TROUBLE IN TRANSAMERICA: DEFERRED COMPENSATION, CONTINGENT DEBT, AND OVERSTATED BASIS

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For many years, owners of motion pictures and television films have optimized the tax benefits of depreciation\(^1\) deductions by employing a broad concept of basis. In addition to their cash investment, these taxpayers have increased their basis to reflect both fixed and contingent liabilities incurred in creating or acquiring these assets. Some of these liabilities represent royalties for the use of intellectual property such as music and literary works incorporated in the film. Others constitute deferred compensation for the services performed by producers, directors, actors, musicians, and others during the production process. The fixed liabilities do not depend on the financial success of the production, but the contingent liabilities, including payments commonly known as “participations” and “residuals,” are dependent on, and often measured by, the revenues that the film generates.

This article examines the propriety of including these types of fixed and contingent liabilities in the depreciable basis of motion pictures and television films. Although the federal government has challenged the entertainment industry’s practice of including participations and residuals in basis,\(^2\) this effort was thwarted by the Ninth Circuit’s 1993 decision in Transamerica Corp. v. United States.\(^3\) The following discussion, however, contends that most of this contingent debt, as well as any fixed debt that represents compensation for personal services, should be excluded entirely from the depreciable basis of these and similar entertainment products. By including these

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\(^1\) The term “depreciation” is used throughout this article to refer to various methods of accounting for the exhaustion of interests in filmed entertainment and similar assets. Although the term “amortization” is often used in this context because while many of these interests consist largely or entirely of intangible property (see I.R.C. § 197, discussed infra note 4) interests in films, sound recordings, and similar property are not always treated as intangibles for tax purposes. See Mary LaFrance, Days of Our Lives: The Impact of Section 197 on the Depreciation of Copyrights, Patents, and Related Property, 24 Hofstra L. Rev. 317 (1995). In fact, many of the assets discussed in this article consist of both tangible property (e.g., a film negative or print, a phonorecord embodying a master sound recording, a computer disk, a CD-ROM, or a videocassette) and intangible property (e.g., copyright, contract, or trademark rights). For these reasons and for simplicity, only the term “depreciation” will be used here.

\(^2\) The government has not yet litigated the issue of whether fixed liabilities for deferred compensation can be included in basis, although the issue will probably be addressed, at least indirectly, in future litigation. As a practical matter, most deferred compensation paid to key participants in motion picture and television production is contingent rather than fixed.

\(^3\) Transamerica Corp. v. United States, 999 F.2d 1362 (9th Cir. 1993).
amounts in basis, entertainment industry taxpayers have consistently overstated the basis of their motion pictures, television films, and videocassette releases, thus generating inflated depreciation deductions.

Part I of the article outlines the Transamerica decision, in which the Ninth Circuit allowed a taxpayer to include unaccrued and unpaid participations and residuals in the basis of its motion pictures for purposes of calculating depreciation deductions under the income forecast method. Part II discusses the deferred compensation rules introduced by the 1986 amendments to section 404 of the Internal Revenue Code ("the Code") and suggests that, in light of these statutory provisions, the Transamerica decision has been legislatively overruled in part and should have, at most, only limited prospective application. Because Transamerica has only been partially superseded by these provisions, Part III undertakes a critique of the Ninth Circuit's decision under principles of tax law independent of section 404 of the Code. The article concludes that the practice approved in Transamerica allows taxpayers to overstate basis and thereby front-load depreciation deductions, which not only conflicts with the language and purpose of section 404 of the Code but also violates two long-standing principles of federal income taxation: (1) contingent liabilities should be excluded from depreciable basis, and (2) income and expense must be matched in a way that produces a clear reflection of income.

I. TRANSAMERICA CORP. V. UNITED STATES

In Transamerica, the Ninth Circuit addressed for the first time the propriety of allowing the owner of a film to include in depreciable basis various forms of contingent compensation that had not yet accrued or been paid and the amount of which was uncertain at the time the depreciation deductions were taken. In a remarkable decision, a divided panel of the Ninth Circuit ruled that, even though such debt would have been excluded from basis if the taxpayer had employed the straight-line method of depreciation, in this case the taxpayer could include these amounts in basis because the taxpayer was
employing an alternative depreciation method known as the income forecast method.

A. The Income Forecast Method

To understand the reasoning of the Transamerica decision, it is important to understand the depreciation method employed by the taxpayer in that case. That method, generally known as the income forecast method, is widely used by the owners of copyright-based assets such as motion pictures, television films, and master sound recordings. This method frequently allows

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4 When the Internal Revenue Service ("the Service") originally authorized the use of the income forecast method for "television films, taped shows for reproduction and other property of a similar character" in Rev. Rul. 60-358, 1960-2 C.B. 68, the government reasoned that time-based depreciation methods, such as the straight-line method, would not clearly reflect the income associated with such assets. A successful film, for example, might continue to produce substantial income over a number of years, while an unsuccessful one might produce little or no income after its initial year of service.

In later rulings, the government approved the income forecast method for theatrical motion pictures, Rev. Rul. 64-273, 1964-2 C.B. 62, accord H.R. Rep. No. 426, 99th Cong., 2d Sess. 914 (1985), reprinted in 1986-3 C.B. (vol. 2) 914; for books, patents, and master sound recordings, Rev. Rul. 79-285, 1979-2 C.B. 91; for rental videocassettes, Rev. Rul. 89-62, 1989-1 C.B. 78; for videogames, P.L.R. 93-23-007 (Mar. 8, 1993); and for musical compositions, P.L.R. 85-01-006 (Sept. 24, 1985) (noting, however, that the ruling is limited to copyrighted musical compositions, the income from which "is generated in a manner similar to that described in Rev. Rul. 60-358").

In P.L.R. 93-23-007 (Mar. 8, 1993), the Service observed that the assets for which use of the income forecast method has been approved, have the following attributes in common: (1) the physical life of the asset is largely irrelevant to its income-producing ability; (2) each asset has unique income-producing ability; and (3) the useful life of the asset is measured in terms of its income-producing ability.


The availability of the income forecast method for certain acquired assets has recently been subjected to new limitations under I.R.C. § 197 of the Internal Revenue Code of 1966, as amended to date ("the Code"), which mandates 15-year straight-line depreciation for certain acquired intangibles that previously could have been depreciated under the income forecast method. I.R.C. § 197. The impact of I.R.C. § 197 is difficult to predict, however, because of numerous ambiguities in the statute. It does not appear that Congress intended to curtail the use of the income forecast method for most motion pictures (or similar assets) that are individually acquired by taxpayers, but the new rules apply whenever such assets are acquired as part of a going concern, and they may apply to certain acquisitions involving a film library or similar grouping of assets. See generally LaFrance, supra note 1 (discussing the impact of I.R.C. § 197 on the availability of income forecast depreciation). Although the question of I.R.C. § 197's scope awaits clarification by Congress or the Treasury, this article assumes that any such clarification will carry out Congress' apparent intent to retain the income forecast method for most entertainment products that are separately acquired by the taxpayer seeking to depreciate them. In addition, it does not appear that I.R.C. § 197 will apply at all to entertainment products that are produced rather than acquired by the taxpayer.
more rapid depreciation of entertainment products than the straight-line method\(^6\) and, in the government’s view, more accurately matches income and expense.\(^6\)

Under the income forecast method, the taxpayer must estimate in advance the income that an asset will generate during its useful life.\(^7\) Then, for each taxable year, the taxpayer deducts a percentage of the asset’s basis (net of its estimated salvage value),\(^8\) which corresponds to the percentage of the asset’s estimated lifetime income generated during that year. Thus, for a given taxable year, the numerator of the “income forecast fraction” is the income derived from the asset during that year,\(^9\) and the denominator is the estimated total income\(^10\).


\(^6\) Unless a film produces little or no revenue in its early years, the income forecast method will provide faster basis recovery than the straight-line method. See infra note 12. The depreciation methods commonly described as “accelerated depreciation” do not apply to interests in motion pictures, television films, videotapes, sound recordings, and other assets which derive their value largely from copyrights. I.R.C. § 168(f)(3)-(4); I.R.C. § 167(a); Reg. § 1.167(b)-1(a) (1960); Rev. Rul. 89-62, 1989-1 C.B. 78. Current rules require such assets to be depreciated under the straight-line method unless the taxpayer can establish the reasonableness of another method. Reg. § 1.167(b)-1(a) (1960).

\(^7\) In the case of motion pictures and television films, the Service has ruled that certain sources of income that are deemed too “speculative” should be excluded from the income forecast fraction. See Rev. Proc. 71-29, 1971-2 C.B. 568, 569 (excluding certain television revenues as too speculative unless taxpayer arranges television exhibition before film has been depreciated to salvage value); Durkin v. Commissioner, 87 T.C. 1329, 1375 (1986), aff’d, 872 F.2d 1271 (7th Cir. 1989) (holding that anticipated income from network television exhibition of a theatrical film must be included in the income forecast calculation as soon as there is an “agreement in principle”). Compare Harrington v. Commissioner, 48 T.C.M. (CCH) 837 (1984) (stating that television revenues are too speculative) with Sheid v. Commissioner, 50 T.C.M. (CCH) 663 (1985) (noting that $10,000 of television revenues must be included in denominator because distributor was willing to advance that much to taxpayer). In a 1979 ruling, the Service ruled that merchandising income (as distinguished from exhibition income) should be excluded from the income forecast calculation. P.L.R. 79-18-012 (Jan. 24, 1979).

\(^8\) The salvage value depends on whether the taxpayer normally disposes of a film while it still has substantial value or exploits each film until its commercial potential is exhausted. Rev. Rul. 60-358,1960-2 C.B. at 69-70.

\(^9\) In the case of a motion picture, courts have held that “income” refers to the proceeds that the taxpayer receives (or is entitled to receive, in the case of an accrual method taxpayer) from the film net of its distribution costs. See Gordon v. Commissioner, 766 F.2d 293 (7th Cir. 1985) (affirming Tax Court memorandum opinion); Garner v. Commissioner, 54 T.C.M. (CCH) 824 (1987); Abramson v. Commissioner, 86 T.C. 360, 377 (1986); Fox Park Corp. v. Commissioner, 50 T.C.M. (CCH) 917 (1985); Fife v. Commissioner, 82 T.C. 1, 8-9 (1984); Greene v. Commissioner, 81 T.C. 132, 136-39 (1983); Wildman v. Commissioner, 78 T.C. 943, 951 (1982); Siegel v. Commissioner, 78 T.C. 659, 691-94 (1982). Revenue Ruling 60-358 appears to agree, but in G.C.M. 37,800 (Dec. 27,
to be derived from the asset during its entire useful life.\textsuperscript{11}

The income forecast method allows more rapid depreciation than the straight-line method when, as is typical of many entertainment products, the depreciable asset produces higher income in its early years of exploitation than it produces in later years.\textsuperscript{12} Under the income forecast method, each year’s depreciation deduction is determined solely by comparing the actual income generated by the asset during that year with the total income stream that the asset is expected to generate

1978), the IRS General Counsel argued for limiting this characterization to situations in which the taxpayer uses an outside distributor rather than self-distributes.

\textsuperscript{10} Rev. Rul. 60-358 defines the “income” to be included in the denominator as “the forecasted or estimated total income to be derived from the films during their useful life, including estimated income from foreign exhibition or other exploitation of such films . . . less the expense of distributing the films, not including depreciation.” Rev. Rul. 60-358, 1960-2 C.B. 68.

For each year’s calculation, the estimated total income must be based on the conditions existing at the end of that year. If these conditions change so that the original expectations prove inaccurate, any over- or under-estimates of the asset’s total income stream are corrected by changing the denominator of the fraction in the year that an error becomes apparent and multiplying the revised fraction by the unrecovered basis. Id. at 69. Estimated salvage value can also be altered as conditions change. Id. at 70.

For tax purposes, this projected income figure is not discounted to present value. However, at least one commentator suggests that a strong argument can be made that it should be. See Schuyler M. Moore, Taxation of the Entertainment Industry, ¶ 5.03[3][a] and n.73 (Warren, Gorham & Lamont). Generally accepted accounting principles require discounting to present value only when there is a “sale of long-term, non-interest-bearing television exhibition rights.” In such cases, television revenues must be included in the numerator at the same present value in the year in which they are received (or when receivable under the accrual method). See Financial Accounting Standards Board, Financial Reporting by Producers and Distributors of Motion Picture Films, Statement of Financial Accounting Standard No. 53, ¶ 11, at 534 (Fin. Accounting Standards Bd. 1993) [hereinafter SFAS 53].

\textsuperscript{11} Algebraically, the formula can be expressed as follows:

\[ D = (C-S) \times \frac{Y}{T}, \]

where:

\[ D = \text{depreciation allowable for Year X} \]
\[ C = \text{asset’s cost} \]
\[ S = \text{asset’s salvage value} \]
\[ Y = \text{income from the asset during Year X} \]
\[ T = \text{total anticipated income from the asset} \]

\textsuperscript{12} Rev. Rul. 79-285, 1979-2 C.B. 91. In general, the income forecast method is beneficial to taxpayers seeking rapid recovery of their film production or acquisition costs because the largest part of a film’s income stream typically occurs in the early years of its release. See Harold L. Vogel, Entertainment Industry Economics 73 (1990); see also Durkin v. Commissioner, 872 F.2d 1271, 1277-78 (7th Cir. 1989) (discussing typical time frames for theatrical, videocassette, and television release); Paul A. Baumgarten et al., Producing, Financing and Distributing Film, 152-53, (2d ed. 1992) (similar); L.M. Farrell, Financial Guidelines for Investing in Motion Picture Limited Partnerships, 12 Loy. Ent. L.J. 127, 132 n.25 (1992) (indicating percentage of gross receipts derived from various modes of exploitation).
during its useful life.\textsuperscript{13} In contrast, depreciation deductions under the straight-line method are spread evenly over a fixed number of years representing the useful life of the property.\textsuperscript{14} In principle, the income forecast method offers a reasonable means of determining the rate at which a taxpayer’s investment in a motion picture or similar asset is exhausted because it bases annual depreciation on the productivity of an asset during the year in question. This method, therefore, matches income and expense in a way that produces a “clear reflection of income” as required by the Code.\textsuperscript{15}

This article focuses on the problem of how to calculate the amount to be used as the depreciable basis of a film. Generally speaking, the basis of a motion picture or similar entertainment vehicle should be its production or acquisition cost. That amount represents the owner’s long-term investment in the asset, in contrast to the recurring annual costs incurred by the owner in the course of exploiting the asset (for example, distribution expenses and fees), which produce business expense deductions for the year in which they are incurred or paid. The producer or acquirer of a film or similar asset, however, may incur obligations to make deferred payments to some of the persons who contributed property or services to the production process. In some cases, the amount of this debt is determinable at the time of the film’s release. In other cases, the extent of the liability does not become apparent until later years because many of the persons who provide services or property are contractually entitled to receive deferred compensation that is contingent on the gross or net revenues generated by the finished product. The \textit{Transamerica} opinions, outlined below, address only these contingent liabilities. As discussed in Part II of this Article, however, fixed liabilities present a problem that, though analytically distinct, is equally significant.


\textsuperscript{14} Under the straight-line method, a film’s costs are deducted over its useful life, defined as the period during which the asset may reasonably be expected to be useful in the taxpayer’s income-producing activity. Reg. § 1.167(a)-1(b) (as amended 1972). Few films are depreciated under this method. See Moore, supra note 10, ¶ 5.03[2][a].

\textsuperscript{15} I.R.C. § 446(b).
B. Background of Transamerica

At issue in Transamerica were depreciation deductions taken by United Artists ("UA") with respect to motion pictures that it exploited during the taxable years 1971-74. UA had commissioned and financed the production of these films and had distributed them upon completion. In many of its contracts with producers, writers, actors, directors, and others, UA agreed to pay over a percentage of the film's "gross receipts" or "net profits." In addition, UA was required by its collective bargaining agreements to make deferred payments, known as "residuals," to the guilds representing the writers, actors, and directors who performed services in connection with the film. These residuals represented a percentage of the revenues UA received from exhibiting the films on television.

