[COMMITTEE PRINT]

TAX SHELTERS: MOVIE FILMS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

SEPTEMBER 10, 1975

U.S. GOVERNMENT PRINTING OFFICE

58-146 WASHINGTON : 1975 JCS-26-75

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GENERAL

Motion picture shelters generally have two basic forms. In one format, a limited partnership is formed to purchase the rights to an already completed film. The purchase price is heavily leveraged (and often unrealistically inflated) and the partners claim substantial depreciation deductions. The principal features of the shelter are deferral and leverage; also the partners also claim the investment credit with respect to the film. This type of deal is sometimes referred to as a "negative pick-up" or "amortization purchase" transaction. Many of these transactions involve foreign-produced films.

In the second type of format, the limited partnership is formed as a production partnership. The production partnership enters into an agreement with a studio, with a distributor or with an independent producer to produce a particular film. The production partnership uses the cash method of accounting and writes off the costs of production, as they are paid. The partnership is heavily leveraged and significant costs are paid with borrowed funds. The principal elements of this form of motion picture shelter are deferral and leverage. This type of shelter is sometimes referred to as a "service company."

FILM PURCHASE TAX SHELTER

Discription of the shelter

In this type of transaction, a syndicate of investors, usually formed as a limited partnership, purchases a completed film for a cash down payment plus a nonrecourse note given to the seller (often falling due within a range of 7 to 10 years). It is not uncommon for the leverage factor in this type of transaction to be 3 or 4 to 1 (i.e. 3 or 4 dollars of borrowing for each dollar of equity investment) and sometimes even higher. The partnership usually turns over the function of distributing the picture to a major studio-distributor (which is sometimes the same person who sold the film to the partnership), which makes prints, arranges showings and handles advertising and promotion in return for a percentage of the gross receipts.

The income from showing the film is divided many ways. A substantial share goes to the theater owners who show the film locally. The distributor receives a distribution fee and, in addition, it is common for the producer and/or the stars of the film to have rights to a share of the income. The limited partnership, as the owner of the film, has the "negative interest" which is also a right to a certain share of the gross receipts.

As indicated above, however, this negative interest is often heavily mortgaged. The nonrecourse note is to be liquidated from the film's receipts. Some agreements provide that the nonrecourse note must be liquidated first, before the limited partners recover any of their own equity capital or realize a profit. Other arrangements provide for some

form of pro rata pay off, under which each dollar allocated to the negative interest is divided between the noteholder and the limited partners on some predetermined basis.

The shelter aspect occurs because of very rapid depreciation of the (often inflated) cost of the film (which, of course, includes the basis which is attributable to leverage).[1]

Present law as it applies to film purchase tax shelters

A. Rapid write-off expenses.

Under present law, a partner (including a limited partner) is required to take into income his distributive share of the partnership's income or losses (sec. 702). Generally, the partner's distributive share is determined under the partnership agreement (sec. 704). Thus, the partner may deduct from his income, generally, all of the losses of the partnership which are allocated to him under the partnership agreement. In the case of the film-purchase shelter, the most important of these expense items, is the deduction for depreciation which is computed under the income forecast method described below.

B. Leverage.

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705).

Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, where the partnership incurs a debt, and none of the partners have personal liability (the "nonrecourse" loan), then all of the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)). For example, if a partner invested $10.000 in a partnership, in return for a 10 percent profits interest, and the partnership borrowed $100,000 in the form of a nonrecourse loan, the partner's basis in the partnership would be $20.000 ($10,000 of contributions to the partnership, plus 10 percent of the $100,000 nonrecourse loan).

Generally, in this type of transaction, most or all of the profits interest in the partnership (and therefore most of the leverage) is allocated to the limited partners.

C. The income forecast method.

Motion pictures are usually depreciated on the "income forecast" method. (Rev. Rul. 60–358, 1960–2 C.B. 68; Rev. Rul. 64–273, 1964–2 C.B. 62.) This method is used because, unlike most other depreciable assets, the useful life of a motion picture is difficult to ascertain. Under the income forecast method, the taxpayer computes depreciation by using a fraction, the numerator of which is the income received from the film during the year and the denominator of which is the total estimated income which the film is expected to generate over its remaining lifetime. This fraction is then multiplied by the cost of the film. For example, if the taxpayer has a basis of $500,000 in his interest in

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[1] Although relatively insignificant, the deduction of syndication fees is also a factor in some of these shelters.

the film, the income from the film through the end of the first year is $750,000, and the total estimated income from the film over its lifetime is $1,000,000, the taxpayer would be allowed to depreciate 75 percent of his basis, or $375,000. (If the income forecast increases or decreases as a result of changed circumstances, this is taken into account for later periods. Thus, in the second year, depreciation under the income forecast method might be based on an income forecast denominator which was more or less than the amount used for the first year.)

