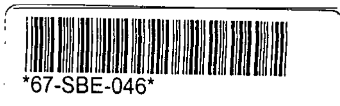

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ANDREW L. STONE, INC.)

Appearances:

For Appellant: William R. Wolanow
Attorney at Law

For Respondent: Joseph W. Kegler
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the deemed disallowance by the Franchise Tax Board of the claim of Andrew L. Stone, Inc., for refund of franchise tax in the amounts of $3,037.96 and $3,081.55 for the income years ended October 31, 1959 and 1960, respectively. Pursuant to section 26076 the claim was deemed disallowed since the Franchise Tax Board did not act on it within six months after it was filed.

Appellant is a California corporation engaged in the business of independently producing motion pictures. Its principal business asset consists of an exclusive contract for the services and talents of Andrew L. Stone (hereafter referred to as "Stone"), an individual. Stone and his wife own all of appellant's capital stock. Appellant keeps its books and records and files its returns under the cash receipts and disbursements method of accounting.

The separate issues presented by this appeal are an outgrowth of two agreements entered into by appellant and Loew's Incorporated (hereinafter referred to as "Loew's") for the production and distribution of a number of motion picture photoplays.

Joint Venture One

The first agreement, dated August 13, 1956, gave rise to a joint venture and provided for the production of two motion picture photoplays by appellant and distribution by Loew's. The cost of producing the photoplays (hereafter termed the "negative cost") was financed jointly with Loew's furnishing 75 percent and appellant 25 percent of the cost. This was accomplished by a "dry mortgage" financing arrangement whereby Loew's put up all the funds and "loaned" appellant the latter's 25 percent of the cost of each photoplay, Loew's was granted a lien on appellant's interest to secure repayment of such advances. All funds were placed in a production account for disbursement upon the joint signatures of the parties. Each party received an undivided ownership interest in the photoplays equivalent to its respective share of "net profits" which was stipulated to be 75 percent for Loew's and 25 percent for appellant.

"Net profits" were defined as any gross receipts from distribution remaining after Loew's recouped and retained the following:

(a) A stated percentage of gross receipts from distribution as a "distribution fee."

(b) Direct distribution expenses.

(c) The cost of producing the negative and other funds advanced to appellant,

Loew's was entitled to recoupment of the total cost of the negatives from "net receipts" (gross receipts - less distribution cost) of both photoplays as a group before appellant was entitled to receive a distribution of net profit. No deficiency judgment was to issue against appellant on account of the funds advanced by Loew's except for a breach of its obligation to fully perform the agreement. Loew's was given the exclusive right to possess and distribute the photoplays.

Appellant duly completed production and delivered the photoplays to Loew's for distribution. Loew's credited 25 percent of net receipts from distribution of the photoplays against the advances made for appellant's share of the production cost, These credits amounted to $79,241.89 and $38,901.20 for the income years ended October 31, 1959 and 1960, respectively. Appellant did not include these amounts in gross ineome for franchise tax purposes. On its returns for these same years it claimed deductions for amortization

of 25 percent of the total negative cost in the amounts of $134,298.32 and $100,107.73, respectively, based upon a projected useful life of 104 weeks for the assets.

Respondent concluded that appellant constructively received income to the extent the net receipts were applied in payment of its proportionate ownership interest in the photoplays. It disallowed the claimed deductions for amortization in excess of the amounts of these net receipts on the basis that appellant's liability to pay the balance of the negative cost was contingent and therefore did not constitute cost subject to amortization. In view of this action the issues raised as a result of the performances under the first agreement may be stated as follows:

1. Did appellant constructively receive income for the income years 1959 and 1960 to the extent that the net receipts were applied in payment of its 25 percent share of the negative cost?

2. Is appellant entitled to deductions for amortization for the years 1959 and 1960 in excess of its invested cost in the photoplays?