For both tax and general accounting purposes, UA included an estimate of these deferred expenses in calculating its depreciable basis for each film using the income forecast method. The estimated deferrals were derived from the film's projected income stream (gross receipts minus distribution fees and expenses). For example, if a film was expected to generate $100 million of gross receipts and $10 million of "net profits" (as contractually defined), and UA was obligated to pay out 2% of

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8 In each case, UA either provided funds directly to the producing entity or caused a third party to provide the funds. Transamerica Corp. v. United States, 670 F. Supp. 1454, 1458 (N.D. Cal. 1986).

17 Id. at 1466. Although the precise definitions of these terms depend on the individual contracts, in general "gross receipts" refers to the total revenue received by a film's distributor as a result of the film's exploitation (with few offsets), and "net profits" refers to gross receipts reduced by distribution fees and expenses and the direct and indirect production costs. These offsets are substantial; thus, the "net profits" figure is usually far smaller than the gross receipts figure. See id. at 1458; see infra notes 112, 115 & 123 (discussing net profits).

19 Transamerica, 670 F. Supp. at 1456. In some cases, residuals are based on revenues other than, or in addition to, television license fees (e.g., revenues from videocassette sales). See infra note 112.

20 Although the District Court's description of the income forecast formula differs somewhat from that of Rev. Rul. 60-358, the substance is the same. Compare Transamerica, 670 F. Supp. at 1457 n.2 (using current plus future earnings as denominator, and multiplying by only unrecovered basis) with Rev. Rul. 60-358, 1960-2 C.B. 68 (using total lifetime income stream in denominator, and multiplying by total basis unreduced by prior years' depreciation).

21 Typically, the expenses subtracted from gross receipts in calculating net profits available to participants include the amounts of any gross receipts participations. See
gross receipts and 10% of net profits, the basis figure would typically reflect $3 million in participations ($2 million in gross participations, plus $1 million in net participations). If, for income forecast purposes, a film’s lifetime income stream proved to be twice the original projection, then the denominator of the income forecast fraction would double. The participations would also increase, however, to reflect the contractually-promised percentages of gross receipts and net profits. Although UA’s forecasts were sometimes inaccurate for individual films, in the aggregate its projections resulted in annual depreciation deductions that were reasonably close to the deductions to which UA would have been entitled had it forecast the lifetime revenues of its films with 100% accuracy.21

The Internal Revenue Service (“the Service”) challenged UA’s basis calculation on the ground that contingent debt was not includible in basis until the contingency was removed.22 For each contingent participation or residual, the Service contended, the contingency was not removed until the obligation to pay the deferred amount had accrued. Because the obligation accrued only as the film generated revenues, the inclusion of the full liability in basis during the first year of depreciation had the effect of overstating basis at the beginning of the film’s useful life, thereby inflating the depreciation deductions during the early years of that useful life.23

C. The District Court Opinion

The district court in Transamerica ruled in favor of the government and held that UA, as an accrual method taxpayer,24

Baumgarten, supra note 12, 63-64. The $10 million figure used here assumes that such gross participations have already been subtracted.
21 Transamerica, 670 F. Supp. at 1458.
22 Id. at 1457, 1459.
23 Transamerica, 999 F.2d at 1369.
24 Transamerica, 670 F.Supp. at 1460. The court implied that the taxpayer’s use of the accrual method of tax accounting was relevant to this ruling: “To the extent a liability is too contingent to be ‘fixed’ in a given year, an accrual basis taxpayer cannot include the liability in basis for the property.” The appellate opinion uses similar language: “For an accrual taxpayer, the amount paid generally includes liabilities that encumber the property when the property is acquired, or that are assumed by the taxpayer in acquiring the property.” Transamerica, 999 F.2d at 1367 (citing Crane v. Commissioner, 331 U.S. 1 (1947); Waddell v. Commissioner, 86 T.C. 848, 898 (1986), aff’d per curiam, 841 F.2d 264
could not include the contingent liabilities in its cost basis until the liabilities had become sufficiently "fixed" to satisfy the "all events" test of section 461 of the Code.\textsuperscript{25} In the court's view, the

(9th Cir. 1988); Denver & Rio Grande Western R.R. v. United States, 505 F.2d 1266 (Ct. Cl. 1974)).

This language does not clearly indicate whether the court would have ruled differently if the defendant were a cash method taxpayer; however, the district court's emphasis on the taxpayer's accounting method is something of a red herring. No authority permits a cash method taxpayer to include unaccrued liabilities in basis. Cash method taxpayers under some circumstances may include accrued liabilities in depreciable basis. See, e.g., Commissioner v. Tufts, 461 U.S. 300, 307 (1983); Crane v. Commissioner, 331 U.S. 1, 11 (1947). As discussed below, however, there are other circumstances in which cash method taxpayers must postpone the addition to basis until the liability is actually paid.

One situation in which cash method taxpayers apparently must measure depreciation deductions differently from accrual method taxpayers is where the deductions represent payments in the nature of an annual royalty (a payment measured by the year's revenues derived from the use of the property for which the royalty is being paid). In that case it appears well settled that no deductions are allowed until the amount is paid; thus, the contingent liability cannot be estimated and included in depreciable basis before the year it is paid. See infra notes 95-106 and accompanying text. Cash method taxpayers also calculate depreciable basis differently from accrual method taxpayers in the case of property produced by the taxpayer. The uniform capitalization rules do not allow the cash method taxpayer to capitalize unpaid expenses. See I.R.C. § 263A(a)(2); S. Rep. No. 313, 99th Cong., 2d Sess. 143, reprinted in 1986-3 C.B. (vol. 3) 1143. However, in the case of acquired non-inventory property, cash method taxpayers are treated the same as accrual method taxpayers with respect to including fixed liabilities in depreciable basis. See, e.g., Gibson Prod. Co. v. United States, 460 F. Supp. 1109, 1116 n.8 (N.D. Tex. 1978), aff'd, 637 F.2d 1041 (5th Cir. 1981); Reinberg v. Commissioner, 90 T.C. 118, 122 (1988) (including debt in cash method taxpayer's depreciable basis in motion picture). See generally Frederick H. Robinson, Nonrecourse Indebtedness, 11 Va. Tax Rev. 1 (1991); Babette B. Barton, Economic Fables/Tax-Related Foibles: On the "Cost" of Promissory Notes, Guarantees, Contingent Liabilities and Nonrecourse Loans, 45 Tax L. Rev. 471 (1990); Daniel Shaviro, Risk and Accrual: The Tax Treatment of Nonrecourse Debt, 44 Tax L. Rev. 401, 439 (1989); Joseph W. Blackburn, Important Common Law Developments for Nonrecourse Notes: Tufting It Out, 18 Ga. L. Rev. 1 (1983); Diane M. Anderson, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum. L. Rev. 1468 (1982) (arguing that nonrecourse debt should be excluded from basis as inherently contingent); George Javaras, Nonrecourse Debt in Real Estate and Other Investments, 55 Taxes 801, 807-11 (1978); Boris Bittker, Tax Shelters, Nonrecourse Debt and the Crane Case, 33 Tax L. Rev. 277, 281-83 (1978); William Landis, Liabilities and Purchase Price, 27 Tax Law. 67, 68 (1974); Fairness and Tax Avoidance in the Taxation of Installment Sales, 100 Harv. L. Rev. 403, 415-16 (1986).

\textsuperscript{25} Under the "all events" test (applicable to accrual method taxpayers), an expense is not deductible until (1) all events have occurred that determine the fact of the liability, and (2) the amount of the liability can be determined with reasonable accuracy. Reg. § 1.461-1(a)(2). When accrual results in the creation of an asset having a useful life extending substantially beyond the end of the taxable year, the deduction must be taken when the depreciation or amortization deduction is permitted. Id.

The "economic performance" rules of I.R.C. § 461(h), which now adds an additional requirement to the "all events" test as applied to deductions, had not yet been added to the Code when the events of Transamerica took place. See infra note 131 (discussing economic performance rules).

Interestingly, the government argued in Transamerica that the "all events" test of I.R.C. § 461 was irrelevant, and that the case could be decided solely by reference to case
fact that the payees had already rendered their services (as actors, writers, producers, directors, or others) did not render the obligation sufficiently “fixed.” This view was based on the fact that the amounts (if any) that UA would have to pay depended on the future proceeds of the film (gross receipts in some cases, net profits in others, and television license fees in the case of residuals).\textsuperscript{26} The amount or existence of such proceeds would depend on many factors, including the tastes of the public, the aggressiveness of UA’s marketing campaign, and UA’s success in negotiating with licensees such as television exhibitors.\textsuperscript{27}

After concluding that the liabilities were too contingent to be included in basis, the district court rejected UA’s argument that the taxpayer’s adoption of the income forecast method, as opposed to the straight-line method, should alter the analysis. UA argued that, because the income forecast method allowed it to estimate the amount of its future income from the film, it should also be allowed to estimate the amount of the contingent obligations accruing as a result of earning that income since both estimates would be equally reliable.\textsuperscript{28} In effect, UA suggested that the income forecast method should override the “all events” test with respect to contingent liabilities. The district court disagreed with UA, finding no reason to suspend the application of the “all events” test.\textsuperscript{29} The court noted that the income forecast method did not require the taxpayer to report income before it accrued; therefore, there was no

\footnotesize{\textsuperscript{26} Transamerica, 670 F. Supp. at 1459 (citing Lemery v. Commissioner, 52 T.C. 367, aff’d, 451 F.2d 173 (9th Cir. 1971); Mayerson v. Commissioner, 47 T.C. 340, 353-55 (1966)). The district court declined this invitation and ruled, in effect, that the “all events” standard was the appropriate measure of whether the liabilities in question were too contingent to be included in basis. Transamerica, 670 F. Supp. at 1465.}

\footnotesize{\textsuperscript{27} Transamerica, 670 F.Supp. at 1461-65.}

\footnotesize{\textsuperscript{28} Gross receipts are difficult to predict when a film is first released because they depend on the film’s success, but net profits are even more unpredictable because they depend on the film’s distribution costs as well as its success. See infra notes 112, 115 & 123. Residuals are also difficult to predict because they depend specifically on the revenues from a particular licensed medium, such as television exhibition in UA’s case (which also depended on UA’s ability to negotiate a satisfactory licensing agreement).}

\footnotesize{\textsuperscript{29} Transamerica, 670 F. Supp. at 1465-66.}

\footnotesize{\textsuperscript{30} Id. at 1466.}
unfairness or distortion of income in applying the "all events" test to the liabilities associated with that income.\footnote{Id. See infra text accompanying note 130.}

\textit{D. The Ninth Circuit Reversal}

On appeal, the Ninth Circuit reversed, holding that it was proper for UA to include the estimated deferred payments in the films' bases. The appellate court reasoned that "the practical effect of including participations and residuals in the cost factor is to permit the depreciation of all costs of production in order to match expenses evenly with income."\footnote{\textit{Transamerica}, 999 F.2d at 1365.} This approach, the court observed, conformed with generally accepted accounting principles applicable to the motion picture industry.\footnote{Id.; see SFAS 53, supra note 10, ¶ 14. Of course, tax accounting rules do not always parallel financial accounting rules, see, e.g., American Automobile Ass'n v. United States, 367 U.S. 687, 692-93 (1961), although industry practice is often treated as relevant in determining the appropriate tax treatment of an item, see, e.g., G.C.M. 37,800 (Dec. 27, 1978).} For the income forecast calculation to operate as designed, the court reasoned, all production costs had to be included in basis from the start and, thus, spread "evenly over the flow of income derived from the film."\footnote{\textit{Transamerica}, 999 F.2d at 1366.} Allowing a deduction only when these contingent costs became due and payable, the court concluded, would improperly back-load the taxpayer's depreciation deductions.\footnote{Id. at 1367.}

The Ninth Circuit distinguished prior cases in which contingent liabilities were not allowed to be included in basis, observing that these cases "all involve[d] situations in which the inclusion of contingent liabilities in the cost basis would permit depreciation deduction[s] on costs that might never be incurred."\footnote{Id. at 1368. For example, in Lemery v. Commissioner, 52 T.C. 367, 378 (1969), aff'd per curiam, 451 F.2d 173 (9th Cir. 1971), a taxpayer who acquired a covenant not to compete could not include in the covenant's basis an amount that was payable to the seller only from the buyer's future profits, if any. In Denver & Rio Grande Western R.R. v. United States, 505 F.2d 1266, 1271 ( Ct. Cl. 1974), a taxpayer was not allowed to include in the basis of a newly-constructed railroad spur line an obligation to pay out a share of the annual revenue earned from the spur line. The \textit{Transamerica} majority characterized both of these cases as situations where a cost was excluded from basis because it might never be incurred. \textit{Transamerica}, 999 F.2d at 1368. The court distinguished several other cases}
reasoned, "the deduction of an expense that may never be incurred cannot occur."  

Dissenting, Judge Hall argued that the majority focused too narrowly on the issue of whether UA’s method would allow it to deduct costs that it might never incur. She noted that the rule excluding contingent liabilities from basis was “equally concerned with the timing of the deduction, i.e., the time value of money.” Absent express statutory authorization, Judge Hall urged, the court should not authorize the deduction of an expense before it was incurred.

* Transamerica, 999 F.2d at 1369-70. This is true only if the taxpayer continues to own the film until all participations and residuals have accrued. If, as often happens, the owner of the film disposes of it before the film has earned 100% of the revenues on which the depreciation deductions are based, then the seller will have deducted expenses that the seller never incurred. See infra note 38.

* Id. Judge Hall also suggested that UA’s method would lead to a “double-deduction problem.” Specifically, if a taxpayer were to depreciate a film under UA’s method and then sell or otherwise transfer the film to a second taxpayer who took over the liability for future participations and residuals, the buyer would be allowed to deduct those same expenses even though the seller might have already deducted them in full through depreciation. (In fact, UA’s assets were sold by its parent company before UA was required to pay its participations and residuals; therefore, UA did deduct expenses that it never incurred.) Two parties could take depreciation deductions for the same expense, although it was only incurred once. According to Judge Hall, even if the buyer took few depreciation deductions (e.g., if the buyer resold, retired or abandoned the film shortly after purchase), capitalizing these contingent debts allows each taxpayer to inflate the film’s basis and thereby understate the gain (or overstate the loss) upon selling or otherwise disposing of the film. Id.