D. Depreciation recapture.

There is some question as to whether a movie film in the hands of a limited partnership, such as those described here, would constitute a capital asset (within the meaning of sec. 1221), or "property used in the trade or business" of the taxpayer which is neither "inventory," nor "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (within the meaning of sec. 1231).[2] There is certainly an argument that where the limited partnership owns a single film, which it did not produce, and which it holds for a period of years, such property should be viewed as inventory as a section 212 investment,[3] or as 1231 property which is not either and is not held "primarily for sale." On the other hand, the Service, in applying these provisions to movie films, has applied the primarily for sale principle on a broad basis which might well reach many of the fact situations involved in these shelters. (See Rev. Rul. 62-141, 1962-2 C.B. 182).

If the film is not a capital asset (or section 1231 property), any income received with respect to the film would be ordinary income. Assuming that the film is found to be a capital asset, income realized on the sale or exchange of the film would be subject to the depreciation recapture rules of section 1245. Thus, the proceeds of the sale in excess of the taxpayer's adjusted basis would constitute ordinary income to the extent of any depreciation previously allowable with respect to the film.[4]

Even if the film is not sold, there should eventually be recapture of the depreciation attributable to the nonrecourse note. If the film is successful and the loan is repaid out of the partnership income, each partner would take into income his distributive share of the amounts used for repayment; the partner's basis would not be affected. (The partner's basis would increase to the extent that his distributive share of the partnership income was used for partnership purposes, such as repayment of the loan, but his basis would decrease in an equal amount because his share of the nonrecourse partnership liability was being reduced by the repayment.) If the film is not successful and the nonrecourse debt becomes worthless, this generally constitutes income to the partnership when the debt is foreclosed, because the foreclosure is treated as a "sale" of the movie film, (See *Commissioner* v. *Rogers*,

[2] Under section 1231, a taxpayer who sells certain property used in his trade or business obtains special tax treatment. All gains and losses from section 1231 property are aggregated for each taxable year and the net gain if any, is treated as capital gain. The net loss, if any, is treated as an ordinary loss.

[3] Section 212 permits the deduction of expenses paid or incurred for the production of income, or for the management, conservation or maintenance of property held for the production of income.

[4] If the partner sold his interest in the partnership, the depreciation would be recaptured as an "unrealized receivable" under section 751.

37 B.T.A. 897 (1938), aff'd 22 AFTR 1129 (9th Cir., 1939)), which is subject to the recapture rules of section 1245.[5]

How the shelter works

As a practical matter, there is relatively little sheltering effect where the total estimated revenues to be received from the film exceed the purchase price paid for the film.[6] Where the projected income stream of the film is less than the purchase price, and depreciation is based on the income forecast method, the depreciation deduction claimed by the limited partners will exceed the amount of income from the film which the partners are required to recognize.

The shelter occurs where the limited partnership "pays" more for the film than its economic value. (Much of this payment, of course, is in the form of a nonrecourse note.)

Assume, for example, that prior to commercial release of a completed film, the limited partnership pays the production studio $1,000,000 for the film, consisting of $200,000 cash and a 10-year nonrecourse note of $800,000. After the film is released, it becomes apparent that it will not be successful and will not generate box office receipts equal to the purchase price paid by the investors. The film is reappraised and it is now determined that its estimated income over its lifetime will not exceed the $200,000 cash down payment. If this reappraisal proves accurate the depreciation and income which would be passed through to the limited partners over the following 10 years would be as follows:

	Percent of revenue	Revenue	Depreciation	Tax loss
Year:				
1	80.0	$160,000	$800,000	($640,000)
2	10.0	20,000	100,000	(80,000)
3	5.0	10,000	50,000	(40,000)
4	2.5	5,000	25,000	(20,000)
5	1.0	2,000	10,000	(8,000)
6–10	1.5	3,000	15,000	(12,000)
Total	100.0	200,000	1,000,000	(800,000)

At this point, the investors might default on the note, and the partners would have to recognize $800,000 of income.[7] This $800,000 is the

[5] At least this is the law. Likewise, if the partnership discontinues its operations, this should constitute a constructive distribution of the partnership assets (including, for this purpose, the unpaid portion of the nonrecourse note) to the partners, which in turn triggers the recapture rules of section 1245. However, it is by no means clear that all taxpayers follow sound tax accounting principles at this point in the shelter transaction, and much of this income may be "forgotten". When this occurs, it is difficult for the Internal Revenue Service to detect unless there is a field audit.