Appellant contends that it did not derive income from the application of the net receipts in payment of its share of the negative cost because, by the terms of the agreement, Loew's was entitled to recoup the entire cost of the negative and all other loans before appellant was privileged to share in "net profits." It submits that the advances made for appellant's share of the negative cost were bona fide loans representing appellant's cost basis in the assets subject to amortization over the period selected.

We agree with respondent's determination that appellant constructively received income from the application of the net receipts in payment of its share of the negative cost. The power to dispose of income is the equivalent of ownership of it, and the exercise of that power to procure the payment of that income to another is the enjoyment and hence the realization of the income by the one who exercises it. (Helvering v. Horst, 311 U.S. 112 [85 L. Ed. 75-J.) Pursuant to the agreement appellant acquired the right to have the receipts applied in payment of its share of the negative cost. The application of the funds by way of offset was of benefit to appellant because such payment was necessary to fund its capital interest in the asset and thereby entitle it to share in any distribution-of net profit. Appellant thus obtained satisfaction

of economic worth and hence the realization of the full benefit of the income. (Old Colony Trust Co. v. Commissioner, 279 U.S. 716 [73 L. Ed. 918]; Acer Realty Co. v. Commissioner, 132 F.2d 512.)

Appellant's claim in essence seeks approval of the "cost recovery" method of accounting for income. Under this method it would realize no taxable income until all costs have been fully recovered. The cost recovery method has been expressly rejected as a basis for determining income from motion picture photoplays for federal income tax purposes. (Rev. Rul. 60-358, 1960-2 Cum. Bull., 68; Rev. Rul. 64-273, 1964-2 Cum. Bull. 62; Inter-City Television Film Corp., 43 T.C. 270.) We find nothing in the record which warrants its application here.

With respect to the second issue, the amount allowable to appellant as a deduction for amortization is dependent in the first instance upon the extent of its capital investment in the photoplays. The capital sum subject to amortization is the actual cost incurred by appellant. (Cal. Admin. Code, tit. 18, reg. 24121g(4); Detroit Edison Co. v. Commissioner, 319 U.S. 98 [87 L. Ed. 1286].) We have previously held that independent motion picture producers should use the "estimated gross receipts method" to determine the annual amount of the deduction. (See Appeal of Filmcraft Trading Corp., Cal, St. Bd. of Equal., Feb. 17, 1959.)

While the amounts advanced by Loew's were designated as loans to appellant, the question remains whether the obligation created thereby was so fixed and absolute and constituted such an economic burden as to represent cost to appellant. The true nature of an obligation for tax purposes hinges not upon formal characterization, but rather upon the whole of the underlying transaction and the relationship in fact created thereby. (Gooding Amusement Co., 23 T.C. 408, aff'd, 236 F.2d 159, cert. denied, 352 U.S. 1031 [1 L. Ed. 2d 599].)

The parties* agreement was in the nature of a joint venture, with Loew's advancing 100 percent of the cost retaining an element of control over disbursement of the funds during production, and acquiring an immediate ownership interest. After release of a photoplay Loew's was entitled to retain a substantial portion of gross receipts as a distribution fee and to recoup its direct distribution expenses before any portion of the receipts were applied in payment of the negative cost. Payment of the negative cost was to be recouped from the remaining net receipts, with no deficiency judgment to issue against appellant in the event receipts were insufficient to recoup the cost.

While Loew's was given a lien to secure repayment, this vested it with no substantial additional right since by the terms of the agreement it held the exclusive right to possess and distribute the photoplay and apply the payments until the advances and fees were paid in full.

It is thus apparent that Loew's received preference in the order of distribution of gross income including the payment of a distribution fee of substantial value, whereas appellant's right to derive any benefit from the use of the funds was conditioned upon the earning of net receipts. When this condition, precedent to appellant's right to benefit from the use of the funds, is considered together with the substantial restriction placed on the source of funds available for payment of the "loans," the probability that the security for the loans would be without value at the date of maturity and the limitation of appellant's liability to repay the funds from net receipts, we believe there is a clear demonstration that the parties intended to create an obligation to repay only if net receipts were earned, and only to the extent thereof. Such a limited obligation to pay out of future receipts or profits is too indefinite to constitute depreciable cost prior to the time payment became certain. (Inter-City Television Film Corp., supra, 43 T.C. 270; also see Reisinger v. Commissioner, 144 F.2d 475.) Since respondent has allowed a deduction for the full amount of the net receipts applied in the year payment became certain, we affirm its action on this issue.