Judge Hall’s “double deduction” analysis, however, ignores the fact that participations and residuals properly included in a film’s depreciable basis must also be included in the amount realized by the seller when the film is sold. Tax law requires the inclusion of debt relief in the amount realized by a seller when a buyer assumes (or, in the case of nonrecourse debt, takes subject to) a debt of the seller. See Commissioner v. Tufts, 461 U.S. 300, 317 (1983); Crane v. Commissioner, 331 U.S. 1, 14 (1947); Reg. § 1.1001-2(a) (1980). The Transamerica opinion does not indicate whether UA in fact included these unaccrued liabilities in its amount realized. Even if it did include them, it would still enjoy a timing advantage, as the taxpayer would be taking depreciation deductions based
II. PARTICIPATIONS AND RESIDUALS AS DEFERRED COMPENSATION UNDER SECTION 404: LIMITING THE PROSPECTIVE APPLICATION OF TRANSAMERICA

As set forth below, the depreciation method approved in Transamerica cannot be reconciled with the current rules in section 404 of the Code that govern the timing of depreciation deductions reflecting capitalized deferred compensation costs. The holding in Transamerica regarding deferred payments for personal services conflicts with the current rules that prohibit taxpayers from deducting non-qualified deferred compensation before it is actually paid. Specifically, under the current version of section 404 of the Code, persons who pay deferred compensation to employees or independent contractors under any arrangement other than a tax-qualified retirement plan may not deduct the compensation until it is includible in the recipient’s gross income.39

As discussed below, although Transamerica arguably can be reconciled with the version of section 404 of the Code that was in effect during the taxable years at issue in that case, it cannot be reconciled with the current version.40 Thus, although neither the Ninth Circuit nor the Service has spoken on the question of prospective application, as a matter of law, the opinion in Transamerica should have only limited application to income on unaccrued contingent debt during the years preceding the disposition and would not realize the offsetting gain until the property was sold. Although a similar timing advantage is available to any taxpayer who takes depreciation deductions, the problem in Transamerica was that UA was able to generate these depreciation deductions out of contingent debt, which is ordinarily excluded from depreciable basis. See supra note 35 and accompanying text.


forecast property placed in service after the effective date of these rules.41

A. Deducting Deferred Compensation Under Section 404

Outside the context of a tax-qualified retirement plan, section 404 of the Code limits the deduction for “compensation . . . accrued on account of any employee under a plan deferring receipt of such compensation”42 by denying the payor any deduction for that amount until “the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan.”43 In contrast, contributions to a qualified plan are deductible when paid into the plan.44 This gives employers an incentive to use qualified plans and to fund them promptly.45 In the case of non-qualified plans, whenever the recipient of deferred compensation46 is a cash method taxpayer (as are most employees and many independent contractors), the effect of the rule is to force the payor onto the cash method with respect to the deferred payment, even if the payor is an accrual method taxpayer for other purposes.47 The “matching” principle inherent in section 404 of the Code eliminates the tax revenue losses that would occur if employers using nonqualified plans could deduct payments years before the recipients included them in gross income, and it protects employees by ensuring that they promptly receive the benefits they are owed.48

41 For the effective date of the pertinent amendments to I.R.C. § 404, see supra notes 39-40.
42 I.R.C. § 404(a).
43 I.R.C. § 404(a)(5).
44 I.R.C. § 404(a)(1)-(3).
46 Compensation is treated as deferred if it is received “more than a brief period after the end of an employer's taxable year in which the services” were performed. Temp. Reg. § 1.404(b)-1T, A-2(a) (as amended 1992). Anything longer than 2 1/2 months is normally considered “more than a brief period.” Id. at A-2(b)(1).
47 G.C.M. 37,546 (May 23, 1978) (noting that Section 404(a) is an exception to accrual method principles, effectively placing taxpayers on cash method for purposes of that section); Reg. § 1.404(a)-1(c) (1966).
48 Albertson's, 42 F.3d at 543; see Don E. Williams v. Commissioner, 429 U.S. 569, 578-79 (1977) (stating that the policy behind section 404(a) is “that an objective outlay-of-assets test would insure the integrity of the employees' plan and insure the full
Some of these same concerns are implicated when a party takes depreciation deductions for unpaid residuals and participations. If the payor can deduct these amounts before they are paid, the payor will enjoy a tax deduction before the payee (who is typically a cash method taxpayer) has anything to include in taxable income. In the case of deferred payments to key participants in motion picture production, however, enforcing the timing rules of section 404 of the Code is unlikely to encourage payors to switch to tax qualified plans. Most of their payees are independent contractors or short-term employees who would not be vested in an individual employer’s plan if it were available.\textsuperscript{49} The fact that Congress extended section 404 of the Code to include independent contractors, however, suggests that the timing considerations that motivated section 404 of the Code were at least as important as the desire to improve employee welfare.\textsuperscript{50} Nothing in the statute or its legislative history indicates congressional intent to exempt the entertainment industry from the strictures of section 404 of the Code.

The current version of section 404 of the Code’s disallowance applies to all methods of deducting compensation, including depreciation.\textsuperscript{51} Under the uniform capitalization rules, deferred

\textsuperscript{49} The short-term nature of most employment in the entertainment industry is driven by the piece-work manner of creation and the uniqueness of many workers’ services. Most entertainment industry workers who find steady employment are covered by multi-employer retirement plans offered through their guilds and craft unions.

\textsuperscript{50} Congress may also have been concerned that payors would try to evade I.R.C. § 404 by recharacterizing their workers as independent contractors.

\textsuperscript{51} Although the statutory language does not address depreciation deductions specifically, it does state that the deferred compensation “shall not be deductible under this chapter.” I.R.C. § 404(a); see also I.R.C. § 404(d) (using similar language for payments to independent contractors). The phrase “under this chapter” was added by § 1851 of the Tax Reform Act of 1986, replacing a more specific reference to “section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).” Tax Reform Act of 1986, Pub. L. No. 99-514, § 1851(b)(2)(C)(i), 100 Stat. 2085, 2863; see also id. § 1851(b)(2)(C)(ii) (striking out phrase “under section 162 or 212” and replacing it with “under this chapter” throughout I.R.C. § 404(d)). The Senate Finance Committee Report that accompanied the 1986 amendments explains the reason for this change:
compensation related to self-constructed real or tangible personal property must be capitalized at the time it would otherwise be deductible.\textsuperscript{55} According to section 404 of the Code, this compensation is deductible when it is actually paid.\textsuperscript{55} Residuals and participations, whether based on net profits or gross receipts or some other defined stream of revenue, frequently represent payment for services and, thus, fall within the domain of section 404 of the Code.\textsuperscript{54} Accordingly, even though such deferred obligations may be accruing ratably as the taxpayer receives the film’s revenues, under section 404 of the Code their accrual date should be irrelevant if the payee uses the cash method.\textsuperscript{55}

The Transamerica opinion, however, authorizes taxpayers to include deferred payments for services in the cost basis of a motion picture prior to the taxable year in which they are paid. This approach allows the taxpayer to deduct the deferred compensation before the compensation is includible in the gross income of the payees (typically, the year in which the amounts

\begin{footnotesize}
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\item The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation. 


\item I.R.C. § 263A(a).

\item Reg. § 1.263A-1T(b)(2)(iii)(P) (1987); Reg. § 1.263A-1(c)(2), (e)(3)(ii)(C)-(D) (as amended 1994); see David R. Webb Co. v. Commissioner, 77 T.C. 1134 (1981), aff’d, 708 F.2d 1254 (7th Cir. 1983) (requiring capitalization rather than deduction of amounts paid to fulfill pension obligations assumed as part of asset acquisition); F&D Rentals, Inc. v. Commissioner, 44 T.C. 335 (1965), aff’d, 365 F.2d 34 (7th Cir. 1966), cert. denied, 385 U.S. 1004 (1967) (noting that to allow basis increase for unpaid pension obligations would allow taxpayer to deduct, through depreciation, amounts which it could not deduct under I.R.C. § 404(a)(1)); P.L.R. 82-47-098 (Aug. 25, 1982) (similar); see also infra note 56.

\item Reg. § 1.404(a)-1(b) (as amended in 1963) (limiting deductions under I.R.C. § 404 to “compensation for personal services actually rendered”).

\item Most individual taxpayers and some corporations, particularly personal service and other small corporations, use the cash method. I.R.C. § 448(b)(2), (3). Many, if not most, persons providing personal services in the entertainment industry are cash method taxpayers.
\end{itemize}
\end{footnotesize}
are paid). This disparity undermines the matching principle inherent in section 404 of the Code. By allowing these costs to be capitalized and deducted through depreciation before they are paid, the Transamerica approach is inconsistent with the uniform capitalization rules as governed by section 404 of the Code.

The reach of section 404 of the Code goes beyond the contingent payments at issue in Transamerica and extends also to guaranteed deferred payments (fixed liabilities) that are now routinely included in the depreciable basis of motion pictures. The timing rules of section 404 of the Code do not distinguish between fixed and contingent payments. For example, if some portion of an actor's, producer's, writer's or director's guaranteed compensation is paid significantly after the close of the taxable year in which a film is placed in service, then section 404 of the Code would require that amount to be excluded from the film's depreciable basis during that first taxable year.

Section 404 of the Code should apply regardless of whether the taxpayer in question is the creator or a subsequent acquirer of the property. If the taxpayer created the film, then section...

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56 See supra note 48 and accompanying text.
57 If the government enforces section 404 of the Code against fixed as well as contingent payments (as it should), it will mark a significant departure from current tax accounting practices in the entertainment industry. On the other hand, if the government or the courts were to decide that I.R.C. § 404 is inapplicable to film depreciation, then guaranteed deferred payments would continue to be includible in depreciable basis under the rules discussed in Part III of this article, even though those same rules dictate that contingent deferred payments should be excluded from basis.
58 When the contingent obligation is assumed by a party that is acquiring an existing asset or group of assets (such as an interest in a completed motion picture or other entertainment product) the contingent obligation could be viewed in either of two ways after its assumption by the buyer: (1) as deferred compensation for personal services, or (2) as part of the purchase price for the acquired assets. Using the first approach, I.R.C. § 404 indicates that the contingent obligation should be deductible when paid. Under the second approach, however, whether the contingent obligation should be deducted or capitalized when paid depends on whether it has accrued at the time of the acquisition.

There are no cases or rulings specifically addressing the application of I.R.C. § 404 to assumed participations and residuals, but several authorities have analyzed the role of I.R.C. § 404 when a party purchasing a going concern assumes the seller's obligation to contribute to a tax-qualified retirement plan on behalf of its employees. The outcome in each of these cases has depended on whether the liability accrued prior to the buyer's assumption. See G.C.M. 39,274 (Aug. 16, 1984) (collecting cases, and noting that accrued liabilities are those that could not be unilaterally extinguished by the purchaser once assumed). If so, then the liability represents a capital expenditure upon payment rather than accrual, according to I.R.C. § 404. Id. See infra note 59 (discussing cases).
404 of the Code should apply because the contingent payments represent compensation for personal services rendered to that taxpayer. In contrast, authorities discussing the assumption of deferred compensation obligations by an acquirer of a going concern suggest that under section 404 those deferred obligations that have already accrued should be capitalized when paid and those that have not yet accrued should be deducted when paid. 59 Although these authorities do not apply specifically to participations and residuals in the entertainment industry, their reasoning should be equally persuasive in that context.

The version of section 404 of the Code that was in effect during the years at issue in Transamerica was somewhat narrower than the current version in two respects. First, the earlier version purported to limit deferred compensation deductions only under sections 162 and 212 of the Code and did not expressly apply to depreciation deductions. 60 Before the

59 Id. Although the case law and rulings discussed in G.C.M. 39,274, supra note 58, predate the 1986 amendment to I.R.C. § 404, see supra note 40, the amendment does not undermine their conclusion: A buyer’s payment of accrued pension liabilities, which were assumed at the time of purchase, may not be currently deducted because payments of such already-accrued liabilities are capital expenditures. See, e.g., David R. Webb Co. v. Commissioner, 77 T.C. 1134, 1137 (1981), aff’d, 708 F.2d 1254 (7th Cir. 1983); M. Buten & Sons, Inc. v. Commissioner, 31 T.C.M. (CCH) 178, 181 (1972). But see F&D Rentals v. Commissioner, 44 T.C. 335, 348-49 (1965), aff’d, 365 F.2d 34 (7th Cir. 1966), cert. denied, 385 U.S. 1004 (1967) (denying a current deduction for acquirer’s assumed but unpaid pension liabilities but implying that, upon payment, the amount would be a current deduction), criticized as dictum in David R. Webb Co., 708 F.2d at 1257-58; and in P.L.R. 82-05-022 (Nov. 3, 1981) (relying on F&D Rentals to conclude that allowing immediate addition to basis of acquired assets for unpaid pension liabilities would “allow the taxpayer corporation to deduct, by way of depreciation deductions, the very amounts which it failed to deduct under the only statutory authority for the deduction of contributions to pension plans, i.e., section 404(a)(1)’’); cf. Reg. § 1.263A-1(c)(2), (e)(ii)(C-D) (as amended 1994) (requiring capitalization of deferred compensation liabilities incurred in producing or acquiring property for resale, but only to extent those liabilities are deductible).

These authorities have not allowed a deferred compensation liability to be added to basis before it is paid, even where it clearly constitutes a capital expenditure (i.e., part of the purchase price of the acquired assets). Thus, although the accrual date (i.e., before or after the acquisition) determines whether the deferred compensation is a current deduction or a capital expenditure, under I.R.C. § 404 the payment date is still the earliest point at which a deferred amount representing a capital expenditure can be added to depreciable basis.

60 See supra note 51. Prior to its amendment in 1978, I.R.C. § 404 also did not apply to workers who were independent contractors rather than employees, see supra note 39; however, many of the persons receiving participations and residuals from UA (such as actors) would probably have been considered employees for tax purposes. See
1986 amendment, the federal government considered applying section 404 of the Code to participations and residuals, but it

Springfield Prod. v. Commissioner, 38 T.C.M. (CCH) 74, 83 (1979) (stating that common law principles apply to determine who is an employee for I.R.C. § 404 purposes).

41 G.C.M. 36,590 (Feb. 12, 1976) 1976 IRS GCM LEXIS 322 (discussing and modifying G.C.M. 33,329 (Sept. 12, 1966)). As early as 1966, the Service's General Counsel opined that I.R.C. § 404(a)(5) applied to an agreement under which a motion picture actor received "the right to participate in the profits of the [taxpayer's] motion picture on a percentage basis after taxpayer recouped its negative cost." Id. at *1. The memorandum concluded that under I.R.C. § 404(a)(5), the contingent payments to the actor were deductible only when paid. Id. at *13.

In the same opinion, however, the General Counsel reached a different conclusion with respect to fixed deferred compensation—i.e., "guaranteed payments to actors of a specified dollar amount (payable in equal annual installments extending beyond the normal life of the motion picture negative)." Id. at *9. The General Counsel determined that the fixed deferred compensation was "includible in the depreciable base and recoverable through depreciation deductions." Id. The 1966 memorandum explained this distinction as follows:

[H]istorically the Service has regarded production costs for motion pictures as a capital expense recoverable under the income forecast method over the useful life of the film. Accordingly, production costs (which would include salaries paid actors) represent capital expenditures recoverable by amortization deductions under section 167 rather than under section 162 which would make section 404 operative. See section 1.404(b) of the regulations which provides that to be deductible under section 404(a), contributions must be business expenses deductible under section 162.

Id. at *10 (quoting G.C.M. 33,329).

The 1966 decision stated that participations could be treated differently from guaranteed payments because participations "did not become effective until after the producer's basis in the film had been recovered." Id. (citing G.C.M. 33,329). This distinction begs the question whether contingent deferred compensation is a production or a distribution cost. See infra notes 88-89 and accompanying text. The General Counsel concluded in 33,329 that only guaranteed payments were includible in basis and, therefore, depreciable under I.R.C. § 167. Id. at *10. As I.R.C. § 404(a) at that time referred only to payments deductible under I.R.C. § 162 and said nothing about I.R.C. § 167, the fixed payments includible in basis were arguably beyond the scope of the I.R.C. § 404 disallowance. In contrast, I.R.C. § 167 did not apply to the contingent payments because they could not be included in basis; therefore, contingent payments would be deductible under I.R.C. § 162 when they accrued, thus triggering the I.R.C. § 404 disallowance.

In 1976, however, the Service liberalized its position on participations, concluding that they represented a cost of creating the motion picture and should therefore be viewed as capital expenditures and deducted in full as depreciation in the tax year during which they became fixed. Id. at *13. In the 1976 General Counsel Memorandum, the Service determined that its 1966 memorandum applying I.R.C. § 404(a)(5) to participations was inconsistent with the treatment of participations as capital expenditures for purposes of the investment tax credit (ITC). The 1976 Memorandum includes this excerpt from the Service's comprehensive study of the film industry and the ITC:

The classification of participation payments is . . . difficult to resolve. The question is whether these represent a contingent profit pay out and not a cost of the film. The answer to this question depends on the various ownership relationships existing between the producer and the distributor. In some instances the profit participations will undoubtedly represent profit distributions that should not be considered as part of the capital cost of the film. The problem becomes more complex

when it is understood that both actors and directors in addition to producers are often entitled to profit participations. It is to be doubted that most actors, unless they are acting as the producer, are receiving profit participations in any real partnership, joint-venture or co-ownership sense. Accordingly, it should be easier to conclude that the profit participations of an actor, in such a situation, represent contingent film costs.

Id. at *11-12 (quoting an unspecified Service study of motion picture ITC, § D, at 21-22). The 1976 memorandum observed that the ITC regulations (which were still in draft at that time) incorporated the same approach, treating deferred contingent compensation as a production cost. Id.

The Service concluded that deferred compensation should be treated the same for calculating a film's depreciable basis as for calculating a film's cost for ITC purposes:

It has generally been recognized that various forms of compensation paid for services performed in the construction of property are properly a capital cost of such property. There would not appear any basis in this respect to distinguish compensation clearly related to the construction of an identifiable asset merely because the compensation is contingent on future events. Although the payments in the instant case are contingent on the profitability of the film, to the extent they represent compensation for services rendered in the production of the film or other costs of a capital nature if currently paid, we see no reason why they should not be considered a capital cost.