[6] This is easiest to illustrate in a case where the income stream is greater than the purchase price. For example, if the film is purchased for $2 million (and has this as its basis), but has an estimated income stream of $4 million, $3 million of which is earned during the first year, the result would be as follows. The partners would be allowed to take 75 percent of their $2 million basis as depreciation in the first year under the income forecast method (or a $1,500,000 deduction). However, the film would be also generating $3 million of income which the partners would have to recognize. Thus, the net tax effect would be positive taxable income to the partners of $1,500,000. Where the purchase price of the film and its estimated income stream are exactly equal, the depreciation deduction and the amount of income from the film should exactly offset each other.

[7] In most cases, all, or a substantial part of the $200,000 income from the film would have been used to reduce the amount of the nonrecourse note. Thus, the amount which the partners' would have to take into income would generally be less than $800,000. Economically, however, the deferral on the $800,000 of accelerated deductions would end at this point, because the combination of the amount which the partners would be required to take into income, plus their real economic loss on the $200,000 of equity investment, would total $800,000.

same as the cumulative deductions which they had taken over the ten year period. Since the major portion of these accelerated deductions would have occurred in the early years, the value of the deferral on these amounts would be substanital. (For example, a $640,000 loss was generated in the first year).

Assuming that the taxpayer was in the 70-percent bracket, a $640,000 would save him $448,000 in taxes. At a 7-percent rate of interest, compounded annually for 9 years, the value of the deferral on the first year's loss alone is about $375,000.

The total income from a film might be less then the purchase price paid by the investor. This can occur for one of several reasons. Estimating the probable income stream from a motion picture is difficult. Generally films are purchased before they are distributed to the public. There are ways of estimating the income stream, even at this point (for example, by examining the results of private screenings, the distribution contracts, and the promotional efforts of the distributor), but there is also a highly subjective element involved, and it is possible to make good faith mistakes in valuation which can be substantial.[8]

But there is also an abuse potential here, which may sometimes be exploited. It is true that the limited partners have an arms-length interest in seeing to it that their down payment is not excessive in view of the actual value of the film, but they have little to lose, however, in paying an inflated sales price which is represented only by a nonrecourse note. Although it is also true that an inflated sales price will reduce the partner's ultimate profits, should the film prove to be successful, many of the investors in this type of limited partnership may be far more concerned with immediate tax benefits than with the speculative possibility of profits which may or may not materialize in the future.

From the standpoint of the seller, it can afford to be generous in terms of the size of the note it is willing to take. If the film is successful, the note will be paid and the seller's profits will be relatively large; if the film is failure, the seller still has the cash down payment in the bank, plus whatever amounts on the note have been paid off.

Thus, both parties to the transaction may have little incentive to place a low value on the film at the time it is sold to the limited partnership, to the extent that the purchase price is represented by the nonrecourse note. On the other hand, as indicated above, the tax advantages which can result from a high overvaluation of the film can be substantial.

Questions Under Present Law

As explained above, the film purchase transactions works as a shelter only where the purchase price of the film (including nonrecourse indebtedness) exceeds its economic value.

There is a substantial question under present law whether taxpayers in a film-purchase shelter are legally entitled to claim depreciation which is based on nonrecourse indebtedness where the "purchase price" of the film is in excess of the income pre cost on the film.

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[8] Another factor which may help to explain a disparity between the purchase price paid for a film, and a lower "income forecast" is that taxpayers are not required to include projected income from television rights as part of the income forecast, if the film is American made, and no television contract has been entered into. Rev. Proc. 71–29, 1971–2 C.B. 568. But, in many cases, the potential revenues from television rights are taken into account in determining the purchase price of the film.

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While the authorities in this area have not been uniform, there are several cases which have disallowed the depreciation deduction based on nonrecourse liability where there was no substantial prospect that this liability would be discharged. In *Leonard Marcus*, 30 T.C.M. 1263 (1971), the court held that where the taxpayer purchased two bowling alleys for a 5 percent down payment, with a 20-year nonrecourse note for the balance, the taxpayer could depreciate only the basis represented by his down payment, and that the note could be taken into account for purposes of increasing the taxpayer's basis only to the extent that payments were actually made. The court held that the liability represented by the note was too "contingent" to be included in basis until payments were made.[9]

In *Marvin M. May*, 31 T.C.M. 279 (1972), the Tax Court held that a transaction in which the taxpayer purchased 13 television episodes for $35,000, and obligated himself to pay an additional $330,000 on a nonrecourse basis was a sham, because this amount was far in excess of the fair market value of the films and there was no realistic prospect (or intention) that the debt would ever be paid. Therefore the Court disallowed the depreciation deduction claimed with respect to the film. The facts of *May* were rather extreme, however, because the taxpayer apparently made no effort to ascertain the value of the films before his "purchase," and there were a number of other factors suggesting that the transaction was not *bona fides*. See also, Rev. Rul. 69–77, 1969–1 C.B. 59.[10]

It would seem that some of these same principles could often be applied in the case of a film purchase shelter, where the purchase price of the film consists largely of nonrecourse indebtedness and substantially exceeds the film's income forecast. However, to date at least, the uncertainties of present law have not deterred the use of this type of shelter, perhaps because each court case turns on its own facts, the results of litigation in this area have not been uniform, and taxpayers and their counsel who take an interest in tax shelters tend to be optimistic.

