

Appeal of Harold and Joyce E. Wilson

The issue to be decided is whether **appellant** is entitled to deduct a loss generated by a depreciation deduction taken on a master recording.

Appellant is an engineer by profession. On November 5, 1977, he purchased a master recording; entitled "**Why Me Lord**" from Ray F. Burdett, a country and western singer. The purchase price of the master recording was \$36,000. Appellant paid \$3,000 in cash and executed a \$33,000 nonrecourse promissory note secured by the master recording. The note was to be paid from 50 percent of the proceeds earned from the master recording. Interest was to accrue on the note at the rate of 6 percent per annum. Any accrued interest and unpaid principal was due on or before November 5, 1982. Appellant also made a \$1,400 cash payment to Mushroom Music for "promotional expenses."

Appellant had **no prior** experience in the production or distribution of phonograph records. He did not obtain an independent appraisal before making the investment. Under the terms of the purchase agreement, appellant assumed complete responsibility for exploitation of the master recording. To date, no copies of the recording have been manufactured for distribution.

On his 1977 tax return, appellant claimed an \$8,571 depreciation deduction which respondent disallowed. Respondent contends that appellant is not entitled to the deduction because purchase of the master recording was not an activity engaged in for profit. Secondly, **respondent** argues that even if appellant had a profit motive, the amount of the nonrecourse note does not represent an actual investment in property and, therefore, cannot be included in the depreciable basis of the property.

We will deal first with the issue concerning the nonrecourse note. The basis for depreciable property is its cost. (Rev. & Tax. Code, §§ 17211, 18041, 18042.) Generally, the cost of property includes the amount of a liability assumed by the buyer. (Crane v. Commissioner, 331 U.S. 1 [91 L.Ed. 13013 (1947).]) A nonrecourse note can be included in the cost basis of an asset even if the liability is secured only by the asset transferred. (Manuel D. Mayerson, 47 T.C. 340 (1966).) However, depreciation must be based on an actual investment in property to be deductible. (David L. Narver, Jr., 75 T.C. 53 (1980), *affd. per curiam*, 670 F.2d 855 (9th Cir. 1982).) If the purchase price and the principal amount of the nonrecourse note unreasonably exceed the fair

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market value of the property, no actual investment will exist since the purchaser acquires no equity in the property by making payments. He therefore has no economic incentive to pay off the note, (Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976); Edward B. Hagar, 76 T.C. 759, 773-774 (1981).)

In Estate of Franklin v. Commissioner, supra, a limited partnership purchased a motel for \$1,224,000 and leased it back to the sellers. The purchase price was to be paid over a period of ten years by immediate payment of \$75,000 prepaid interest, by principal and interest payments of approximately \$9,000 per month, and by a balloon payment of the remaining purchase price due at the end of the ten year period. The buyers leased the motel back to the sellers for approximately \$9,000 per month so that except for the \$75,000 prepaid interest payment, no cash was to transfer between the buyers and the sellers until the balloon payment came due. The balloon payment was secured only by the motel. The taxpayers sought to deduct their distributive shares of partnership losses based on depreciation and interest deductions. The court affirmed the commissioner's disallowance of these deductions because the taxpayers failed to show that the purchase price was approximately equal to the value of the motel. The court found that this lack of proof was fatal. The court said:

An acquisition such as that of Associates if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.

No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase.

(Estate of Franklin v. Commissioner, supra, 544 F.2d at 1048-1049.)

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In David L. Narver, Jr., supra, two partnerships purchased a building at a price that was substantially in excess of the building's fair market value. The buyers put no cash down. The purchase price was to be paid in installments and the obligation to make payments was secured only by the building. The court found **that** because the purchase price was so far in excess of the value of the building, the nonrecourse indebtedness represented neither an actual investment in **property** nor genuine indebtedness. Accordingly, the partners were not entitled to deduct their distributive shares of **depreciation** on the building or interest on the indebtedness.

As can be seen from the foregoing cases, in order to show that the nonrecourse note in the present case represents an actual investment in property, appellant must establish that the fair market value of the master recording reasonably approximated **the purchase price** and the principal amount of the note.