Id. at *12-13 (citing Redford v. Commissioner, 28 T.C. 773 (1957) and Inter-City Television Film Corp. v. Commissioner, 43 T.C. 270, 287 (1964)). Income would be properly matched with expense, the memorandum concluded, if the taxpayer deducted each participation in the year it became "fixed" under the all-events test of accrual accounting. Id. at *13 (citing Associated Patenees v. Commissioner 4 T.C. 979 (1945), discussed infra at notes 95-105 and accompanying text). It would not, however, be proper for the taxpayer to deduct these costs before they accrued:

While in other circumstances depreciation of subsequently incurred costs under the income forecast method may be appropriate, we are not of such opinion in the instant case. Although the income forecast method provides a reasonable depreciation allowance for film costs that cannot be attributed to the income of a particular year, the instant participation costs are directly related to the profits of the year in which such participations are fixed.

Id. Participations of parties who provided production funding rather than services, however, were excluded from cost basis as profit interests of co-venturers. Id. at n.2 (citing Robinson v. Commissioner, 44 T.C. 20, 34 (1965); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964)). See infra note 71 (discussing such participations).

Thus, in the 1976 memorandum, the Service recharacterized film participations as capital expenditures and therefore abandoned the argument that I.R.C. § 404(a) required these participations to be deducted only when paid. Although the Service did not allow taxpayers to include the contingent deferred amounts in basis at the start of the film's useful life (in contrast to the rule allowing immediate inclusion of guaranteed deferred payments in basis), it did not postpone the deduction until actual payment was made. Instead, it allowed deduction at the time the contingency was removed (upon accrual).

After the 1976 Memorandum was written, Congress enacted the uniform capitalization rules of I.R.C. § 263A. Tax Reform Act of 1986, Pub. L. No. 99-514, § 803, 100 Stat. 2085, 2355. Although I.R.C. § 263A itself is silent on deferred compensation, the temporary and final regulations and notices have addressed deferred compensation in specific terms. These rules generally require deferred compensation to be capitalized whenever it is related to the construction of tangible property, including films. See I.R.C. § 263A(2); Reg. § 1.263A-1(e)(3)(ii)(C-D) (as amended 1994); Reg. § 1.263A-1T(b)(2)(iii)(F) (1987) (effective until Dec. 31, 1993); Notice 88-86, 1988-2 C.B. 401 (Aug. 22, 1988). The rules indicate that deferred payments should be capitalized when the contributions are "paid to or under" a deferred compensation plan and only "to the extent such contributions or expenses are otherwise allowable as deductions" under the Code. Reg.
rejected this idea, reasoning that participations and residuals represented capital expenditures and should have been deducted as depreciation rather than as expenses under section 162 of the Code.\(^6\) Because the 1986 amendment to section 404 of the Code extended the reach of the statute to include depreciation deductions,\(^4\) this reasoning no longer applies.\(^4\) Second, it was not clear during those years whether the earlier version of section 404 of the Code was intended to apply to all arrangements that deferred the receipt of compensation or only to those arrangements that closely resembled a stock bonus, pension, profit-sharing, or annuity plan.\(^6\) For example, it could have been argued that residuals and profit participations did not sufficiently resemble these plans to be encompassed by section 404 of the Code.

In light of these critical ambiguities, one might have expected at least one of the Transamerica opinions to explicitly discuss the inapplicability of this earlier version of section 404 of the Code to the facts of the case;\(^6\) however, neither the district court nor the appellate court even mentioned section 404 of the Code. By upholding the taxpayer's method as an appropriate matching of income and expense without any

\(^6\) See supra note 61.
\(^6\) See supra note 51.
\(^4\) In both the 1966 and 1976 memoranda, the government assumed that I.R.C. § 404(a) did not apply to depreciation deductions; however, it is now clear that depreciation deductions may not be used to accelerate deductions for unpaid deferred compensation that is subject to I.R.C. § 404. See supra note 51. That rule should apply regardless of whether the deferred amount is fixed or contingent, because I.R.C. § 404 draws no such distinction. Unfortunately, the prevailing practice of the film industry has been to ignore the requirements of I.R.C. § 404 and include participations and residuals in basis, and the Service has not, until recently, begun to take issue with that practice (and no cases have yet been litigated). The author has learned from a spokesperson for the Service task force on the entertainment industry that the Service did not recognize the I.R.C. § 404 issue until after the 1993 appellate decision in Transamerica, but that the Service is now prepared to litigate the issue.


\(^6\) This issue was not addressed by the district court, the appellate court, or even the dissent in Transamerica, and apparently it was never raised by the government.
discussion of section 404 of the Code, the appellate court created the impression that section 404 of the Code, in any version, was completely beside the point. In fact, this has been the prevailing assumption throughout much of the entertainment industry, both before Transamerica and today. The entertainment industry reacted to the Ninth Circuit's decision as though it had given a judicial seal of approval on capitalizing unpaid contingent compensation,\textsuperscript{67} and some tax planners have explicitly advised their clients to continue this practice.\textsuperscript{68}

B. Avoiding Section 404

Even if section 404 of the Code were enforced against all taxpayers seeking to capitalize unpaid deferred compensation for personal services, all in basis, some taxpayers will be able to plan around its constraints and continue to include some of these unpaid amounts in basis. Section 404 of the Code applies only to payments for personal services and not to payments for property or for the use of property.\textsuperscript{69} Therefore, even if the government enforces section 404 of the Code with respect to participations and residuals, some taxpayers may avoid section 404 of the Code by structuring their compensation arrangements so that most of the deferred payments represent payments for property or for the use of property rather than for personal services.\textsuperscript{70} The Transamerica decision allows


\textsuperscript{69} Reg. § 1.404(a)-1(b) (as amended in 1963) (limiting deductions under I.R.C. § 404 to “compensation for personal services actually rendered,” and would seem to be prohibited under 1986 amendments to section 404, see supra note 51.).

\textsuperscript{70} In Albertson’s v. Commissioner, 42 F.3d 537 (9th Cir. 1994), cert. denied, 64 U.S.L.W. 3239 (1995), a taxpayer sought to avoid I.R.C. § 404 by characterizing as interest a portion of its nonqualified deferred compensation that had accrued but had not been paid. The Ninth Circuit initially decided the case in favor of the taxpayer, 12 F.3d 1529 (9th Cir.
accrual method taxpayers to include these contingent liabilities in depreciable basis during the first year the property is placed in service, regardless of whether the liabilities have accrued. Thus, taxpayers will no doubt rely on Transamerica to support the inclusion in basis of some unaccrued deferred payments because the deferred payments are not compensation for services in the first place.

In the context of creating or acquiring a film or similar asset, several types of deferred payments can escape section 404 of the Code because they can be characterized as payments for property or for the use of property. These payments would include interest, rents, royalties for the use of intangible property, and lump sum or installment payments for purchasing property (tangible or intangible). An obvious example is a net profits or gross receipts participation given to the seller of literary property rights. Because this type of participation does not represent compensation for services, section 404 of the Code would not apply. In other cases, a contingent deferred payment might be earmarked as consideration for such property as a waiver of privacy or

1993), but then reversed itself upon rehearing. 38 F.3d 1046 (9th Cir. 1994). If the taxpayer were allowed to prevail in a case such as Albertson's, then payors of deferred compensation for services would be able to avoid I.R.C. § 404 with respect to portions of those payments that could reasonably be characterized as interest, which is deductible (or capitalizable and depreciable whenever the uniform capitalization rules) as it accrues. Such as a result would appear to frustrate the intent of I.R.C. § 404.

7 G.C.M. 36,590, supra note 61, at *3-4, identifies the various parties who might receive profit participations as remuneration for their contributions to the filmmaking effort, not all of which represent personal services. For example, completion bond companies and investors might receive participations.

Where a profit or gross receipts participation is given in exchange for financing the production or acquisition activity, such an arrangement would often be considered a partnership for tax purposes. See Schuyler M. Moore, supra note 10, ¶ 2.07[4] (noting that a profits-for-equity film financing arrangement is a partnership for tax purposes); Split Rights Financing Helps Movies Get Made; Overseas Investors, Ent. L. & Fin. (Sept. 1994), at 7 (interview with Joel H. Reader) (discussing international joint ventures); G.C.M. 36,590, supra note 61, at *13 n.2.

In these cases, one partner's profit participation would not represent a portion of the other partners' basis in the partnership assets and would, therefore, not generate deductions for the other partners. Rather, each partner's share of the profits would represent a separate income stream beyond the dominion of the other partners. See G.C.M. 36,590, supra note 61, at *11 (distinguishing profit payouts from production costs).
defamation claims, or an agreement to provide “exclusive life” story rights.\textsuperscript{72}

A more aggressive, and risky, strategy could be employed for actors, directors, and other service providers. This strategy recognizes that an entertainer’s name or likeness can be treated as a form of property. An actor’s agreement, for example, could specify that the guaranteed minimum salary is compensation for services but that some or all of the actor’s profit participation is compensation for the use of the actor’s name or likeness.\textsuperscript{73} Virtually any contributor to a film whose name or likeness will be exploited (even if the person’s name simply appears in the film’s advertising or screen credits, as in the case of a writer or director) could be compensated under a similar two-part arrangement.\textsuperscript{74}

\textsuperscript{72} Guild-mandated residuals or reuse payments might not be susceptible to this same treatment unless the relevant collective bargaining agreement were revised accordingly. Of course, any residuals or reuse payments above and beyond the guild minimums can already be designed to fit the two-part structure.

It is important to note that many writers cannot characterize their deferred compensation as payment for literary property; if they are paid under a work-made-for-hire arrangement, their compensation is for personal services. See 17 U.S.C § 201(b) (noting that copyright belongs to payor under work-made-for-hire arrangements).

\textsuperscript{73} Numerous cases have recognized that persons have a compensable right to control commercial exploitation of their identity. See, e.g., White v. Samsung Electronics America, 1992 U.S.App. LEXIS 19253 (9th Cir. 1992), rehearing en banc denied 989 F.2d 1512 (9th Cir. 1993); King v. Innovation Books, 976 F.2d 824 (2d Cir. 1992); Midler v. Ford Motor Co., 849 F.2d 460, 463 (9th Cir. 1988); Memphis Dev. Found. v. Factors Etc., 616 F.2d 956, 957-58 (6th Cir. 1980).

“Name” artists often receive substantial participations (increasingly based on gross receipts rather than net profits) due to the box office value of their names and/or likenesses (the goodwill associated with their identities). Even when a performer is not a major “name,” he or she typically provides labor for a specific period of time, but the recording of that person’s image or sounds may be commercially exploited for decades thereafter. Thus, the property that an entertainer can convey in exchange for deferred payments includes not only the goodwill attached to his or her name, but the commercial value of that performer’s likeness, which is an essential element of the entertainment product.

\textsuperscript{74} Allocation would be possible not only for the large participations in profits or gross receipts typically reserved for “name” performers, but also for more modest participations. Where a person receives only a small net profits participation, allocating that participation entirely to the use of the person’s name and/or likeness and allocating guaranteed payments entirely to services would be consistent with the economics of the transaction. The artist in such a case does not participate to any great extent in the risks of the venture; thus, rather than receiving a significant share in the proceeds of an investment, he or she is simply being compensated for providing labor to the investors and enjoys a more secure but potentially smaller measure of compensation.

Those whose talents are valuable but whose names do not yet have substantial commercial value because they are not well known are more problematic. These artists may receive some deferred compensation (either fixed in amount or else tied to net profits), even though they are unlikely to receive gross receipts participations. There is
This structure will only succeed if it accurately reflects the substance of the transaction. In many cases, this structure makes economic sense. A person's right of publicity is not exploited until his or her name or likeness is used for a commercial purpose. Where the right to use that name or likeness is acquired for incorporation in a product or service, the commercial use does not occur until that product or service is marketed to the consumer (meaning the public, or a licensee such as a network). In addition, a producer's contract with an artist grants the producer the right to exploit that name or likeness; or, in the case of a writer or producer, the right to exploit the name through advertising or screen credits. Without this exploitation right, there is often little value in the artist's labor. Thus, while an actor, director or musician is giving a performance that is being recorded, he or she is performing a service. When the recorded performance is exploited, the artist's identity is being used for commercial gain. Likewise, a writer's creative services cease when the script is completed; however, the use and licensing of his or her name in the screen credits or the marketing of a film represents a second, albeit related, transaction. If the allocation of deferred payments is reasonable in light of the market value of the person's identity, then section 404 of the Code should be inapplicable to that portion of the payment.\textsuperscript{25}

\textsuperscript{25} This argument would have little application outside of a context where the payor is exploiting an intellectual property right belonging to the worker, such as copyright or the right of publicity or privacy. In a context where the worker provides only services, there would be no "property" for which the deferred compensation represented payment. In the \textit{Albertson's} case, discussed supra notes 45, 48 \& 70, the payor argued unsuccessfully that the property was the time value of the deferred payment itself.

One aggressive strategy to create a "property" interest on behalf of such a pure service provider would be to assign a small share of the copyright in the finished entertainment product to that worker as part of his or her compensation package, then characterize part of the worker's deferred compensation as a royalty for the use of that share. One tax advisor has suggested this technique as a way to convert compensation for services performed outside their country of residence into royalties in order to obtain favorable treatment under United States tax treaties, see Gerald Damsky, "Tax Planning for Foreign Entertainers," \textit{Entertainment Law and Finance}, July 1995, at 3; see also Richard L. Curtis, "Tax Tips on Managing Artists' Royalty Income," \textit{Entertainment Law and Finance}, Nov. 1992, at 1, 6 (describing similar strategy as "open to question" as a way to reduce social security taxes), but it would seem to have equal relevance in the context of section 404. However, the success of this strategy remains untested in either context.
It would normally be impossible to use this strategy to allocate *all* of a service-provider's deferred compensation away from the value of the services provided. For example, if a performer is paid a guaranteed minimum regardless of whether the end product of his or her labor is exploited, that guaranteed amount should not be characterized as a payment for property or the use of property. It is difficult to see how any fixed payment to an actor could be allocated to the use of property, as the amount would be payable regardless of whether the property were used at all. Deferred contingent payments would present a stronger case for such an allocation, as they become payable only if and when some form of property is exploited by the payor, but even here the allocation must be reasonable.²⁶

Where a contract fails to specify that deferred payments are for property rather than services or fails to make a reasonable allocation, the taxpayer may have difficulty establishing such an allocation after-the-fact. See, e.g., Boulez v. Commissioner, 83 T.C. 584, 591-92 (1984) (holding that payments to musician based on sales of recordings are compensation for personal services and not royalties); Karrer v. United States, 152 F.Supp. 66 (Ct. Cl. 1957) (noting that basing remuneration on a percentage of future sales does not prove the intent to license or sell property, rather than receive compensation for services); Commissioner v. Ferrer, 35 T.C. 617, 626 (1961), aff'd, 304 F.2d 125 (2d Cir. 1962); Kimble Glass Co. v. Commissioner, 9 T.C. 183, 189 (1947) (ruling that labels used by parties are not determinative); Lewis v. Rothensies, 61 F.Supp. 862 (E.D. Pa. 1941); Badgett v. United States, 175 F.Supp. 120 (W.D. Ky. 1959); Hofferbert v. Briggs, 178 F.2d 743 (4th Cir. 1949); Waldschmidt v. CBS, Inc., 14 Bankr. 309 (D. Tenn. 1981); Strauss v. Commissioner, 8 T.C. 1068, 1064-66 (1947); Ferguson v. Commissioner, 20 B.T.A. 130 (1930); In re Mahoney, 100 Bankr. 472 (E.D. Mo. 1989).

* This approach would be consistent with the approach taken by the Tax Court in Kramer v. Commissioner, 80 T.C. 768 (1983). In that case, the taxpayer received royalties from the sale of tennis equipment for allowing the use of his name and likeness and for making personal appearances in connection with marketing the products. The court concluded that the license rather than the services "was the principal item of consideration in the contract," and it allocated 30% of the payments to personal services and 70% to the license for the use of his name and likeness. Id. at 780-82; see also Rev. Rul. 81-178, 1981-2 C.B. 135 (stating that payments for use of athlete's name and likeness were royalties rather than payments for services); P.L.R. 83-52-090 (Sept. 30, 1983) (stating that payments for use of organization's name and logo in connection with sale of a product represent royalties and that "[p]ayments for the use of trade marks, trade names, service marks, or copyrights that are measured by the sales of the licensed products and services are ordinarily classified as royalties for federal income tax purposes"); see generally Reg. § 1.61-8(a) (as amended 1994) (noting that tax concept of royalties includes payments for use of trademarks).