THE PRODUCTION COMPANY TRANSACTION

Description of the shelter

In this type of arrangement, the limited partnership enters into an agreement with a distributor to produce a motion picture. Generally the distributor's requirements in connection with the film are spelled out in some detail, and the distributor will generally retain some rights of quality control including, for example, the right to request added scenes and retakes. The limited partners typically have no knowledge of the motion picture business and the production services are managed by the general partner or an individual producer who is (directly or indirectly) pre-selected by the distributor. (In some cases, the partnership subcontracts the actual production work to a production company owned by an independent producer.)

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[9] In *Marcus*, the 20-year term of the note was substantially in excess of the useful life of the bowling alleys.

[10] As indicated above, under the partnership provisions, the partner may add to his basis in the partnership his share of the nonrecourse liabilities. However, section 752(c) provides that "a liability to which property is subject" shall be considered as a liability of the owner of the property "to the extent of the fair market value of such property . . ." Since the "fair market value" of a movie film can hardly be in excess of its projected lifetime earnings, this suggests that a partner's basis cannot include his share of nonrecourse indebtedness to the extent that this indebtedness (plus the partners' down payment) exceeds the income forecast for the film.

The financing for the production costs of the film comes from capital contributions by the limited partners and a substantial nonrecourse loan, which may be made by a bank, but is guaranteed by the distributor. It is common for partnerships of this type to be leveraged in a ratio of 3 or 4 to 1, and higher ratios of leverage are not unheard of.

The limited partnership does not have any ownership interest in the film. The total fee which the partnership receives generally equals the cost of making the film plus a potential profit. Frequently, there is a guaranteed or "fixed fee" which equals the bank loan and must be paid over to the bank as soon as the partnership receives it. There is also a contingent portion of the fee which is based on a percentage of the income from the film. Often there is a ceiling on this contingent fee (in other words, a maximum fee which will not be exceeded even if the film is very successful). Sometimes the total fee is payable over a period of 6 to 7 years after which the investors' rights terminate.

The partnership elects the cash method of accounting, and deducts the production costs of the film as they are paid. Naturally no income is generated during the production period because the film has not been completed.

When the film is distributed, the partners are required to recognize their respective shares of the partnership income, including the income which is used to discharge the nonrecourse loan. However, there has been a period of deferral which varies from deal to deal, depending on the fee schedule provided under the agreement with the distributor and, to some extent, on the success of the film.[11] It is common for the payments under the contracts to be spread over a period of about 6 or 7 years, with the larger payments coming at the end, to maximize the tax benefits of deferral for the limited partners.

Since the partnership will have deducted its expenses in the first year (instead of capitalizing them), it will have no basis in the fee payments when they are received, and the entire amount will be taxable income which will be passed through to the partners. (If the partnership has already begun producing another picture, the deductions from the new picture may shelter all or part of the income from the first picture.)[12] Eventually, all of the deductions claimed by a partner in excess of his actual investment will have to be included in his income, but the benefit of deferring his tax liability for a lengthy period of time can be considerable.

The "service company" formate thus differs from the "negative pick-up" transaction because the investors do not own the completed picture. The distributor or the independent producer owns the picture and claims depreciation and the investment credit.[13]

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[11] The possibility that the limited partners will realize an economic profit on their investment may depend to a great extent in the success of the film. However, the success or failure of the film does not determine the success of the shelter to nearly the same extent as in the film purchase shelter type deal. This is precisely because the length of the period of deferral for the production company partners depends on the fee payment schedule, which can be controlled under the contract. Generally part of the fee payments are contingent on profits, but are not to exceed a stated amount for a given year, regardless of film's profitability. (As discussed above, in the film purchase deal, if the film is successful, there should be no shelter effect from the transaction because income should equal or exceed the accelerated deductions.)

[12] Some recent syndicates have combined investments in completed pictures with production of new pictures. In this way, excess depreciation from the completed picture can effectively shelter income received under the production contract.

[13] Another variation of this shelter (although not as widespread) is the film distributor partnership. In this shelter, the partnership also does not own an interest in the film. The partnership obligates itself to distribute the film and writes-off the costs of distribution. Deferral occurs because the partnership's income from its distribution services is not realized until later years.

