Revenue Ruling 78-28

Depreciation; "income forecast" method. Payments earned by a limited partnership and not included in the partnership's gross income are not includable in the numerator of the fraction used under the "income forecast" method to compute allowable depreciation of the cost of a motion picture. Further, the denominator in the fraction cannot be less than the amount of the nonrecourse loan secured by the property.

Advice has been requested, under the circumstances described below, regarding the computation of depreciation of films using the income forecast method provided in Rev. Rul. 60-358, 1960-2 C.B. 68, as amplified by Rev. Rul. 64-273, 1964-2 C.B. 62.

P is a limited partnership formed under the laws of state M to acquire screenplays and rights to stories suitable for motion picture and television films and to produce such films. P uses the cash receipts and disbursements method of accounting provided in section 446 (a) of the Internal Revenue Code of 1954 and has adopted the calendar year as its taxable year.

In June 1976, P entered into a contract with corporation N, an independent distributor of motion picture films, to distribute a film produced by P in 1975. The total cost of the production of the film was 100x dollars of which 60x dollars was paid out of capital contributions from the partners of P and 40x dollars was paid out of the proceeds of a loan from X to P. The loan from X to P bears interest at the rate of 8 percent, was made without personal liability to P, and is secured by a pledge of all of the revenues from exploitation of the film until the loan is satisfied. N has guaranteed the repayment of the loan if the revenues from the film are not sufficient. The fair market value of the completed film is more than 40x dollars. P, N, and X are unrelated and N is not an agent of P. Under terms of the distribution contract, P will receive a percentage of the gross receipts from the distribution of the film less specified expenses. N will submit quarterly statements to P showing rental billings, collections and expenses, and P's share of gross receipts. Quarterly statements will be furnished to P within 90 days after the close of the quarter together with any amounts due P under the terms of the distribution contract.

The question presented is whether, under the income forecast method, P can include as income in the numerator of the fraction used to compute allowable depreciation on the film for 1976, payments to which P is entitled as evidenced in quarterly statements from N, but which have not been received by P as of December 31, 1976. In computing taxable income for the year, P does not include such amounts in gross income.

Section 167 (a) of the Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade or business, or (2) of property held for the production of income.

Rev. Rul. 60-358, as amplified by Rev. Rul. 64-273, provides that in order to avoid distortion of income, depreciation of the costs of motion picture films must follow the flow of income, and that the income forecast method of computing depreciation is an acceptable method of recovering the cost of such films under section 167 (a) of the Code. The income forecast method requires the application of a fraction, the numerator of which is the income from the films for the taxable year, and the denominator of which is the forecasted or estimated total income to be derived from the films during their useful life. The term "income" for purposes of the computation is defined as income from the film less the expense of distributing the films, not including depreciation. This fraction is multiplied by the cost of the film that produced the income during the taxable year, after appropriate adjustment for salvage.

Since the reason for using the income forecast method to depreciate the cost of movie films is to minimize the distortion of income by matching depreciation deductions with income derived from assets giving rise to the deductions, income reflected in the numerator of the fraction used to compute the depreciation deduction for the tax year must reflect the same gross income used to compute taxable income from the film for the same period.

Accordingly, amounts due P from N at the end of the calendar year and not included in P's gross income for the taxable year, are not includable in the numerator of the fraction used to compute depreciation by the income forecast method provided in Rev. Rul. 60-358. In addition, in computing depreciation under the income forecast method, the denominator in the fraction (the amount of revenue anticipated to be received) cannot be less than 40x dollars, the amount of the nonrecourse loan secured by the film, since the liability to pay this loan will be satisfied either by revenues from the film or by enforcement of N's security interest. Moreover, if the denominator does not exceed the cost of the film, this fact may indicate that the original cost of the film was in excess of its true fair market value.

Further, the conclusion would be the same with respect to a sound recording, book, or other similar property depreciated under the income forecast method.