Arguably, however, the use of a person's likeness or name to promote merchandise presents a stronger case for allocating compensation to license fees than the use of a person's likeness or name in an entertainment vehicle to which he or she contributed acting services.

In the context of an international transaction, extending the allocation rationale of *Kramer* to treat participations and residuals as royalties might have consequences beyond I.R.C. § 404, such as converting taxable, personal services income into royalty
In Commissioner v. Ferrer, the Tax Court and the Second Circuit upheld an allocation of an actor's fee where a different kind of property was involved. Actor Jose Ferrer acquired the stage rights to a novel together with an interest in the film rights. Later, Ferrer entered into a film production contract in which he agreed to star in the film and to relinquish his interests in the stage and film rights in exchange for a salary plus a share of the film's net profits. The Commissioner contended that the entire interest in profits was compensation for acting services, emphasizing that, if Ferrer failed to fulfill any portion of his acting commitment, he would forfeit a pro rata portion of his profit share. Nevertheless, Ferrer prevailed by presenting evidence that the profits interest was intended specifically as consideration for the sale of the stage and film rights. Most service providers in the entertainment industry,


In addition, there may be negative tax consequences to the recipient if the participations or residuals were not treated as personal service income (e.g., no payroll tax withholding), but such consequences would be of minor importance to many recipients, or who may indeed consider them a benefit rather than a detriment.

78 304 F.2d at 127, 131.
79 Id. at 128-29.
80 Id. at 135. The issue in Ferrer was whether these amounts constituted capital gains or ordinary income. In contrast, the issue under I.R.C. § 404 would be whether income represents compensation for services or compensation for property or the use of property. In many cases, all of the compensation would be ordinary income, even if it were not all compensation for services within the meaning of I.R.C. § 404. Ferrer, however, is still enlightening because the focus of the analysis in that case is on the proper allocation of the contracted-for compensation.
81 Specifically, the forfeiture applied if Ferrer was unable to finish his acting duties, if production of the film were halted due to an "unavoidable accident," or if Ferrer violated the contract's morals clause. Ferrer, 35 T.C. at 623.
82 The evidence also showed that, although Ferrer was an established actor, the largest total salary Ferrer had previously received for a motion picture appearance was $75,000. In contrast, his total acknowledged salary for the film in question was over $109,000, and, in addition, he had received almost $179,000 solely from the profits interest which he sought to characterize as non-services income. 35 T.C. at 618; 304 F.2d at 126, 129.

The Court of Appeals rejected the Commissioner's argument regarding the forfeiture provisions and refused to hold that the proportionate forfeiture changed the character of the net profits interest from a payment for property to a payment for services. 304 F.2d
however, would not be able to demonstrate that they conveyed such a traditional property interest as part of their creative contribution to a film or similar project, and courts would be wary of allowing the concept of a right of publicity license to

at 135-36. In spite of the taxpayer's victory, Ferrer does not present the best-case scenario for allocating compensation away from personal services. The proportionate forfeiture provision (typically included in film industry personal services contracts) could reasonably be read as evidence that the profits participation represented additional compensation for services rather than for the intellectual property rights to which the Tax Court and the Second Circuit allocated them. A forfeiture provision, however, need not turn every contingent deferral into compensation for services. Even in Ferrer, the parties could have drafted a better contract or voiced a more persuasive justification for the forfeiture. In the case of an actor, for example, the amount of acting services provided normally bears some relation to the amount of time the person's image is on-screen. Thus, if the contract provides for forfeiting some or all of the actor's deferred compensation for failure to fulfill the contracted acting obligations, the forfeited compensation would roughly correspond to the diminished value of the right of publicity conveyance. The same argument could apply to a writer, director, or musician who has a distinctive style. E.g., Waits v. Frito-Lay, 975 F.2d 1093 (9th Cir. 1992), amended 92 Daily Journal D.A.R. 13682 (9th Cir. 1992), amended 92 Daily Journal D.A.R. 14382 (9th Cir. 1992); Midler v. Ford Motor Co., 849 F.2d 460 (9th Cir. 1988); Lahr v. Adell Chemical Co., 300 F.2d 256 (1st Cir. 1962); Jim Doyle, Carlos Santana Sues Over TV Ad, S.F. Chron., Oct. 16, 1990, at A-2 (concerning a suit based in part on distinctive guitar style).

This argument could have been advanced even on the facts of Ferrer. Even though the forfeiture of deferred compensation was generally calculated based on the number of weeks of acting services which Ferrer failed to provide, there would be no deferred compensation at all unless Ferrer had provided enough usable services so that his "acts, poses, and appearances" in the film "were recognizable to the public." Ferrer, 304 F.2d at 129. In addition, the forfeiture applied to all of the deferred compensation, not just the profit participation that the parties claimed was allocable to the sale of property rights. Thus, the taxpayer could reasonably take the position that the value of the lost services was recompensed solely by forfeitures other than the net profits forfeiture.

In addition, the same forfeitures would result if Ferrer violated his morals clause. Id. Behavior offensive to the movie-going public would not make him a worse actor and would not render him incapable of providing the required twelve weeks of service, but it would likely diminish his box office appeal (i.e., the drawing power of his name and likeness). This would also indicate that the deferred compensation was not entirely for acting services.

Sometimes the only property being licensed is the artist's name. This will be true of most contracts with writers, directors, or musicians who are not being compensated for any other aspect of their identity. In such cases it may be more difficult to characterize the payments subject to forfeiture as compensation for the right of publicity; however, it is typical for a screen credit to be shared or forfeited entirely when the artist does not complete the assigned task. If a screen credit is forfeited entirely, then the original artist should not be paid anything for the right to use his or her name. If a screen credit is to be shared, the payor has engaged a replacement to take over for the original artist and must pay the replacement artist for the right to use his or her name in the screen credits. This certainly warrants a diminution in the compensation paid for the right to use the original artist's name in the credits. Thus, even where the only arguable property being licensed is the right to use a person's name, a contractual provision for forfeiture based on incomplete performance need not turn every deferred payment into compensation for services.
undermine the concept of compensation for purposes of section 404 of the Code.\footnote{One additional strategy that service providers might explore is incorporation. It is not clear whether I.R.C. § 404 would apply to deferred payments owed to an actor’s, writer’s, or director’s “loan-out” corporation. See generally Mary LaFrance, The Separate Tax Status of Loan-Out Corporations, 48 Vanderbilt L. Rev. 879 (1995) (discussing whether and when a loan-out corporation should be recognized as the principal in a transaction).}

III. APPLYING TRANSAMERICA TO PAYMENTS EXEMPT FROM SECTION 404: MATCHING INCOME AND EXPENSE

As discussed in Part II above, no cases or rulings have addressed the question of whether section 404 of the Code applies to film-related residuals and participations, and the entertainment industry is likely to defend its tax accounting vigorously in any future litigation. In addition, the current version of section 404 of the Code does not apply to all deferred payments. It is, therefore, instructive to examine Transamerica under broader principles of tax law.

As discussed below, further examination of Transamerica reveals that the Ninth Circuit’s decision was wrong for a reason unrelated to section 404 of the Code. By creating an exception to the rule that a taxpayer may not capitalize liabilities, the Transamerica approach fails to properly match income with expenses and, thus, violates the fundamental rule that a taxpayer’s accounting method must produce a clear reflection of income.\footnote{See I.R.C. § 446(b) (requiring taxpayer’s accounting method to clearly reflect income).} As the dissent noted, the Transamerica decision conflicts with the familiar rule that contingent liabilities incurred in acquiring property cannot be deducted or capitalized until the contingency is eliminated.\footnote{See cases cited supra note 35. Once the debt becomes fixed, the question becomes whether, according to the taxpayer’s method of accounting, the amounts should be capitalized and deducted ratably over the useful life of the asset, or whether they should become deductible in full as soon as they are paid or payable. See infra notes 95-105 and accompanying text.} No authority prior to Transamerica had allowed a taxpayer to capitalize such a debt before it became fixed.
A. Participations and Residuals as Distribution Costs
Deductible when Accrued or Paid

Although the appellate opinion in Transamerica asserts that "the costs of the participations and residuals . . . are clearly costs of producing the film and not expenses incurred in distribution," this conclusion is not as "clear" as the court states. In labeling the deferred compensation as a production rather than a distribution expense, the Ninth Circuit glosses over the central issue of the case: how to match these costs with the taxpayer's revenues in a way that produces a clear reflection of income. The underlying principle of depreciation is that, in order to produce this clear reflection of income, the cost of producing or acquiring an income-producing asset should be allocated over the period during which it is used by the taxpayer for income-producing purposes.\(^7\)

The costs related to the income produced by a particular asset cannot always be attributed ratably to the entire stream of income produced by the asset. Some costs are more accurately attributed to income streams occurring within specific time periods. When both the existence and the amount of a liability are contingent on the property generating a particular stream of income in order to produce a clear reflection of income, the liability should be attributed to the taxable period in which that income stream is generated. Contingent deferred payments such as participations and residuals are examples of such costs, as they are attributable to identifiable streams of income rather than to the entire income produced during the asset's useful life. Under this approach, the only relevant income stream for net profit participations is the income received after the film reaches net profits. For residuals, the only relevant income stream is the type of

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\(^5\) Transamerica, 999 F.2d at 1365.

\(^7\) See supra note 14. For example, delaying an accrued depreciation deduction to a later year would cause a taxpayer to recognize income in the earlier year without getting proper "credit" for that portion of out-of-pocket costs (in the case of cash basis) or accrued liabilities (in the case of debt basis) that is attributable to generating that income. This mismatching, however, would be required under I.R.C. § 404(a)(5) whenever the accrued liabilities represent deferred compensation because Congress's concern was with a different matching principle: the principle of delaying a deduction for deferred compensation until the amount is includible in the payee's gross income. See supra notes 43-55 and accompanying text.
revenues specified in the contract (typically, revenues received from television and/or videocassette licensing). Even for gross participations, the contingent expense is only incurred as the gross revenues are earned, which may occur ratably from the first year forward or, depending on the contract, may be delayed until a certain trigger point is reached either during the first taxable year or later. Thus, each year's separate gross revenue stream is attributable to a specific level of gross participation expenditure. Where a contract calls for a gross participation after a designated trigger point—such as the "break-even" point or some other specified level of gross receipts—the participation is a cost relating only to the stream of income received after this trigger point has been reached.

The Ninth Circuit’s labeling of all participations and residuals as “production costs” ignores the fact that these contingent liabilities (with the exception of some “first-dollar” gross participations) do not relate ratably to each dollar of gross revenue that the film generates. The court’s approach implies that the costs are attributable pro rata to each year's income, but, these costs can be more accurately “pegged” to specific taxable years in which specific revenues are generated. A film can be produced without a penny of these expenses being paid or becoming payable; the liability becomes fixed, if at all, only after the film is released. A film that collects dust in the studio’s library is not generating any liabilities for participations or residuals. Although it may be essential to promise an artist a participation in order to make a film (thus incurring the contingent liability), it is only when the film is exploited that the promise becomes payable (i.e., the liability becomes fixed). Even after the film’s release, the amount payable in a given year is contingent on the extent to which the film produces revenue during that year. It would, therefore, not be unreasonable to conclude that these expenses are distribution costs rather than production costs.\footnote{This conclusion would not necessarily control the characterization of these costs for purposes of the motion picture investment tax credit (ITC), should it be resurrected. See supra note 61 (discussing ITC).}

As distribution expenses,
they should not be deductible until they accrue or are paid, depending on the taxpayer's method of tax accounting.\textsuperscript{60}

This approach parallels the treatment of payments for the temporary use rather than the acquisition of property. Annual license or rental fees are deductible as paid or payable, depending on the taxpayer's method of accounting. For example, an annual license fee paid for the use of a trademark, trade name, or franchise is deductible as a current expenditure.\textsuperscript{60} A person's name or likeness (i.e., the right of privacy or publicity) is analogous to a trademark or trade name,\textsuperscript{61} therefore, the annual cost of exploiting a person's name or likeness also reflects a royalty that should be deductible on a year-by-year basis. Payments that are incurred and measured by the exploitation of property arguably represent current, not capital, expenditures.

The preceding analysis applies to both participations (in gross receipts or net profits, however these are defined) and residuals. It does not apply, however, to deferred payments that are payable regardless of the income or revenues produced by the film. For example, if a producer promises to pay an actor $300,000 during principal photography and another $200,000 payable six months after the completion of principal photography, the only contingency to which the deferred payment is subject (completion of principal photography) will be satisfied before the end of the first year in which the film is placed in service. In other words, the debt becomes a fixed liability by the end of the first year in which the film can be depreciated. The expense would relate to the entire income stream of the asset and, thus, would be more accurately termed a production cost rather than a distribution cost. In contrast, if the producer promised the performer an additional $200,000 payable if and when the film reached a specified level of gross receipts, this would be a contingent cost traceable to a specific portion of the income stream (the income stream commencing at the specified level of gross receipts), and this could be viewed as a distribution cost similar to a participation or residual. This

\textsuperscript{60} On the impact of characterizing these amounts as current expenses rather than capital expenditures for purposes of recapture, see infra note 92. See infra note 113.

\textsuperscript{61} I.R.C. §§ 162(a)(3), 1253(a).

\textsuperscript{61} See supra notes 73-76 and accompanying text.
cost would not become fixed until sometime after the film was placed in service, and it could be added to basis only at that later date. Because this expense relates to the film’s entire income stream after the specified level of gross receipts, it could not be deducted in its entirety when paid or accrued but should be deducted ratably over the remaining useful life of the film.

B. Comparing Cases Involving the Acquisition of Patents

In many cases, a contingent liability incurred in acquiring an asset has been treated for tax purposes as a royalty because the amount of the liability depends on the benefits generated by the asset in the hands of the acquiring party (the debtor). Although the cases do not always make clear whether these liabilities represent business expense deductions under section 162 of the Code or depreciation deductions under section 167 of the Code, there is a strong consensus on the more fundamental point that when the contingent portion of the acquisition price is based on the productivity of the acquired asset during the taxable year in which the contingent amount is

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See, e.g., Simmonds Precision Prod. v. Commissioner (1980), 75 T.C. 103 (holding that royalties that are consideration for sale of capital assets are deductible as depreciation); Newton Insert Co. v. Commissioner, 61 T.C. 570 (1974) (holding that annual payments after patent acquisition were depreciable); McCullough Tool Co. v. Commissioner, 33 T.C. 743 (1960) (holding that installment payments for patents were a fixed cost susceptible to depreciation), aff’d 318 F.2d 790 (9th Cir. 1963); M.E. Cunningham Co. v. Commissioner, 10 T.C.M. (CCH) 276 (1951) (leaving open the question of whether royalty payments under a sales agreement are taxable as ordinary expenses or deductible as depreciation); Associated Patentees v. Commissioner 4 T.C. 979 (1945) (holding that royalties that are consideration for sale of capital assets are deductible as depreciation), acq., 1959-2 C.B. 3; Nelson v. Commissioner, 28 B.T.A. 529 (1933) (stating that deferred payments representing patent royalties and/or compensation for services should be deducted when paid rather than capitalized and amortized); Rev. Rul. 67-136, 1967-1 C.B. 58 (stating that patent royalties are depreciation deductions); see also cases cited infra note 93.

Before I.R.C. § 197 was enacted, this distinction was of great importance whenever the acquired asset was wholly or partly nondepreciable; a license fee for the use of the property for business purposes would usually be deductible under I.R.C. § 162, whereas certain amounts paid to acquire an intangible might not be depreciable at all if the intangible were closely related to goodwill. See, e.g., Holden Fuel Oil Co. v. Commissioner, 31 T.C.M. (CCH) 184, 187 (1972), aff’d per curiam, 479 F.2d 613 (1973) (holding that payments for a customer list were for a capital asset and not currently deductible). Such a distinction is less important now that I.R.C. § 197 has expanded the class of depreciable (or “amortizable”) intangibles; see supra note 4. However, it is important when determining whether any of the gain on a subsequent sale of the property is subject to recapture under I.R.C. § 1245. See Newton Insert Co. v. Commissioner (1970); infra note 113.
paid or payable, then that amount should be deducted in full in the year it is paid or payable, because "it is a cost pertaining to that year alone and measured by income over that period."