Example.—In 1975 an independent producer, P, owns a screen play which he wants to develop into a film. P interests D, a major studio-distributor, in guaranteeing part of the financing of the project in return for exclusive distribution rights to the film. The budget for the picture is $2 million. P obtains the services of a promoter who solicits investors for a limited partnership (in which the general partner is a corporation formed by the promoter). Ten individuals, each in the 60 percent tax bracket, agree as limited partners to contribute a total of $500,000 to the capital of the partnership. The partnership then obtains a nonrecourse loan for the balance of the budget cost (secured by the partnership's right to payment and by a guarantee from D). The project is thus financed as follows:

Investors' equity (25 percent)	$500, 000
Bank loan (75 percent)	1, 500, 000
Total cost	2, 000, 000

The limited partnership contracts to make the picture from the screen play and to deliver the negative to P. Simultaneously, P contracts with D to deliver the completed film to D. The partnership agrees to deliver the completed film to D on or before January 1, 1976, and the partnership will receive $3 million in installments as follows:

A fixed amount of $1,500,000, payable without regard to box office receipts, as follows: $1,200,000 on January 1, 1977, and $300,000 on January 1, 1978;

30 percent of $2,750,000 of D's grosses after D first grosses $2,500,000 from the film;

25 percent of the next $2,700,000 of D's grosses.

The fixed fee is earmarked to be paid over to the bank when it is received by the partnership. (The partnership is entitled to interest on the fixed fee at the same rate it must pay on the bank loan.) The partnership's right to payments terminate in all events after seven years. Net profits (after payment to the service company) are divided equally between P and D.

The partnership elects to use the cash method of accounting and hires the necessary personnel. The picture is made within its budget, all of which is expended during 1975. On January 1, 1976, the completed film is delivered to the distributor. Assume that the movie is successful and that the investors receive the full profit they expect. The partnership's tax and cash flow results are expected to be as follows (if the production cost deductions are upheld):

	Income	Deductions	(Tax loss)/ income	Tax savings/ (liability) 60 percent bracket	Cash flow: positive (negative)
1975 1976	0	$2, 000, 000	($2, 000, 000)	$1, 200, 000	[1] $700, 000
1977	$1, 200, 000		1, 200, 000	(720, 000)	[2] (720, 000)
1978	600, 000		600, 000	(360, 000)	[3] (60, 000)
1979	525, 000		525, 000	(315, 000)	[4] 210, 000
1980	375, 000		375, 000	(225, 000)	[4] 150, 000
1981	300, 000		300, 000	(180, 000)	[4] 120, 000
Total	3, 000, 000	2, 000, 000	1, 000, 000	(600, 000)	400, 000

[1] Tax saving in 1975 less cash invested ($500,000).
[2] Entire amount of income paid over to bank on loan.
[3] $600,000 income less $300,000 paid to bank and $360,000 in current tax liability.
[4] Income less current tax liability.

If the deductions are upheld, the partnership will have written off all of its production costs (including all the investors' equity) in its first year of operations. The investors will have deducted $4 for each $1 they invested. In the 60 percent tax bracket, this means that each of the ten investors has deferred $120,000 in current taxes on his other income. Having put up $50,000 in cash, each investor has effectively recovered all of his cash investment and also obtained use of an extra $70,000 of tax dollars which he would otherwise have paid to the Treasury.

Present law as it applies to the "production company" shelter

The basic principles of partnership tax law which apply to this shelter were discussed above in connection with the film purchase shelter. These include the use of the partnership form to allow the limited partner to take into income his distributative share of the partnership's income or losses (which are generally determined under the partnership agreement). The amount of loss which the partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership, which includes not only his own contributions to the partnership, but also his share (which is based on his profits interest in the partnership) of any nonrecourse debt which the partnership has incurred. However there are several questions of law which arise only in connection with the "production company" type shelter.

A. *Cash method of accounting.*—Obtaining tax deferral through a production company transaction depends on whether the partnership can properly deduct its costs of producing the film as it pays them. This in turn depends on whether proper tax accounting practices permit the partnership to treat these costs as an item of expense or require the partnership to capitalize these expenditures and amortize them over the life of the asset. (In this case, the asset is the partnership's rights under the contract with the distributor-owner of the film.)

Under present law, a taxpayer is generally permitted to select his own method of accounting (sec. 446(a)) unless the method selected "does not clearly reflect income" (sec. 446(b)). If it does not, the law permits the IRS to compute the taxpayer's income in a way that will clearly reflect his income.