Joint Venture Two

The remaining issue is concerned with a second joint venture agreement which provided for the production and distribution of four photoplays under terms similar to those contained in the first agreement. During the income year ended October 31, 1960 appellant received payment in four installments of the sum of one hundred thousand dollars ($100,000) from the joint venture production account pursuant to the following contract provision:

> (c) The sum of ONE HUNDRED THOUSAND DOLLARS ($100,000.00) shall be included in the budget and negative cost of the, photoplay, as an item payable by the Producer, for and on account of Stone's services as aforesaid and all rights in and to the literary material (including, but not limited to, the story and screenplay) on which the photoplay is based. The aforesaid sum of ONE HUNDRED THOUSAND DOLLARS ($100,000.00) shall be payable to the Producer as follows ...

Other provisions of the agreement made reference to appellant's employment contract with Stone and recited that his employment was the essence of the- parties* agreement. Appellant warranted that its contract with Stone would "remain in full force and effect throughout the entire term of production ...", that appellant had not "transferred, assigned, hypothecated or in any way disposed of its right, title and interest in and to said Stone employment contract ...." and that the cost of Stone's services "shall be borne by and paid by the producer [appellant] and shall not be included in the negative cost of the photoplay." Under the terms of its separate personal service contract, with Stone, appellant had also acquired ownership of Stone's work product excepting certain original publication rights not at issue in this appeal.

Respondent included the one hundred thousand dollar ($100,000) payment in income as compensation received by appellant for services and property furnished the joint venture. A deduction was allowed for payments made by appellant to Stone which amounted to $1,000 per week.

It is appellant's position that no income was realized from receipt of the one hundred thousand dollars ($100,000) because the money was specifically earmarked for fulfilling its legal obligation under an employment contract with Stone, It relies on the recognized rule that the receipt of funds impressed with a trust for disbursement to a third party for a specific obligation does not result in income to one who merely functions as a trustee for disbursement of the funds. (The Seven-Up Co., 14 T.C. 965; Broadcast Measurement Bureau Inc., 16 T.C. 988.) However, close analysis of the terms of the agreement and the action of the parties thereunder discloses that no such relationship or restriction on the use of the funds existed, We do not find, therefore, that the funds were advanced to pay a specific obligation to Stone.

Neither Loew's nor the joint venture, as such, had any contractual agreement with Stone. Whatever right this individual had to compensation was derived from its separate contract with appellant, which called for payments of $1,000 weekly. Whereas the one hundred thousand dollar sum was included in the production "budget and negative cost of the photoplay," the cost of Stone's services was to be borne by appellant and "not ... included in the negative cost." Appellant's contractual promise to discharge this separate obligation from the funds does not prevent the realization of income. (Compton Bennett, 23 T.C. 1073.)

The absence of restriction on the use of the funds is also confirmed by the release of the funds to appellant in four lump sum payments contrary to the usual manner of paying production cost due third parties. We believe respondent properly determined appellant's income on an annual accounting basis without reference to payments made by appellant to Stone in subsequent years.

Having reviewed the entire record and finding no error therein, we sustain the denial of appellant's claim for refund and order accordingly.

ORDER

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 26077 of the Revenue and Taxation Code, that the deemed disallowance by the Franchise Tax Board of the claim of Andrew L. Stone, Inc., for refund of franchise tax in the amounts of $3,037.96 and $3,081.55 for the income years ended October 31, 1959 and 1960, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of August, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

[illegible], Member

[illegible], Member

________________, Member

ATTEST: [illegible], Secretary