The error in Ninth Circuit's analysis becomes particularly clear when the practice endorsed in *Transamerica* is compared with the tax treatment of similar payments representing the cost of acquiring or constructing property other than motion pictures. It is surprising that, when the Ninth Circuit approved UA's depreciation method, the court did not even mention *Associated Patentees v. Commissioner* or subsequent cases that have addressed the timing of deductions for contingent liabilities incurred in acquiring patents. As discussed below, these authorities indicate that (1) unaccrued liabilities cannot be deducted or included in depreciable basis, and (2) where a deferred capital expenditure is attributable to the income received during a particular taxable year, the rule for deducting it parallels the rule for deducting a current expenditure. In

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See, e.g., *Holden Fuel Co.*, 479 F.2d 613 (concerning royalties for a customer list); *Sarkes Tarzian, Inc. v. United States*, 159 F.Supp. 253, 268 (S.D. Ind. 1958) (concerning depreciation of installment payments for a patent); *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284, 290 (1983) (concerning the deductibility of trade secret royalties); *Simmonds Precision Prod.*, 75 T.C. at 116 (concerning depreciation of cost of acquiring patents); *Allied Tube & Conduit Corp. v. Commissioner*, 34 T.C.M. (CCH) 1218, 1225 (1975) (holding that payments for rights to patent are depreciable); *Newton Insert Co.*, 61 T.C. at 586 (holding that payments for patent rights are depreciable); *Omholt v. Commissioner*, 60 T.C. 541, 547, & n.6 (1973) (stating that when a reasonable percentage of patent earnings are paid for a patent right, such payments can be currently deducted over the remaining useful life of the patent); *Carter Found. Prod. Co. v. Campbell*, 61-2 U.S.T.C. ¶ 9830 (N.D. Tex. 1961) (concerning oil and gas profits interest payable for purchase of equipment); *Best Lock Corp. v. Commissioner*, 31 T.C. 1217, 1234 (1959) (concerning depreciation of patent royalties payments); *M.E. Cunningham Co. v. Commissioner*, 10 T.C.M. (CCH) 275 (1951) (concerning whether royalties paid for use of invention should be depreciable or currently deductible); *Associated Patentees v. Commissioner*, 4 T.C. 979, 986-87 (1945) (concerning depreciation of payments for patents when the total acquisition cost is not known until the patents are valueless); *Innis v. Commissioner*, 4 T.C.M. (CCH) 729 (1945) (concerning depreciation for lease payments based on minerals profits); *Rev. Rul. 67-136, 1967-1 C.B. 58* (concerning deductions for patent royalties paid as the cost of acquiring a patent); *I.R.C. § 1253(d)(1)* (concerning trademark, franchise and trade name royalties).

* Associated Patentees, 4 T.C. at 986; accord *Newton Insert Co.*, 61 T.C. at 586. This reasoning would not apply to payments that are contingent but unrelated to the acquired asset's productivity. Although such payments should be added to basis only when they are paid or payable, they should be capitalized over the asset's remaining useful life (or the specific portion of that life to which they relate) rather than being deductible. Deferred payments that are not contingent at all can be included in the basis of acquired assets from the start under the general rule allowing noncontingent liabilities to be included in basis. See supra note 24 and accompanying text.

* 4 T.C. 979 (1945).
other words, the taxpayer can deduct that year's capital expenditure in full, but only when it accrues or is paid.

In Associated Patentees, the taxpayer corporation acquired a group of patents, in exchange for which it agreed to pay a royalty based on the revenues that the patents generated. The court found that, for tax purposes, the royalties constituted a capital expenditure. The issue presented in Associated Patentees involved the amount of royalties to be deducted as depreciation in the first year that the royalties were placed in service. The government contended that the first year's royalty payment should be added to basis and then deducted ratably over the useful life of the patents. The second year's royalty payment would be prorated among the second and succeeding years, and so on. The taxpayer argued that the entire first year's royalty should be deductible in the first year because it represented "a cost pertaining to that year alone." The Tax Court found the government's method inappropriate because it would distort income by producing inadequate depreciation allowances in the early years and excessive allowances in the later years when the income from the patents was likely to be smaller. The taxpayer's method, the court held, would produce a more reasonable depreciation allowance; thus, each royalty payment should be deductible in its entirety in the year paid. The Treasury acquiesced in

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*Id.*

*Id. at 986.

*Id. at 986. Associated Patentees was based on a Board of Tax Appeals precedent, John A. Nelson Co. v. Commissioner, 28 B.T.A. 552, 556-37 (1933), aff'd, 75 F.2d 696 (7th Cir. 1935), rev'd on other grounds, 296 U.S. 374 (1935), which held that, although the cost of a patent is a capital expenditure, royalties should be deducted rather than capitalized. In that case, the Board of Tax Appeals rejected the government's claim that annual patent royalties incurred by an accrual method taxpayer should be capitalized and deducted over the remaining patent term rather than deducted as incurred:

Whether we consider the payments based upon a percentage of profits as compensation for services rendered, or as in the nature of a rental or royalty for the use of the product of their inventive genius, such payments were in satisfaction of an obligation relating directly to the business of the particular year for which they were paid. We can not see that these payments add anything to the petitioner's capital investment, it having already acquired the patents and applications therefor. There are further practical difficulties in treating these payments, relating to the business of a particular year and measured by the success of that year's operations, as capital expenditures. These difficulties are the changing base upon which to rest an amortization allowance, the variable terms of the several patents, and the term of the agreement as opposed to the term of the patents, requiring the payments . . . even in
Associated Patentees," and subsequent cases and rulings have adopted the same approach.106

While Associated Patentees did not address the question of whether estimates of future royalty payments should be included in the depreciable basis of the patents at the time they were placed in service, subsequent case law established this corollary:

Where the taxpayer purchases a patent for a noncontingent, fixed amount, that total purchase price constitutes the basis on which depreciation may be taken. If, however, the sales price of a patent is expressed by a formula by which a fixed dollar amount cannot be ascertained until future years (such as royalties which are a fraction of sales), the purchaser may deduct each year as depreciation only the amount of the purchase price actually paid or payable.107

the last year of the term of a patent or patents, but not requiring payments in a year when there were no profits, even though the cost of the patents would nevertheless be subject to amortization.

28 B.T.A. at 536-37 (citations omitted). Similar concerns led the Supreme Court to recognize debt basis in Crane v. Commissioner, 331 U.S. 1 (1947).

Like residuals and profit participations, each annual royalty payment in John A. Nelson Co. pertained only to one year's income and was not only a reasonable estimate, but, indeed, the most reasonable estimate of the amount of royalty expense that was properly allocated to that year's income. Thus, proper "matching" of income and expenses required a deduction as each year's liability accrued or was paid. 28 B.T.A. at 536-37.

106 E.g., Holden Fuel Oil Co. v. Commissioner, 479 F.2d 613 (6th Cir. 1973) (annual royalty for customer list was deductible in full in the year it accrued); Sarkes Tarzian, Inc. v. United States, 159 F. Supp. 253, 256 (S.D. Ind. 1958) (stating that annual contingent payments for the purchase of patents are deductible in the year during which the accrual method taxpayer earned the related income); Rev. Rul. 67-136, 1967-1 C.B. 58, 59 (approving Associated Patentees method for acquired patents and patent applications where purchase price "is contractually fixed as a reasonable percentage of the annual earnings from such patents and patent applications over the period of their remaining lives . . . ."); Best Lock Corp. v. Commissioner, 31 T.C. 1217, 1234 (1959) (noting that annual depreciation deduction should equal full amount of patent royalties paid each year); see also infra note 101.


107 Simmonds Precision Prod. v. Commissioner, 75 T.C. 103, 115 (1980) (citations omitted); see also Newton Insert Co. v. Commissioner, 61 T.C. 570, 586, 588 (1974) (where taxpayer purchased patents in exchange for annual contingent payments based on sales, those payments are deductible in the year paid: "since a patent purchased for percentage payments has no fixed cost, it is impossible to compute the depreciation allowance ratably over its useful life," and basis of patents at time of acquisition is zero because "future payments under the license were contingent, and . . . petitioner cannot increase the basis of the agreements by speculative amounts which may never become due and
Except for the *Transamerica* case, the rule excluding contingent liabilities from basis has consistently been followed in cases involving deferred capital expenditures that are contingent on a future revenue stream. For example, it has been applied to deny depreciation deductions for a covenant not to compete, in which the consideration was fixed in amount but was payable only from the buyer's future profits.\textsuperscript{102} It has also been used to disallow depreciation deductions for construction debt that was to be repaid solely from future revenues.\textsuperscript{103} In

which certainly [petitioner] had not paid), aff'd per curiam, 545 F.2d 1259 (9th Cir. 1976); McCullough Tool Co. v. Commissioner, 33 T.C. 743, 749-50 (1960) (where taxpayer modified patent royalty contract and substituted fixed payments for royalties based on gross receipts, taxpayer established a fixed cost for the patent and should, therefore, include the fixed payments in depreciable basis rather than deduct them when paid), aff'd, 318 F.2d 790 (9th Cir. 1963). Cf. I.R.C. § 1253(d) (allowing annual business expense deduction under I.R.C. § 162 for amounts paid to purchase trademark or trade name where amount paid is contingent on productivity, use, or disposition of asset purchased).

The reference by the court in *Simmonds Precision Prods.* to depreciation deductions for amounts "paid or payable" suggests that the rule for such productivity-based installment payments is different from the general rules governing depreciation of debt basis. Ordinarily, under the principles of *Crane* v. Commissioner, 331 U.S. 1 (1947), depreciation deductions for acquired assets are based on the taxpayer's total basis, including both cash and debt basis. That is, a fixed acquisition debt is included in depreciable basis even if the taxpayer uses the cash method of tax accounting. *Crane*, therefore, allows a taxpayer to take depreciation deductions in excess of cash basis. See, e.g., Denver & Rio Grande Western R.R. v. United States, 506 F.2d 1266, 1269 (Ct. Cl. 1974). The reference to amounts "paid or payable" in *Simmonds Precision Prods.*, however, suggests that the timing of depreciation deductions arising from royalty-type payments depends on a taxpayer's method of accounting and that a cash method taxpayer could not, therefore, take a depreciation deduction for an accrued but unpaid royalty.

\textsuperscript{102} Lemery v. Commissioner, 52 T.C. 367, 377 (1969), aff'd per curiam, 451 F.2d 173 (9th Cir. 1971). Section 404 apparently would not apply in this context because payments for a covenant not to compete are not considered payments for personal services. See, e.g., Kreider v. Commissioner, 762 F.2d 580 (7th Cir. 1985); Allen v. Commissioner, 50 T.C. 466, 475-76 (1968); Korfund v. Commissioner, 1 T.C. 1180, 1187 (1943); Rev. Rul. 74-103, 1974-10 C.B. 11.

\textsuperscript{103} Denver & Rio Grande Western R.R., 505 F.2d at 1270-71. The rule is well-settled that contingent debts are not includible in basis. See, e.g., Rodman v. Commissioner, 542 F.2d 845, 850 (2d Cir. 1976) (holding that no inclusion in basis where taxpayer could not show existence of bona fide debt); Gibson Products Co. v. United States, 460 F. Supp. 1109, 1115, & n.8 (N.D. Tex. 1978) (collecting cases and noting that a standard similar to the all-events test would be appropriate), aff'd, 637 F.2d 1041 (5th Cir. 1981); Newton Insert Co., 61 T.C. at 588; Inter-City Television Film Corp. v. Commissioner, 43 T.C. 270, 287 (1964) (stating that film buyer's obligation to pay $1.25 million to seller only after gross receipts reached $2.4 million was not includible in film's basis before gross receipts reached that level); Columbus & Greenville Ry. v. Commissioner, 42 T.C. 834, 849 (1964) (holding that mortgage was not includible in basis where amount was negotiable), aff'd per curiam, 368 F.2d 294 (5th Cir.), cert. denied, 385 F.2d 827 (1966); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963) (holding that obligation to provide severance pay to unionized employees if they received inadequate notice of plant closing was too
another case, an accrual method taxpayer purchasing a customer list was allowed to deduct each annual contingent payment that was based on sales to those customers during the year in question, but the final lump sum payment made in the fourth year was required to be capitalized and depreciated over the list’s remaining useful life, commencing in the fourth year.\textsuperscript{184} This lump sum could not be added to basis during the first year because the amount was contingent on the third year’s sales, and it could not be deducted in full during the fourth year, presumably because the sum reflected the purchaser’s cost of using the list over its entire remaining useful life, not simply the cost during the fourth year.\textsuperscript{185}

In summary, before Transamerica, it was uniformly recognized that where a contingent liability was expressed by a formula that calculated total debt using revenues generated in future years (e.g., a royalty), the buyer could deduct as depreciation in each taxable year only the amount of the purchase price actually paid or accrued during that year but could not add any still-speculative amounts to basis. This rule is simply one application of the general rule illustrated by the cases cited by the District Court and the dissent in Transamerica: contingent liabilities cannot be included in depreciable basis.

The result in Transamerica cannot be reconciled with these authorities. The residuals and profit participations paid by UA in each year represented a cost of exploiting the related films in that year alone. Whether these payments are viewed as giving rise to depreciation deductions or current expense deductions, the amounts should be deductible only during the year in which they are paid or are payable. UA used accrual accounting;

speculative to be included in basis), aff’d per curiam, 333 F.2d 653 (2d Cir. 1964); Redford v. Commissioner, 28 T.C. 773, 777-78 (1957) (concluding that liability contingent on debtor’s future profits must be excluded from cost basis); see also, Daniel Shaviro, Risk & Accrual: The Tax Treatment of Nonrecourse Debt, 44 Tax L. Rev. 401, 441 (1989).

\textsuperscript{184} Holden Fuel Oil Co., 479 F.2d 613.

\textsuperscript{185} Id. at 616. (noting that in fourth year and thereafter, “the total contract price having been determined, petitioner must return to the traditional method of depreciation, amortizing . . . the remaining unpaid cost of the list over its 12-year remaining useful life.”). This appears to be the proper rule whenever a contingent payment does not relate solely to a single year. For example, if a lump sum liability is fixed in amount but does not accrue until revenues reach a designated level, the amount payable should be added to basis and spread over the remaining useful life of the acquired asset. Cf. Inter-City Television Film Corp., 43 T.C. at 287.
therefore, its contingent obligation to distribute gross receipts or net profits became fixed only when the triggering revenues were earned.\footnote{\textsuperscript{106}}

The Ninth Circuit upheld UA’s accounting method because it resulted in “spreading the costs of production evenly over the flow of income.”\footnote{\textsuperscript{107}} This proration led the court to conclude that the contingent debts could be included in depreciable basis before accrual rather than “deducted as expenses when they become due and payable.”\footnote{\textsuperscript{108}} As the court stated, including such contingent debts in basis has the effect of spreading them ratably over the asset’s entire income stream; however, many of the participations and residuals at issue in Transamerica did not accrue in this ratable fashion. As Judge Hall observed, they instead tended to accrue in larger amounts later in the film’s useful life, whereas the proration method caused them to be deducted in large amounts early in the film’s useful life. The effect of the “ratable” spreading of these expenses under the income forecast formula was to understate taxable income in the early years by inflating depreciation deductions and to overstate income commensurately in the later years. The same is true of many, if not most, participations, residuals, and reuse payments today; much of this contingent debt accrues more slowly than gross revenues, even when it is measured in some respect by those revenues. As a result, allocating the debt-based depreciation ratably over the stream of gross revenues tends to inflate depreciation deductions in the early years.