Thus, the question here is whether failure to capitalize the expenses of producing the film (and thus, of the partnership's rights under the contract) results in a material distortion of income. There is a strong argument under present law that a material distortion of income does occur under these circumstances. See *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974), holding that "accepted accounting practice" and "established tax principles" require the capitalization of the cost of acquiring a capital asset, including costs, such as depreciation on equipment, which would generally be deductible if they were not allocable to the construction of the asset. (The production company's contract rights are not a capital asset, but these rights are an asset with a long useful life, so there is a strong argument that the capitalization principle should apply.)

On the other hand, there is one case relied on heavily by the industry which held that a building contractor's income was not distorted where the company constructed apartments and shopping centers under long-term construction contracts and deducted its costs on the

cash method, while receiving payments over a five-year period after each project was completed. *C. A. Hunt Engineering Co.*, 15 T.C.M. 1269 (1956). Production company investors have argued that the same result should be allowed in their situation.[14]

A related question is whether the limited partnership is engaged in selling or delivering a product (the film) and is therefore required to maintain an inventory. If this were the case, the labor costs paid in producing the inventory could not be deducted until the inventory item was sold. The argument against that view is that the partnership does not own the film at any time. Thus, it is argued that the production company is selling services (i.e. production services) rather than a product. The Service has ruled that building contractors (operating under circumstances arguably analogous to movie production companies) are selling "services" rather than "property." (See Rev. Rul. 73–438, 1973–2 C.B. 156.)

B. Other issues.

In some cases, the personnel hired by the partnership to make the film are not in reality the investors' own employees but are supplied by the distributor. This factor, along with others, raises questions under present law whether a particular service company is really engaged in a joint venture with the distributor (in which case it would have to capitalize its production costs). Issues such as these must be resolved on the facts of the particular situation, such as the nature of the investors' rights to compensation, the distributor's day-to-day involvement in production, etc.

IRS RULINGS POSITION

The IRS has issued several relatively recent rulings with respect to the use of limited partnerships and nonrecourse loans. Although these rulings have applicability outside the area of movie shelters, they also impose some limitations, at least in so far as the position of the IRS is concerned, which apply both to the film purchase type transaction, and the production company arrangement.

The Service has been concerned with the bona fides of the financial responsibility assumed and level of participation in the limited partnership operations by the general partner. Thus, in Rev. Proc. 74–17, 1974–1 C.B. 438, the requirement for advance ruling was established that the general partner or partners, during the existence of the partnership, should have at least a one percent interest in each material item of partnership income, gain, loss, deduction, or credit.

With regard to nonrecourse loans, the Service stated that it would not issue an advance ruling granting partnership status to a limited partnership where a creditor had made a nonrecourse loan to the partnership and could acquire at any time, as a result of such loan, a direct or indirect interest, other than as a secured creditor, in any profits, capital or property of the partnership. Also, the Service ruled that for the first two years of operation of a limited partnership, the partners may not claim aggregate deductions which exceed the amount of equity

[14] In 1973, the Internal Revenue Service issued a few private rulings that a movie production partnership may use the cash method of accounting in deducting movie production costs as they are paid. Since 1973, however, the Service has refused to rule favorably in this area and has set up a study group to look further into the merits of the issue.

capital invested in the limited partnership. This requirement has the effect of precluding the use of nonrecourse liability included in the partner's adjusted bases to absorb losses incurred during the first two years of operation.

In addition to these requirements imposed under Rev. Proc. 74–17, in 1972, the Service issued two Revenue Rulings pertaining to certain nonrecourse "loans." While both rulings dealt with and had particular application to limited partnerships engaged in gas and oil exploration, they are susceptible to a broader application.

In Rev. Rul. 72–135, 1972–1 C.B. 200, the Service ruled that an alleged nonrecourse loan from the general partner to a limited partner, or from the general partner to the partnership, would be treated as a contribution to the capital of the partnership by the general partner, and not as a loan, thereby precluding an increase in the bases of the limited partners' partnership interests with respect to any portion of such loans. In Rev. Rul 72–350, 1972–2 C.B. 394, the Service ruled that a nonrecourse loan by a nonpartner to the limited partnership, which was secured by a highly speculative and relatively low value property of the partnership, and which was convertible into an equity interest in the partnership's profits, did not constitute a bona fide loan, but was, in reality, an equity contribution to the partnership.

PROBLEM

Both of the two types of basic formats which are commonly employed in connection with movie films, the film purchase shelter and the production company shelter, have the same basic elements, i.e., the use of deferral and the use of leverage. In the case of the film purchase shelter, the deferral occurs because of the very rapid depreciation which is allowed in connection with movie films, and which is passed through to the limited partners, particularly in cases where the film is not economically successful. In the case of the production company, the mismatching of expenses and income occurs because the partnership deducts the full cost of producing the film before the film is released and because the contract which the limited partnership enters with the "owner" of the film often provides that payments to the production company for its "services" will be spread over a relatively long time period.

