerships' rights in the motion pictures, the appropriateness of depreciation methods, and the validity of deductions for various expenses.

Issue(s)

1. Whether the partnerships acquired depreciable ownership interests in the motion pictures?
2. How should the partnerships compute depreciation on their interests in the motion pictures?
3. Are the partnerships entitled to investment tax credits for their investments in the motion pictures?

4. Are the partnerships entitled to deductions for guaranteed payments to their general partners?
5. Are other expenses, such as advertising and professional fees, deductible by the partnerships?

Holding

1. No, because the partnerships acquired only contractual rights to proceeds from the films, not ownership.
2. The partnerships must use the income-forecast method based on their net income from the films and include estimates of network television income. Shelburne must use the straight-line method for depreciation, with a useful life of 6 years for its contractual rights.
3. Yes, because the partnerships had an "ownership interest" in the films for investment credit purposes, but the credit base is limited to cash and short-term recourse notes paid to FWC.
4. No, because the guaranteed payments to general partners were not for ordinary and necessary business expenses but were related to partnership organization and syndication.
5. No, for advertising payments as they were part of the purchase price and should be capitalized, but yes for certain professional fees incurred after the partnerships were operational.

Court's Reasoning

The court analyzed the legal substance of the transactions, concluding that the partnerships retained only a "bare" copyright while Paramount retained all substantial rights to exploit the films. The court determined that the partnerships' interests were contractual rights to gross receipts and net profits, which could be depreciated. The court applied the income-forecast method for depreciation, emphasizing the use of net income and the inclusion of network television income estimates. The court also rejected the use of the double-declining-balance method for intangible contractual rights, opting for the straight-line method. The court disallowed deductions for guaranteed payments and advertising costs, reasoning that these were not ordinary and necessary business expenses but were linked to partnership organization and the purchase price of the films, respectively. The court's decision was influenced by the need to reflect the economic substance of the transactions over their legal form.

Practical Implications

This decision affects how similar investments in intellectual property should be structured and analyzed for tax purposes. It highlights the importance of distinguishing between ownership and contractual rights, with the latter being subject to different tax treatments. The ruling impacts how depreciation is calculated for such investments, requiring the use of the income-forecast method based on net income and the inclusion of all anticipated revenue sources. It also sets a precedent for disallowing deductions for payments related to partnership organization and syndication, and for treating certain expenses as capital rather than current deductions. Subsequent cases have referenced Durkin in analyzing similar transactions involving intellectual property rights and tax benefits.