\section*{C. The Timing of Deductions for Contingent Liabilities}

Although the Ninth Circuit recognized that a typical net profits liability does not accrue until the film reaches some designated break-even point,\footnote{\textsuperscript{109}} it disregarded the time value of the accelerated deductions, stating that “[t]he only way there could be an overstated amount of participations and residuals is

\footnote{\textsuperscript{106} Thus, for a cash method taxpayer, the results under the Associated Patentees approach will usually be the same as under I.R.C. § 404, which forces most taxpayers into the cash method for deducting nonqualified deferred compensation. See supra notes 42-54 and accompanying text.}
\footnote{\textsuperscript{107} Transamerica, 999 F.2d at 1366.}
\footnote{\textsuperscript{108} Id.}
\footnote{\textsuperscript{109} See infra note 112.}
if the projected lifetime net income is overstated.\textsuperscript{10} This result, the court observed, was precluded by the taxpayer's use of the income forecast formula.\textsuperscript{11} The timing factor disregarded by the majority, however, can be substantial. A taxpayer enjoys a tremendous timing advantage if a liability that does not begin to accrue until the fifth year of a film's exploitation can be deducted in substantial part during the first four years. Although in less extreme cases, some portion of the liability may become fixed during each year of the film's exploitation, exactly how much becomes fixed during a given year depends on the nature of the participation and the revenues generated (and, in many cases, the expenses incurred) during the year. In addition to net profits participations such as those discussed in \textit{Transamerica},\textsuperscript{12} there are a wide variety of "back-loaded"

\textsuperscript{10} \textit{Transamerica}, 999 F.2d at 1369.

\textsuperscript{11} Id.

\textsuperscript{12} Id. The court's description of how "net profits" are determined is overgeneralized, as the determination depends entirely on the contract between the parties. See infra notes 115, 123. For example, although the Ninth Circuit defined net profits as the excess of revenues over "pre-release" production costs, 999 F.2d at 1366 n.2, post-release expenses can also reduce net profits. These expenses include distribution fees and expenses, prints and advertising, and gross receipts participations. See Baumgarten et al., supra note 12, at 57-64. It is possible that the court has accurately described the arrangement made by UA in the instant case, although the court does not quote any contractual language that would support this conclusion, and the economic consequences of this particular contract should not be generalized into a rule for uniform tax consequences for all payments labeled as "net profits."

Net profits, in most cases, remain speculative longer than gross receipts. Net profits will never be paid if revenues do not exceed expenses, as is frequently the case with studio-released films. Steven D. Sills & Ivan L. Axelrod, Profit Participation in the Motion Picture Industry, 12 L.A. Law. 31 (April 1989) (stating that fewer than 5% of standard studio deals produce net profits to participants); Arts, Boston Herald, June 19, 1995, at 30 (noting that after grossing over $800 million worldwide, "Forrest Gump" was still $62 million in the red); Leonard Klady, Outtakes: Ruthless Money, L.A. Times, July 26, 1987, at 23 (reporting that "Ruthless People" still showed $11 million deficit as of July 1987, although it had already grossed $90 million); Hillary Sue Bibicoff, Net Profit Participations in the Motion Picture Industry, 11 Loy. Ent. L.J. 23, 23-24 (1991) (stating that "Rain Man" showed loss exceeding $25 million as of May 1989, although it had grossed more than $300 million); Leonard Klady, Outtakes: The Color of Bunny, L.A. Times, January 15, 1989, at 31 (noting that "Who Framed Roger Rabbit" had grossed $150 million by January 1989 but was still showing a loss); Adam J. Marcus, Buchwald v. Paramount Pictures Corp. and the Future of Net Profit, 9 Cardozo Arts & Ent. L.J. 545, 547 (1991) (stating that "Coming to America" had grossed over $160 million but still showed loss of $18 million); Dennis McDougal, Paramount's Net Profit Central to Buchwald Suit, L.A. Times, March 23, 1990, at F1 (stating that, by March of 1990, gross receipts of "Coming to America" reached $250 million but loss was still $17 million); John Richardson, Inside the Business of Hollywood: Moguls, Movies, and Money, Premiere, June 1992, at 24 (stating that "Coming to America" had grossed over $350 million but still showed no profit); Dennis McDougal, A Blockbuster Deficit, L.A. Times,
contingent compensation arrangements (variously described as "gross receipts" participations, "gross revenues" participations, residuals, and reuse payments) that do not accrue ratably as gross revenues are received.\textsuperscript{113} Under Transamerica, however, March 21, 1991, at F1 (noting that "Batman" grossed over $250 million as of March 1991 but still showed almost $36 million deficit).

\textsuperscript{113} The Transamerica majority clearly assumed (with the government's tacit consent) that, in contrast to "net profits" participations, residuals and participations that are "based on gross revenues" always accrue ratably as a film generates revenues. In a footnote, the court noted that:

When participations and residuals are based on gross revenue, their treatment as ordinary expenses or depreciation would make no practical difference because they would become due and payable as the annual gross revenue is received. The Government agrees that they would become accrued expenses properly deductible even though paid in a subsequent year. Thus, whether these costs are deducted as ordinary expenses or as depreciation makes no practical difference when they are based upon gross revenue. It is when the [deferred payments are based on some notion of net profits that the distinction arises because they do not become contractually due and payable until the pre-release costs of production have been recovered, that is, until the cumulative net revenue exceeds the pre-release costs, resulting in profit.

Transamerica, 999 F.2d at 1386 n.2. Evidently, the court was considering only a gross receipts participation which accrues dollar-for-dollar as gross revenues are earned. This may have accurately described the gross receipts participations in UA's contracts, although the court does not say so, and, indeed, during the taxable years at issue in Transamerica, this may have been the only kind of gross receipts participation that was in use. Today, however, gross receipts participations come in many varieties. Many of these begin to accrue only after a designated trigger point is reached, such as the "break even" point (in which case the gross receipts participation may be as speculative as a net profits participation), or else a designated level of gross receipts or recoupment of specified costs. Robert Kolker, Drafting Film Development Agreements; Studio Deals, 7 Ent. L. & F. 1, 6 (May 1994) (revealing how even gross receipts participants frequently must wait until film's designated "break-even" point is reached); Baumgarten et al., supra note 12, at 65-67 (discussing different kinds of gross receipts participations).

Alternatively, a participant's gross receipts percentage may change as gross receipts reach specified levels; if the percent increases, then the Transamerica approach again offers a timing advantage by allowing the taxpayer to deduct liabilities ratably with the film's revenues even though the liabilities do not accrue ratably.

Although residuals are typically based on a percentage of the distributor's gross receipts from a particular medium of exploitation, the percentage may increase progressively as the gross receipts reach specified levels. See Robert Kolker, A Guide to Residuals for Talent, 9 Ent. L. & F. 1, 4-5 (July 1994) (stating that, under SAG agreements, mandatory home video residuals increase from 4.5% to 5.4% after video earns $1 million in accountable receipts; WGA and DGA agreements are similarly constructed); Id. at 6 (noting that residuals beyond guild minimums are negotiable). In addition, residuals are often "back-loaded" in another sense: because of contractually-required holdbacks, exploitation in a particular medium (television, for example) often does not commence for one or more years after the license has been negotiated, in order to avoid competing with a previously licensed medium (such as movie theatres). See Baumgarten et al., supra note 12, at 152-53 (describing holdbacks to six months to several years). This delays the accrual of the residuals that are based on the gross receipts from the second medium, yet under Transamerica the projected residuals can be included in the income forecast formula as soon as the television license has been negotiated.
all of these amounts may be included in basis under the income forecast formula, with the result that they may be deducted in large part well before they are paid or become payable.

The Ninth Circuit failed to recognize that, while UA's method of accounting for its anticipated participations and residuals had the effect of spreading these estimated liabilities ratably according to the film's revenues, the result of this method was inappropriate whenever the debts accrued more slowly than the revenues. Under UA's approach, any factor that delays the accrual of contingent liabilities will cause the income forecast calculation to accelerate a portion of these deductions ahead of the date on which they accrue. By allowing the deduction before the accrual, this method violates the general rule that excludes unaccrued liabilities from basis. In addition, by allowing a cash method taxpayer a deduction before the expense has been paid, this method also violates the specific rule of Associated Patentees and its progeny, which treat a cash method taxpayer's royalty-type capital expenditures as deductible only when paid.

The acceleration that results under the Transamerica approach can be illustrated by the following simplified example: Suppose a film has a pre-release cost of $20 million and projected revenues (net of distribution fees and expenses, other than participations and residuals) of $60 million based on conditions existing at the end of the first year of the film's release. In addition, suppose that the producer has agreed to

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The labeling of a liability as a "gross receipts" or "net profits" participation, or as a "residual" or "reuse" payment does not matter for tax purposes. What does matter is the economic reality of when the liability is sufficiently fixed to be included in basis and whether including the liability in depreciable basis before it accrues will have the effect of distorting the taxpayer's income. Of all the types of contingent liabilities discussed here, only a "first-dollar" gross receipts participation with no holdback, no change in percentage, no cut-off point, and no restriction as to the medium or market in which the revenues are generated, will produce the result assumed by the appellate court: spreading the liability evenly over the flow of income.

It is also worth noting that the court's suggestion, in the above-quoted passage, that the distinction between ordinary expenses and depreciation deductions makes no practical difference, is not entirely correct. If the costs in question represent depreciation deductions rather than expense deductions, then a larger amount of recapture may occur under I.R.C. § 1245 if the asset is subsequently sold or exchanged for a gain. See Newton Insert Co., 61 T.C. at 586-89. See supra notes 92, 89. Also, until the repeal of the investment tax credit for motion pictures, treating deferred payments as a cost of production increased a taxpayer's basis for purposes of the credit. See G.C.M. 36,590, supra note 61.
pay out participations equaling 30% of the film's net profits,\(^{114}\) defined as the excess of gross receipts over pre-release costs.\(^{115}\) The anticipated net profit participations for this film would, therefore, total 30% of $40 million, or $12 million. Assume, for simplicity, that the initial gross receipts projection proves accurate, and the film's salvage value is correctly projected as zero. Finally, assume that the film's $60 million in gross receipts are earned over five consecutive years as follows:

| Year 1: | $25 million |
| Year 2: | $15 million |
| Year 3: | $10 million |
| Year 4: | $7 million |
| Year 5: | $3 million |

Using the method approved in *Transamerica*, the taxpayer in this example would add the projected $12 million in net profit participations to the pre-release costs of $20 million for a total basis of $32 million. Under the government's approach, however, the total basis would be $20 million.

As noted earlier,\(^{116}\) under Revenue Ruling 60-358, the income forecast fraction is based on the net revenues generated by the depreciable asset. In the case of a film, this means the revenues that remain after subtracting distribution costs.\(^{117}\) Unfortunately, the opinions and briefs in *Transamerica* reveal some confusion over whether the parties treated the participations and residuals themselves as distribution expenses and subtracted them in calculating the "net revenues" included

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\(^{114}\) This example assumes that the profit participations are paid out in the same taxable year in which they accrue, so that the calculations are the same for cash and accrual method taxpayers. If the taxpayer used the cash method and did not pay out the participations in the same taxable year that they accrued, the taxpayer would enjoy an even greater acceleration of deductions under the *Transamerica* method as compared with the *Associated Patentees* method. *Associated Patentees* v. Commissioner, 4 T.C. 979 (1945); see cases cited supra notes 94-105 and accompanying text.

\(^{115}\) This definition is used here for simplicity. The net profits definitions commonly used in the film industry are notoriously complex, may vary considerably from one contract to another, and are often designed to postpone and/or minimize net profits. See, e.g., Buchwald v. Paramount, 90 D.A.R. 14482 (Dec. 26, 1990); Jeremy Nussbaum, "There is no Net": Profit Participation Agreements in the Motion Picture Industry, 3 Ent. L. Rev. 79 (1994); see supra note 112.

\(^{116}\) See supra notes 7-13 (discussing Rev. Rul. 60-358).

\(^{117}\) See supra note 9.
in the numerator and denominator of the income forecast fraction.\textsuperscript{118} It appears that UA's position was that these contingent amounts should be both subtracted in calculating net revenues and added to basis. The government's position clearly prohibits adding them to basis, but it is not clear whether the government would allow them to be subtracted in calculating net revenues for purposes of the income forecast fraction (although it does allow their deduction against income once they are paid or accrued).\textsuperscript{119} Accordingly, this example considers four possibilities: Table I assumes that participations are not subtracted from revenues but are added to basis; Table II assumes that participations are neither subtracted from revenues nor added to basis (but are still deducted when paid or accrued); Table III assumes that participations are subtracted from revenues but are not added to basis; and Table IV assumes that participations are subtracted from revenues, and added to basis.

\textbf{TABLE I}
\textbf{($\$ \text{ in millions}$)}

<table>
<thead>
<tr>
<th>(a) Taxable Year</th>
<th>(b) Income Forecast Fraction</th>
<th>(c) Basis</th>
<th>(d) Total Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>25/60</td>
<td>$32</td>
<td>$13.33</td>
</tr>
<tr>
<td>Year 2</td>
<td>15/60</td>
<td>32</td>
<td>8.00</td>
</tr>
<tr>
<td>Year 3</td>
<td>10/60</td>
<td>32</td>
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</tr>
<tr>
<td>Year 4</td>
<td>7/60</td>
<td>32</td>
<td>3.73</td>
</tr>
<tr>
<td>Year 5</td>
<td>3/60</td>
<td>32</td>
<td>1.60</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>$32</td>
<td>$32.00</td>
</tr>
</tbody>
</table>

\textit{TOTAL DEDUCTIONS = $32 million}

\textsuperscript{118} Compare Transamerica, 999 F.2d at 1366-67, 1369 (indicating that the participations and residuals were not subtracted in calculating net revenues) with 670 F.Supp. at 1457 & nn.2-3 (implying the contrary); see also Cameron W. Wolfe, Jr., Projected Costs Included in Calculating Depreciation Based on Projected Income, 80 J. Tax'n 104, 109 (Feb. 1994); Brief for the Appellee, Transamerica, 999 F.2d 1362 (9th Cir. 1993), at 36, 44-45.

\textsuperscript{119} Transamerica, 999 F.2d at 1366 n.2.
TABLE II  
($ in millions)

<table>
<thead>
<tr>
<th>(a) Taxable Year</th>
<th>(b) Income Forecast Fraction</th>
<th>(c) Basis</th>
<th>(d) Depreciation Deduction Before Participations</th>
<th>(e) Participations Paid or Payable ¹²⁰</th>
<th>(f) Total Deductions (d)+ (e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>25/60</td>
<td>$20</td>
<td>$8.33</td>
<td>$1.5</td>
<td>$9.83</td>
</tr>
<tr>
<td>Year 2</td>
<td>15/60</td>
<td>20</td>
<td>5.00</td>
<td>4.5</td>
<td>9.50</td>
</tr>
<tr>
<td>Year 3</td>
<td>10/60</td>
<td>20</td>
<td>3.33</td>
<td>3.0</td>
<td>6.33</td>
</tr>
<tr>
<td>Year 4</td>
<td>7/60</td>
<td>20</td>
<td>2.33</td>
<td>2.1</td>
<td>4.43</td>
</tr>
<tr>
<td>Year 5</td>
<td>3/60</td>
<td>20</td>
<td>1.00</td>
<td>0.9</td>
<td>1.90</td>
</tr>
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<td>$12.0</td>
<td>$32.00</td>
</tr>
</tbody>
</table>

TOTAL DEDUCTIONS = $32 million

In Table II, the taxpayer uses the same income forecast fraction as in column (b) of Table I, but this is multiplied by a basis of only $20 million because anticipated net profit participations are excluded from basis. This results in a lower preliminary figure for depreciation (compare column (d) of Table II with column (d) of Table I). Added to this, however, would be the actual amount of any participations that are paid or payable in that year. Because the film has only $5 million of net profits in the first year of release, only 30% of that amount —$1.5 million—would be paid out to participants in that year (column (e) of Table II). In Years 2 through 5, however, the film has already earned back its pre-release costs, and the entire amount of net revenues in each of those years represents net profits. Therefore, the net profit payouts will represent a larger portion of the film’s net revenues in those years.

In both cases, the cumulative depreciation over the useful life of the property is the same, but the timing of the deductions is different. The taxpayer using the Table I method receives larger deductions in the early years ¹²¹ because the film earned

¹²⁰ The court in Associated Patentees considered these deductions to be a “reasonable allowance” for depreciation. 4 T.C. 979, 986 (1945). Arguably, however, these deductions be viewed as a I.R.C. § 162 expense. See supra notes 86-94 and accompanying text.