Both types of arrangements involve the use of leverage (i.e., nonrecourse loans) which allow the limited partners to receive Federal tax deductions for amounts in excess of their economic investment. This result distorts the economic substance of the transaction by permitting the taxpayer to deduct money which he has neither lost nor placed at risk. In the case of movie shelters, the use of heavy leverage factors of 3 or 4 to 1 is typical.

In some cases, the tax avoidance made possible by the use of this shelter can reach extreme proportions, as is illustrated by the case histories prepared by examining the returns relating to movie shelter investments.[15] Eight of the partnerships examined involved movie films. In total, $1,470,000 was invested in these partnerships, all of which lost

[15] Tax Shelter Investments: Analysis of 37 Individual Income Tax Returns, 24 Partnerships and 3 Small Business Corporation Returns. Prepared for the use of the Ways and Means Committee, September 3, 1975.

substantial amounts of money for the year, and only one of which had any gross income ($16,000).[16] The aggregate net loss of the 8 partnerships was $4,363,000 for an average of almost $3.00 for each $1.00 of actual investment by the partners.

In case number 17, the partnership began operations in October and generated $548,000 of losses on an investment base of $124,000. Two partners with a combined economic income of $311,000 escaped tax completely.

In case number 18, the partnership began operations in July and experienced $1,041,000 of losses on an investment base of $352,000. One partner paid $1,000 of minimum tax on an economic income of $181,000.

In case number 19, the partnership, which commenced operations in December, was leveraged in a ratio of 8 to 1, although losses for the year were only slightly more than double the capital contributions of the partners. In case number 21, the partnership was leveraged in a ratio of 17 to 1.

Altogether, out of 12 partners whose returns were examined in connection with the movie shelter returns, 7 paid no tax whatsoever, one paid $1,000 in tax, and another paid $3,000. The total tax (including minimum tax) paid by all 12 partners was $47,000 on a total economic income of $1,232,000.

As indicated above, there are serious questions as to whether taxpayers are entitled to the deductions they are claiming in connection with movie shelters under present law. Thus, many participants in these shelters may be claiming deductions which will later be disallowed by the IRS.[17]

One effect of this may be that unsophisticated (albeit highly tax motivated) investors may be lured into economically unwise investments because of the hope of tax benefits which may never be realized. Whether or not the tax benefits are realized, where investments are marketed almost exclusively for their tax advantages, rather than on the basis of the underlying soundness of the investment itself, this distorts the workings of the free market and may tempt taxpayers to throw away their money in unwise adventures. This problem is also illustrated by the examination of the tax shelter returns referred to above. In case number 20, for example, a physician with a large family and economic income of $39,000 apparently invested about $12,000 in a movie shelter,[18] and reported a $20,000 tax loss, which saved him approximately $6,000 in tax. In case number 24, an individual with only $10,000 of economic income invested at least $27,500 and reported losses of $44,000, saving himself, at most, only a little more than $1,000 in tax.

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[16] Depreciation expenses were claimed on 6 of the 8 returns. This is puzzling in light of the fact that use of the income forecast method of depreciation requires that there be income from the film before depreciation is allowed. Even where the income forecast method is not used, the film must be placed in service (i.e., shown) before depreciation is allowed. For these reasons, it is not at all clear that all of the claimed deductions would be allowed upon audit.

[17] In the case of the film purchase shelter, the principal issue in potential abuse situations is whether the taxpayers have used an inflated basis for purposes of depreciation. In the case of the production company, the issue is whether it has failed to reflect income properly by not capitalizing the production costs of the film. In both shelters, the use of leverage to increase the partners' bases might be subject to question, at least under certain facts and circumstances.

[18] The shelter passed through $1.75 of losses for each $1.00 of actual investment.

There are those who would argue that the existence of the shelters serves as an incentive to attract investment capital to the industry. There is a real question as to whether a need for capital could justify the mismatching of income and expenditures which can occur in these shelters, or the very high leverage factors which are used. But, in any event, to the extent that capital incentives are needed in this area, it may well be the case that such incentives can be better provided through means of the investment credit for movie films (an issue which is scheduled to be considered by the committee in connection with capital formation).

Moreover, the industry is by no means in difficult straits at the moment. Several recent articles have indicated that the industry has enjoyed a near record year in 1974 and that prospects for the future are, if anything, brighter.[19]

The "service company," format, in particular, has become increasingly popular. A special report on movie tax shelters in *Business Week* magazine entitled "How to Invest in Movies," August 25, 1975, states that over half the films produced in the U.S. today are financed through leveraged service partnerships. Some of the recent films produced in this way are "Funny Lady," "Shampoo," "Day of the Locust," "Bite the Bullet," "The Harrad Experiment," and "The Great Gatsby." The result of deducting the entire cost of the film, usually in one year, and of high leveraging, this article states, "is a 400%-of-investment write-off—a tax shelter than ranks with the best that real estate, oil, or cattle ever offered."

