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BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

FILMCRAFT TRADING CORPORATION

Appearances:

For Appellant: James W. Gaskill, Jr,, Public Accountant

For Respondent: Burl D, Lack, Chief Counsel; John S. Warren, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Filmcraft Trading Corporation to proposed assessments of additional franchise tax in the amounts of $286.81 and $1,951.64 for the income years ended November 30, 1949, and 1951, respectively.

Since the filing of this appeal the Franchise Tax Board has made two concessions which will eliminate the deficiency for the income year ended November 30, 1949, and reduce the assessment for the income year ended November 30, 1951, as hereinafter described.

Appellant corporation began doing business in California in December, 1946, and dissolved in August, 1953. It was an independent producer of motion pictures and produced two pictures! "Underworld Story," which was released on July 22, 1950, and "Short Grass," which was released on December 25, 1950, "Underworld Story" was distributed by United Artists Corporation. "Short Grass" was distributed by Monogram Pictures Corporation.

Appellant financed the production of its pictures by a system known as "deferment" financing. Under this arrangement persons contributing capital and services to the production of a picture agree to accept payment from the producer's share of future receipts from the particular picture in accordance with assigned priorities. If the picture does not produce the anticipated income then those with low priorities under the deferral agreement may receive nothing,

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Both pictures produced by Appellant were financed in part by advances made by Monogram Pictures Corporation, The deferment agreement for the production of "Underworld Story" provided that the receipts from the picture were to be applied to payment of a $200,000 bank loan before liability was to be incurred to Monogram for its advances. At the end of the year in which that picture was released, the liability to Monogram had not yet become fixed, The picture "Short Grass" yielded sufficient revenue in the year of its release to fix within that year the liability for all costs with respect to it.

Appellant took deductions for amortization of the cost of producing its motion pictures based on the amortization schedule used by Monogram Pictures Corporation. This provided for recovery of the cost within 78 weeks after release of a picture. It did not deduct any part of the payments it was required to make under the deferral agreement covering "Underworld Story" until after that picture had produced enough income to make Appellant liable for those costs under the deferral agreement. Expenditures made by Appellant for advertising and promoting its pictures prior to their release were deducted as current business expenses. It also deducted as current expenses the costs of preparing prints of its pictures to be rented to exhibitors.

Four questions are presented:

(1) Whether the cost of the pictures should be amortized on the basis of estimated gross receipts as contended by the Franchise Tax Board or on the basis of an estimated life as contended by Appellant.

(2) Whether the amortization of costs under the deferral agreement should begin when the picture is released as contended by the Franchise Tax Board or only as receipts become sufficient to subject Appellant to liability for each item in its turn as contended by Appellant.

(3) Whether the pre-release advertising and promotion expenses should be capitalized as contended by the Franchise Tax Board or deducted as current expenses as contended by Appellant.

(4) Whether the cost of the prints should be capitalized as contended by the Franchise Tax Board or deducted as current expenses as contended by Appellant.

We shall discuss each question in turn.

be accurately estimated after the picture has been produced and released, Tannenbaum, supra, stated, "Generally within about six weeks or two months from the time the picture has been released, the distributor is able to estimate the total expected revenue with fair accuracy." Appellant has produced no evidence sufficient to refute our finding in Appeal of Pickford-Lasky Productions, Inc., supra, that the estimated gross receipts method "is in accordance with recognized trade practices of computing depreciation and that, in fact, it is the only correct method from an accounting standpoint, "

(2) The Franchise Tax Board contends that if the estimated gross receipts from a picture will be sufficient to pay the production costs, the amortization of the production costs should begin in the year the picture is released whether or not Appellant is then legally liable to pay such costs under the deferral agreement. It recognizes the general rule that costs are not to be accrued until they become legally fixed, but argues that to apply the rule here would be to reject the estimated gross receipts method of amortization,

We cannot accept the contention that the taxpayer must accrue liabilities before he becomes legally liable to pay them. The reasonable probability during the year that a liability will accrue is not sufficient if, as a matter of fact, it does not actually come into existence during the year. A liability does not accrue for tax purposes so long as it remains contingent, or if the events necessary to create the liability have not occurred (E. H. Sheldon & Co. v. Commissioner, 214 Fed. 2d 655). As stated in Security F.M. Co. v. Commissioner, 321 U. S. 281:

> "The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount. "

Nor do we think that the refusal to make an exception in this situation amounts to a rejection of the estimated gross receipts method of amortization, That method does not rest upon the assumption that an estimate of future receipts is the equivalent of actual, present receipts.

(3) In view of our conclusions as to the first two issues, the third question may be stated as follows: When the liability for pre-release advertising and promotional expense becomes fixed under the deferral agreement, may it be deducted as current expense or should it be amortized over the remaining period in which the estimated gross receipts are to be recovered?

The Franchise Tax Board contends that the pre-release advertising and promotional expenses should be regarded as part of the cost of creation or acquisition of an exhaustible capital asset, the motion picture, and as such, subject to amortization. The Franchise Tax Board made the same contention in Appeal of Screen Plays II Corporation, decided June 25, 1957, and we therein considered the contention at length before rejecting it. As we there pointed out, expenses of this kind fall within the holding of E. H. Sheldon & Co. v. Commissioner (supra), that advertising expense, even though incurred heavily in a certain year with resulting benefits over future years, is currently deductible.

(4) The final question is whether the cost of show prints, when such cost becomes fixed under the deferral agreement, should be deducted as a current expense or amortized over the remaining period in which the estimated gross receipts are to be recovered.

The Franchise Tax Board states that its practice is to treat print costs as part of the capitalized costs of the single asset, the motion picture, and that this practice is now generally concurred in by the industry. Inasmuch as the prints are necessary for the showing of the motion picture, are useful beyond the year of acquisition, and are exhausted at a gradual rate, we feel that the position of the Franchise Tax Board must be sustained as to this point (see Archibald V. Simonson, T.C. Memo., Dkt. No. 8148, entered August 18, 1946).

In recomputing Appellant's tax the Franchise Tax Board transferred a deduction of distribution expenses in the amount of $18,846.41 from the income year ended November 30, 1951, to the income year ended November 30, 1950. The Franchise Tax Board now concedes that this adjustment should be reversed. This change will reduce net income for the year ended November 30, 1951, by the amount of $18,846.41.

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O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code that the action of the Franchise Tax Board on the protest of Filmcraft Trading Corporation to a proposed assessment of additional franchise tax in the amount of $286.81 for the income year ended November 30, 1949, be and the same is hereby reversed; that the action of the Franchise Tax Board on the protest of Filmcraft Trading Corporation to a proposed assessment of additional franchise tax in the amount of $1,951.64 for the income year ended November 30, 1951, be and the same is hereby modified as follows: (1) distribution expenses in the amount of $18,846.41 shall be allowed as a deduction from gross income; (2) costs shall be accrued in the year in which they became fixed liabilities under the deferment agreements used by Appellant to finance its pictures and (3) advertising and promotional costs shall be treated as current expenses; all in accordance with the Opinion of the Board, In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 17th day of February, 1959, by the State Board of Equalization.

Paul R. Leake , Chairman

Geo. R. Reilly , Member

John W. Lynch , Member

_____, Member

_____, Member

ATTEST: Dixwell L. Pierce , Secretary