¹²¹ The district court in Transamerica offered the following real life example: UA deducted approximately $3.6 million in depreciation for the film “Thunderbolt and Lightfoot” in 1974, its first year of release, by including participations and residuals in basis. Under the government's method, the court observed only about $2.4 million could have been deducted. Transamerica, 670 F.Supp. at 1458-59.
almost 42% of its total gross receipts in the first year ($25 million) but less than 13% of its net profits. This timing difference would be even more significant if, as often occurs, the film did not generate any net profits in the first year of release, so that no net profit participations accrued during the first year.

12 First year gross receipts were $25 million, which is 41.6% of the lifetime gross receipts of $60 million. First year net profits were $5 million, which is 12.5% of the lifetime net profits of $40 million. (The same numbers would result from comparing a first dollar gross participation with a net profits participation. In this example, 41.6% of the first dollar gross participations would accrue during the first year, but only 12.5% of the net profit participations would accrue that year.) The Transamerica approach would allow the taxpayer to deduct 41.6% of its liabilities from net profit participations ($13.33 million divided by $32 million, using the figures in Table I) in a year in which only 12.5% of those liabilities accrued.

12 Many studio-released films never reach net profits. When a film does reach net profits, it generally does so one or more taxable years after the film is placed in service. See generally Kolker, supra note 113, at 6-7 (stating that net profit participants typically must wait an extended period of time or indefinitely for payment; producers sometimes receive deferred guaranteed payments at different stages of gross receipts or may receive a percentage of gross receipts after a trigger point other than break-even); David Poland, Prints, Points and Profits: Money Trail Reveals Where Power Lies in the Film Business, Chi. Trib., Jan. 30, 1994, at C18 (demonstrating how a film with gross participants might have to gross more than $160 million before reaching net profits, even with a production budget of $28 million); see supra notes 112, 115.

It is possible for a film to reach net profits, however, especially when there are no gross participations. See generally David Robb, “Batman” Trial’s First Round Goes to Warner Bros.; Judge Rules Exec’s Deal Was Not Unconscionable, Hollywood Rep., Dec. 9, 1993 (explaining that Warner Bros. has paid out over a quarter of a billion dollars in net profit participations on films produced between 1970 and 1985, although gross participations kept “Batman” in deficit even after it grossed $300 million); David Robb, Net Profits: One Man’s View From Both Sides, Hollywood Rep., Aug. 31, 1992 (showing that gross participations do not always wipe out net profits). Net profits are more likely to be realized where a film is independently financed and/or distributed. See John W. Cones, Maximizing Producers’ Negative Pick-Up Profits, Ent. L. & Fin. 1, 6 (June 1992) (outlining strategies for maximizing net profits through negative pick-ups); Trisha Curran, Financing Your Film 26-37 (Praeger 1986) (comparing standard studio distribution deals with alternatives).

Even the simple hypothetical used by the Ninth Circuit assumes that the film does not break even until the end of its second year. In that example, the court assumes a four-year useful life, projected revenues of $1,200,000 spread evenly (albeit unrealistically) over that four-year period, pre-release cost of $600,000, and liabilities for participations and residuals adding up to 33 1/3% of the $600,000 profit. Thus, total production costs equal $800,000. Transamerica, 999 F.2d at 1369-70.

The court’s own calculation based on these simple numbers shows that the Transamerica method produces faster cost recovery ($200,000 of depreciation in each year, versus the government’s method which, by denying any deductions for participations and residuals in the first two years of release, yields $150,000 in each of the first two years and $250,000 in each of the last two). The court concludes, however, that the faster recovery better reflects the flow of income, apparently because the calculation produces equal depreciation deductions each year, just as the taxpayer in the example receives equal revenues each year. Id. at 1370. The court finds it irrelevant that net profit participations (as well as many gross receipts participations and other
Tables III and IV make a comparison similar to that of Tables I and II, but assume that participations are subtracted in calculating net revenues for the purposes of the income forecast fraction. Once again, the inclusion of participations in basis in Table IV leads to a larger overall deduction in Year 1:

**Table III**

<table>
<thead>
<tr>
<th>(a) Taxable Year</th>
<th>(b) Net Revenues</th>
<th>(c) Participations Paid or Payable</th>
<th>(d) Income Forecast Fraction</th>
<th>(e) Basis</th>
<th>(f) Income Forecast Depreciation Deduction</th>
<th>(g) Total Deductions (c) + (f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$23.5</td>
<td>$1.5</td>
<td>23.5/48</td>
<td>$20</td>
<td>$9.79</td>
<td>$11.29</td>
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<tr>
<td>2</td>
<td>10.5</td>
<td>4.5</td>
<td>10.5/48</td>
<td>20</td>
<td>4.38</td>
<td>8.88</td>
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<td>3</td>
<td>7.0</td>
<td>3.0</td>
<td>7.0/48</td>
<td>20</td>
<td>2.92</td>
<td>5.92</td>
</tr>
<tr>
<td>4</td>
<td>4.9</td>
<td>2.1</td>
<td>4.9/48</td>
<td>20</td>
<td>2.04</td>
<td>4.14</td>
</tr>
<tr>
<td>5</td>
<td>2.1</td>
<td>0.9</td>
<td>2.1/48</td>
<td>20</td>
<td>0.88</td>
<td>1.78</td>
</tr>
<tr>
<td>TOTAL</td>
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<td>$12.0</td>
<td>$20</td>
<td>$20.00</td>
<td>$32.00</td>
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</tr>
</tbody>
</table>

TOTAL DEDUCTIONS = $ 32 million

**Table IV**

<table>
<thead>
<tr>
<th>(a) Taxable Year</th>
<th>(b) Net Revenues</th>
<th>(c) Participations Paid or Payable</th>
<th>(d) Income Forecast Fraction</th>
<th>(e) Basis</th>
<th>(f) Income Forecast Depreciation Deduction</th>
</tr>
</thead>
<tbody>
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<td>23.5/48</td>
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<td>4.5</td>
<td>10.5/48</td>
<td>32</td>
<td>7.00</td>
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<td>7.0</td>
<td>3.0</td>
<td>7.0/48</td>
<td>32</td>
<td>4.67</td>
</tr>
<tr>
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<td>4.9</td>
<td>2.1</td>
<td>4.9/48</td>
<td>32</td>
<td>3.27</td>
</tr>
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<td>2.1/48</td>
<td>32</td>
<td>1.40</td>
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<tr>
<td>TOTAL</td>
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<td>$12.0</td>
<td>$32</td>
<td></td>
<td>$32.00</td>
</tr>
</tbody>
</table>

TOTAL DEDUCTIONS = $32 million

Deferred payments do not become payable ratably as revenues accrue but only after a film has broken even or reached some other contractual trigger point. Id. at 1367. In the court's own example, the participations and residuals are both tied to net profits rather than gross receipts. Id. Thus, there is no reason to spread the deductions for net profit participations ratably over the entire gross revenue stream.
Of the four possibilities presented, the result most favorable to the taxpayer seeking to frontload deductions is that of Table IV. Table I represents the second most favorable result. Thus, adding the participations to basis clearly increases deductions in Year 1. This effect is heightened in Table IV, where net revenues are determined after subtracting participations and residuals (along with other distribution-related costs). Although the opinions in Transamerica do not clearly indicate whether UA employed the Table I or Table IV method, the government’s brief characterized it as the Table IV method.124

Despite being favorable to the taxpayer, the Table IV method is clearly incorrect because it counts the $12 million in participations twice by treating this amount as both an offset in calculating net revenues and as a component of basis. Thus, Table IV treats this amount as a distribution expense for one purpose and as a production cost for another purpose.

Even if the extreme result of Table IV is disregarded, adding the $12 million to basis always produces a higher deduction in Year 1. The Year 1 deduction in Table I is greater than the Year 1 deduction achieved in both Tables II and III. As between the latter two, the Table III method is a sounder approach if participations and residuals are recognized as true distribution expenses under section 162 of the Code. However, if these are characterized as depreciation deductions, then, arguably, Table II is the more appropriate method.125

In general, the longer it takes for contingent liabilities to accrue, the greater will be the distorting effect of the Transamerica method. Thus, where accrual of contingent liabilities is postponed until Year 3, the Transamerica approach (Table I or IV) can lead to inflated depreciation deductions in

124 Brief for Appellee, at 36, Transamerica Corp. v. United States, 999 F.2d 1362, (9th Cir. 1993) (No. 90-16674). The taxpayer’s counsel implicitly refuted this characterization in a subsequent article. Wolfe, supra note 118, at 109. The government’s brief acknowledges that these amounts may be subtracted in calculating the income forecast denominator, without mentioning any effect on the numerator. This definition of “net revenues,” however, should be the same for both the numerator and denominator. It would be improper for the government to ignore these amounts in calculating the numerator. Brief for Appellee, Transamerica, 999 F.2d 1362, at 36-37.

125 In a subsequent article, the taxpayer’s counsel characterized the government’s position as corresponding with the Table II method. Wolfe, supra note 118, at 109.
both Year 1 and Year 2.\textsuperscript{126} This distortion is not limited to the net profits scenario; it will result from any factor that "backloads" a revenue-based liability so that the liability does not accrue ratably as the revenues are earned.\textsuperscript{127} Thus, whenever the deferred contingent payment is based on a back loaded figure such as net profits or the gross proceeds after a specified trigger (such as a designated level of gross receipts), the distortion caused by the Transamerica approach will favor the taxpayer by allowing a portion of that expense to be deducted before it is paid or accrued.

IV. CONCLUSION

The deferred compensation rules of section 404 of the Code are more stringent than either the rule adopted in Transamerica for taxpayers using the income forecast method or the rule consistently embraced by courts following Associated Patentees in cases involving royalties. Whereas section 404 of the Code makes payment a prerequisite to taking a deduction, both of these cases allow some deferred payments to be deducted before they are actually paid. Of the two, the Transamerica approach is the more generous because it allows taxpayers who employ the income forecast method of depreciation to deduct a portion of their contingent liabilities before accrual, even though such a timing benefit would be unavailable to a similarly situated taxpayer using the straight-

\textsuperscript{126} A variation on the preceding example can illustrate this effect. Suppose that rather than paying out 30\% of net profits, the producer had agreed to pay out 60\% of any net profits \textit{beyond} the first $20 million of net profits (in other words, after $40 million in revenues less distribution costs). The total participations payable are still $12 million. In that case, the results under the Table I and Table IV approaches do not change; even though the liabilities do not accrue until Year 3, this deferral has no effect on the timing or amount of the taxpayer's depreciation deduction. In contrast, under the Table II approach, $3.33 million is deductible in Year 1 and $5 million in Year 2 (because the income forecast fractions for those years are now 25/48 and 14/48, respectively.). Under the Table III approach, the figures are $10.42 million in Year 1 and $6.25 million in Year 2. Thus, Table I deductions ($13.33 million and $8 million) now exceed Table II deductions for both Year 1 and Year 2, and Table IV deductions ($15.67 million and $7 million) exceed Table III deductions for both years as well.

\textsuperscript{127} See supra notes 112-13. Although net profit participations are by definition backloaded because they are not payable until the film is in profits (however "profits" is defined), other provisions in the net profits agreement can magnify the backloading—\textit{e.g.}, an escalation clause which increases a net profit participant's percentage once the film reaches a certain level of gross receipts (or net profits).
line method of depreciation. In contrast, the Associated Patentees line of cases postpones depreciation deductions for contingent liabilities until either payment or accrual (depending on the taxpayer's method of accounting) without regard to the particular depreciation method employed. Although this approach offers cash method taxpayers no advantage over section 404 of the Code, it offers accrual method taxpayers a timing benefit unavailable under section 404 of the Code. Where a deferred payment is fixed rather than contingent, both Transamerica and Associated Patentees allow accrual method taxpayers to add the payment to depreciable basis at the time the liability is incurred. In contrast, under section 404 of the Code, payment is a prerequisite to depreciating even a fixed liability, provided that it constitutes deferred compensation for services.

One might argue that residuals and participations in the entertainment industry should be exempt from section 404 of the Code because one of Congress' reasons for imposing the timing rules of this section on payors of deferred compensation was to encourage the use of tax-qualified pension plans, and this rationale has little relevance when the receivers of participations and residuals either are not eligible for a qualified plan or already participate in such a plan (for example, through their unions). When enacting section 404 of the Code, however, Congress did not carve out an exemption for the entertainment industry, nor did it authorize the Treasury to do so on its own initiative. Indeed, there may be other industries with equally compelling arguments for exemption. In addition, the matching principle that provides the second rationale for section 404 of the Code—eliminating the revenue losses that occur when compensation it is deducted before the recipient recognizes the income—suggests that no industry-specific exemptions are warranted.

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128 Nor does it appear likely that enforcement of this timing rule would drive entertainment industry employers to restructure their labor relationships and to place more workers in qualified plans. See supra note 49.

129 Non-qualified deferred compensation arrangements in the entertainment industry are common, and their popularity will probably continue. See, e.g., Richard K. Rosenberg, Deferred Financing on the Rise in Film Deals, Ent. L. & Fin. 1 (May 1992).
To the extent that section 404 of the Code is inapplicable to certain participations and residuals, Congress and the courts will need to address the merits of the Transamerica decision. As indicated by the analysis set forth in Part III of this article, the Transamerica decision should be overruled because it conflicts with well-settled tax accounting principles governing contingent liabilities and requiring the matching of income and expense to produce a clear reflection of income.

The rationale of Transamerica has the following logical consequence, which is surely unacceptable to entertainment industry taxpayers. The argument that prevailed in Transamerica was that, under the income forecast method, residuals and participations are sufficiently determinable to be included in basis during the first year of a film’s useful life because they are based upon a predictable stream of revenues. For an accrual method taxpayer, however, the logical corollary of this argument is that, if the liabilities based on a film’s anticipated lifetime revenue stream are sufficiently fixed and determinable to be treated as accrued during the first year of a film’s useful life, then the lifetime revenue stream upon which those liabilities are based must also be sufficiently fixed and determinable to be entirely included in the taxpayer’s gross income for that year. It is unlikely that accrual method taxpayers would be willing to accept this consequence as the price of including contingent liabilities in their depreciable basis. Unless the “all events” test is interpreted to require recognition by accrual-method taxpayers of all projected income from a film at the time the film is first placed in service, it cannot be said that the liabilities arising from the projected income stream become fixed at that time. Rather, liabilities become fixed commensurately with the income from which they are calculated. That fixation occurs as the services or property are being exploited by the taxpayer, as it is the exploitation that gives rise to the obligation to pay and makes it possible to determine the amount of the obligation.

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130 See supra note 30.
131 The same conclusion follows from the economic performance rules added to I.R.C. § 461 of the Code in 1984. Tax Reform Act of 1984, Pub. L. No. 98-369, § 91, 98 Stat. 494, 598. Under these rules, a liability to pay for services or for the use of property cannot accrue until economic performance occurs. Economic performance occurs as the services are
Thus, in a case involving contingent debt that is not subject to section 404 of the Code, the Transamerica approach should be rejected in favor of the familiar rule requiring a matching of income with related expenses: A cost of earning income during a single taxable year should be deductible in full during that year, and it should not be deducted in whole or in part against income earned in any other taxable year.\(^{132}\)

To prevent the revenue distortions caused by the deduction of unpaid participations and residuals, it is incumbent on the Treasury to begin applying section 404 of the Code to these amounts whenever they represent deferred compensation for personal services. At the same time, Congress, the Treasury and the courts must recognize the importance of overruling Transamerica. Until both of these events occur, the entertainment industry will continue to enjoy a de facto exemption from the tax rules that other taxpayers have long been required to observe.

\(^{132}\) It is not necessary, for this purpose, to decide whether such an expense is a “production” cost or a “distribution” cost, although such a determination may eventually be necessary to determine whether the deduction will give rise to recapture income when taxpayer disposes of the asset. In addition, if future legislation revives the motion picture ITC, it may again become necessary to determine whether to consider such expenses in calculating the credit. See supra notes 86, 88-89 & 113 (discussing recapture and ITC issues). Although these issues are important, their resolution does not affect the basic tax accounting question presented by Transamerica.