Doubtless some successful, and perhaps significant films, have been financed through shelters. But not every film which is shelter-backed necessarily falls in this category. The staff understands that a large number of shelter-backed films include horror and pornographic films.

ALTERNATIVE APPROACHES

There are a number of alternative approaches that the committee could consider to deal directly or indirectly with tax shelter investments in movie films. If the committee believes that certain incentives are no longer desirable or that the tax benefits from the preferences are greater than they need be, the committee could revise the provisions directly; that is, the particular provisions could be eliminated or the preference cut back to some extent. For example, the committee could consider certain changes with respect to general partnership tax treatment (such as, not allowing deductions in excess of a partner's equity in the partnership or not allowing nonrecourse loans to increase a partner's basis).

On the other hand, if the committee believes that certain incentives should be continued for movie films but that the tax benefit involved should not be available to offset income unrelated to that particular activity, then the committee could consider limiting the tax write-offs to income from that particular activity. This would prevent the use of excess deductions to shelter other income.

This is the general approach that the Administration adopted in

[19] See "Outlook Bright for Movie Industry," Leisure-Time, May 8, 1975, p. L–2; "Movie Stocks Gain in Appeal as the Industry's Improving Strength Points to Good Earnings," The Wall Street Journal, August 26, 1975.

its limitation on artificial loss (LAL) proposal made in the tax reform presentation to the committee on April 30, 1973 (although LAL did not apply to movie films under that proposal).

A third approach to deal with movie shelter investments could be considered if the committee decides against either of the first two approaches. If the committee believes that there is a desired objective for continuing the tax incentives and that revising the provision directly or applying a LAL approach would unduly restrict their purpose, then the committee could consider dealing indirectly with the preferences, such as by broadening the application of the minimum tax.

The following is a summary of the committee's decisions with respect to movie films in its 1974 tax reform bill, Mr. Ullman's proposals, and alternative proposals by other committee members.

Limitation on artificial losses

A. The 1974 Committee bill.

Last year the committee decided to apply LAL to motion picture films and similar property. Under this provision, the tax deduction for depreciation for motion pictures and similar productions could not be taken currently to the extent it exceeds a taxpayer's income from investments in motion pictures and similar productions. (The provision did not apply to other kinds of accelerated deductions, such as production costs which are deducted in the production company shelter.) Deductions which cannot be taken currently would be set aside in a deferred deductions account and be deductible in later years when the taxpayer receives income from these investments. In the case of a movie film, the LAL account terminates at the close of the 5th taxable year following the year in which the film is placed in service, and the taxpayer may take his deferred deductions for the film at that point (because most of the income from the film will have been realized by then).[19] This provision was to apply to films where the principal production commences after June 30, 1975.

To deal with the problem of accelerated deductions in the case of the production company type shelter, the committee directed the staff to include a statement in the committee report clarifying the committee's understanding that, under present law, the only method of accounting which clearly reflects income in the case of a production company is one under which the expenses of producing the film would have to be capitalized. The Committee could include such a provision in the bill, rather than just in the committee report. (Another approach would be to include production costs as an accelerated deduction which is subject to LAL. Thus, taxpayers could not deduct these costs, which are closely analogous to preproduction period costs which are subject to LAL in connection with certain other shelters, such as real estate and farms, until the partnership received income from the film. Consistent with last year's approach, the committee report could make clear that the LAL approach with respect to production costs of movie films is substantially a codification of present law.)

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[19] If the film is disposed of before the end of the 5th year, the taxpayer could deduct his deferred deductions to the extent of net related income from the film, and any excess deductions which could not be used up in this manner are to be added to basis.

B. Mr. Ullman.

His proposal is the same as that in the 1974 committee bill, except that he would apply LAL on a property-by-property basis.

Limitation of loss with respect to motion picture films to amount "at risk"

A. 1974 committee bill.

In the case of investments in motion pictures and similar productions, the committee last year decided to limit the deduction of losses to the investments "at risk," excluding all nonrecourse loans. This proposal would affect the leverage factor which is present both in the film purchase shelter and the production company shelter. The "at risk" provision was to apply to films where the principal production commences after June 30, 1975.

B. Mr. Ullman.

His proposal is the same as that in the 1974 committee bill.

In addition, the committee might wish to make clear in its report that the effective date with respect to such provisions is not intended to imply that taxpayers are necessarily entitled to the accelerated deductions or use of leverage in this area under present law, but that those issues are being left for the courts to the extent that questions may be raised by the IRS upon audit.