BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
NAT AND BLANCHE HOLT)

Appearances:

For Appellants: Thomas E. O'Sullivan, Attorney at Law

For Respondent: Wilbur F. Lavelle, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Nat and Blanche Holt against a proposed assessment of additional personal income tax in the amount of $801.58 for the year 1957.

Nat Holt (hereafter "appellant") has been active in the motion picture business for some forty years, and has been a producer of motion pictures since 1943. He and a Mr. Rosen were equal partners in a partnership entitled Holt-Rosen Productions. In early June 1955 that partnership commenced production of Texas Lady, a western movie, and on June 16 a bank loan was obtained to finance the film. Under the loan agreement the bank retained an option to declare the loan due if it appeared six months after the picture was released that the anticipated gross receipts from domestic distribution would be insufficient to pay the loan within 21 months after the first advance or one year after the release date. During 1955, when more money was needed to complete the film, appellant and Mr. Rosen each invested $39,163.68.

Texas Lady was released for distribution in November 1955. In October 1956 the lending bank exercised its option and declared the loan to be due. As of November 29, 1956,

gross receipts from distribution and exhibition of Texas Lady totalled $821,298.17, including $155,398.22 from foreign showings. Additional earnings of $332,634.94 were required before appellant could recover any part of his investment.

As late as September 1964 receipts were not yet sufficient to cover the cost of producing Texas Lady, and appellant has never recovered the $39,163.68 he invested to help finance completion of the film. In his personal income tax return for 1957, appellant deducted the $39,163.68 as a loss sustained in that year.

The amount of the loss is not in question, nor is the fact that appellant did suffer such a loss. Respondent determined, however, that the loss was deductible in 1956 rather than in 1957.

Subdivision (a) of section 17206 of the Revenue and Taxation Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. The regulations state that a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. (Cal. Admin. Code, tit. 18, reg. 17206(a), subd. (4).)

Respondent argues that very shortly after a motion picture is released it is possible for film producers to make a fairly accurate estimate of the total earnings which will result from distribution of that movie and that such an early estimate is customarily a factor of the formula used for amortization of motion picture costs. That being so, respondent contends that by the end of 1956 it was clear to appellant, as it was to the bank which called its loan due in October 1956, that the picture would never pay out.

At the hearing appellant testified that the average pay out period (the time necessary for all costs to be recovered) for a picture such as Texas Lady is 18 to 22 months, and that he personally had never had one pay out in less than 20 months. Appellant asserted that foreign distribution of such a film takes much longer than domestic distribution, partially because it is necessary to dub in the foreign translation of the script prior to distribution, and that foreign receipts thus do not generally reach a peak until about 20 months after the film is released. Appellant added, however, that western movies usually sell very well inforeign countries and, as a rule, receipts from foreign sources equal domestic receipts. Appellant testified further that, having compared the relatively small

amount of foreign income which had come in by November 29, 1956, with the foreign receipts generally forthcoming from such a film, he genuinely believed that substantial additional foreign receipts were yet to be received during 1957. Appellant stated that he also anticipated future receipts from television showings of the film but no such income had been received by the end of 1956.

In discussing the question of when a loss is sustained for income tax purposes, the Supreme Court of the United States has recognized that there are circumstances in which a loss may be so reasonably certain in fact and ascertainable in amount as to justify its deduction before it is absolutely realized. (Lucas v. American Code Co., 280 U.S. 445 [74 L. Ed. 538].) In that case the Court stated that the general requirement. that losses be deducted in the year in which they are sustained calls for a practical, not a legal test.

The Court has also concluded that a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. (United States v. White Dental Mfg. Co., 274 U.S. 398 [71 L. Ed. 1120].) On the other hand, a loss is not deductible SO long as there is a reasonable prospect of recovery. (Trowbridge v. United States, 32 F. Supp. 852, 856; E. C. Olson, 10 T.C. 458, 461, 462.) In determining whether a loss was sustained in a particular year, the inquiry should be: Was the taxpayer's deduction of the loss in that year based upon the exercise of reasonable judgment from facts then known? (Rhodes v. Commissioner, 100 F.2d 966; Davidson Grocery Co. v. Lucas, 37 F.2d 806.)

We believe that appellant's judgment at the close of 1956 that the movie might still pay out was reasonable in view of the following facts: Foreign receipts from a movie of this type normally equal domestic receipts, and had they equaled domestic receipts in this case, the picture would have been profitable; foreign receipts generally begin coming in only after a delay and generally reach a peak some 20 months after the film is released, which would have been in the middle part of 1957. We are also of the opinion that appellant reasonably concluded by the end of 1957, when the normal peak time for foreign receipts had come and gone, that he would never recover his investment in the film. We believe he was well qualified to make the above determinations in view of his many years of experience in the motion picture industry and his past production of a number of movies of a similar type.

In its argument that an earlier estimate of total gross receipts was possible,, respondent quotes the following from an article which we have cited with approval in several prior opinions:

> 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. (Tannenbaum, Amortization of Motion Pictures (1949), Proceedings of the Tax Institute, University of Southern California School of Law, Major Tax Problems of 1948, p. 345, 349.)

It is to be noted that our reliance on that statement has been restricted to cases in which we were dealing with amortization problems. Here the issue is quite different. Amortization computations are of necessity based upon estimates and precision is not expected. The sustaining of a loss, on the other hand, is based upon reasonable certainty and upon events which establish that the loss has in fact been sustained.

In support of its position, respondent also relies on the fact that the bank which lent money to finance the production of Texas Lady exercised its option and called the loan due in October 1965. The option was exercisable, however, whenever it appeared that domestic receipts would be insufficient to pay the loan within 21 months after the funds were advanced, which would be in March 1957. It seems apparent that appellant could still have reasonably believed at the end of 1956 that the picture would eventually pay out through foreign as well as domestic receipts, although the bank may have been prohibited by its lending policies from taking any chances on the transaction.

It is well established that the burden is on the taxpayer to prove that he is entitled to a loss deduction. (Burnet v. Houston, 283 U.S. 223 [75 L. Ed. 991].) We believe that appellant has sustained that burden in the instant case, and the loss which he suffered on his investment in Texas Lady was properly deducted by him in 1957.

ORDER

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

Appeal of Nat and Blanche Holt

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Nat and Blanche Holt against a proposed assessment of additional personal income tax in the amount of $801.58 for the year 1957, be and the same is hereby reversed.

Done at Sacramento, California, this 5th day of October, 1965, by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

Attest: Secretary