As we noted above, appellant did not obtain an independent appraisal prior to purchasing the master recording-in 1977. Appellant submitted two letters which are dated September 18, 1979, and September 27, 1979, respectively. The first letter was written by Peter K. Thomason. Mr. Thomason states that he has worked in various aspects of the recording industry for fifteen years. **He further states that he has listened to the master recordings of "I Am the South," "Why Me Lord," "I Believe In The Sunshine," "Has the Cross Ever Really Crossed Your Mind," and "Heart To Heart" by Ray Burdett.** In Mr. Thomason's opinion, the recordings are "Hit Potential" which when placed in album form, should sell between 25,000 to 40,000 units. The second letter was written by Alan Lawler. Mr. Lawler gives no summary of his experience or credentials in the recording industry. He states without elaboration that it is his opinion that an album of the five recordings listed above should sell between 25,000 and 50,000 units.

We do not consider these two letters to be credible appraisals of appellant's master recording. Appellant's master recording is of the song "Why Me Lord." These letters purport to offer opinions on the value of four additional recordings to be placed in album form. Further, the opinions are based on vague generalities and unsupported projections. There is no reliable evidence establishing the expertise of either Mr. Thomason or Mr. Lawler. Mr. Burdett is an unknown **artist** performing unknown material. We find no evidence of value which

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supports either the \$36,000 purchase price or the \$33,000 amount of the note. We conclude that appellant has failed to carry his burden of proving that he had an actual investment in the nonrecourse note. Accordingly, the depreciation deduction attributable to the increase in basis caused by inclusion of the note was properly disallowed.

The next issue is whether appellant is entitled to deduct depreciation attributable to the cash paid for the master recording. It is respondent's position that appellant did not engage in a trade or business because he did not own the master recording with the intent to make a profit.

Revenue and Taxation Code section 17208 allows a depreciation deduction for property used in a trade or business, or property held for the production of income. Appellant deducted depreciation as an expense incurred in a trade or business. The words "trade or business" for depreciation purposes in section 17208 have been interpreted in a manner consistent with the words "trade or business" expenses as used in section 17202. (E. A. Brannen, 78 T.C. 471, 501 n. 7 (1982).) The test for determining whether an individual is carrying on a trade or business is whether the individual's primary purpose and intention in engaging in the activity is to make a profit. Whether an individual engages in an activity with the intention of making a profit is to be resolved on the basis of all the facts and circumstances. (Stanley A. Golanty, 72 T.C. 411, 425-426 (1979), affd. ~~without pub. opn.~~, 647 F.2d 170 (9th Cir. 1981).) Some of the relevant factors; derived principally from case law, which are to be considered in determining whether a profit motive exists are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. (Treas. Reg. § 1.183-2(b).)

In George T. Flowers, et al., 80 T.C. No. 49 (May 16, 1983), a limited partnership purchased four master recordings for \$136,000 in cash plus a \$940,000

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nonrecourse note. After finding that the fair market value of the master recordings was de **minimis**, the court stated:

[A] purchase price that is grossly inflated by means of nonrecourse indebtedness also **raises** serious questions about the motives of the acquiring parties. Where there is a small cash down payment and the remainder of the acquisition price is satisfied with nonrecourse indebtedness that is not supported by the fair market value of the property acquired, the possibility exists that the acquisition was undertaken to generate tax benefit. Thus, where other factors are present, the existence of a high'ly inflated nonrecourse note can contribute to the finding that the activity **with** respect to which the property was acquired was not entered into for profit.

Other factors found present by the court were unrealistic appraisals, general partners who had no experience in the recording business and a lack of effort to promote the records. In holding that the venture was not entered into for profit, the court concluded, "If anything can be described as an 'abusive tax shelter,' this is it."

We believe that the facts in the present case show even less of a profit objective than the facts in George T. Flowers, supra. In that case, 4,000' records were eventually produced and an effort described by the court as "minimal and ineffective" was made to promote and distribute the records. The evidence in the present case shows no effort made to produce and market the master recording. Under the terms of the purchase agreement, appellant was solely responsible for the exploitation of the master recording, yet he knew nothing about the recording industry. There is no evidence to indicate he retained advisers or consulted with any experts. Appellant has expended minimal time and effort in exploiting the master and no copies have been manufactured for distribution. Appellant has received no income from the project. He **did** not obtain an appraisal prior to purchasing the master recording. Neither of the appraisals which he subsequently obtained shows extensive analysis. Appellant's failure to act is not consistent with a profit motive. This, coupled with the existence of a highly inflated nonrecourse note, leads us to conclude that appellant did not own the master recording with the intent to make a profit.

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O R D E R

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

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Harold and Joyce E. Wilson against a proposed assessment of additional personal income tax in the amount of \$942.93 for the year 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of September, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. **Dronenburg**, Mr. Nevins and Mr. Harvey present.

<u>William M. Bennett</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Richard Nevins</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Governemnt Code section 7.9