Office of Chief Counsel
Internal Revenue Service

memorandum

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KSChaberski ID#58-08810

date: March 6, 2001

to: Team Coordinator [redacted] (LMSB, Nashville, Tennessee)

from: Associate Area Counsel (LMSB Area 3 - Nashville)

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subject: [redacted]
(formerly [redacted]
[redacted]
Cycle: [redacted] and [redacted]
Involving: [redacted]
Advisory Opinion - Capitalization of Advance Royalties

This responds to an inquiry by the Service regarding the proper tax treatment of royalties paid by [redacted] to various recording artists during [redacted] under the terms of their standard recording contract.

ISSUES

1. Whether royalty advances paid by [redacted] (a subsidiary of the taxpayer) during [redacted] to various recording artists in accordance with a standard recording contract are currently deductible or must be amortized over the life of the contract?

2. If the costs referred to in Issue No. 1 above must be amortized, what is the life of the contract over which the advances must be amortized?

CONCLUSIONS

1. The advance royalties are not currently deductible; they must be amortized over the life of the contract.

2. The life of the sample contract which was forwarded for our review (which we understand to be a typical contract used by [redacted] during [redacted]) is [redacted] years. Thus, the advance paid to the recording artist under the terms of that contract must be amortized over a [redacted]-year period.

FACTS

[redacted] is a wholly-owned subsidiary of the taxpayer and a member of the group which filed a consolidated federal income return for the taxable year [redacted] (the return under examination). During the period at issue, [redacted] (hereinafter "[redacted]") was engaged in producing and selling musical recordings. As such, [redacted] regularly contracted with musical artists to create and record musical recordings. According to the information furnished with the request for our assistance, [redacted] utilized a "standard contract" for these purposes. Team Coordinator [redacted] has provided a copy of an actual recording contract (with the artist's name excised) as an example of the standard contract.

Mr. [redacted] advises that the sample contract provided (titled "[redacted]") is representative of virtually all of the recording contracts at issue; the contracts do contain variables (such as the amount of advance royalties to be paid[1]), but those variables do not affect the following legal discussion. A copy of the sample contract which we have analyzed is attached hereto and incorporated herein by reference.[2] All references below to "the contract" or to a "standard contract" refer to that attachment.

The standard contract includes the following terms relevant to this discussion:

1. During the term of the contract, the artist agrees to make recordings "having a [redacted], [redacted], or [redacted]" exclusively for [redacted].

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[1] The advance royalty paid to the artist pursuant to the recording contract varies widely between artists. Typically, the amount of the advance increases in direct proportion to the relative fame and popularity of the artist; we understand that during the taxable year at issue, a typical advance paid to a new artist was in the range of $[redacted] to $[redacted] while a "seasoned" artist could receive an advance of $[redacted] or more.

[2] Mr. [redacted] also forwarded a copy of a letter which serves as an amendment to the contract, a copy of which is also attached. It appears that such an amendment was not commonly executed and thus the terms thereof are not incorporated into the "standard contract" which is discussed in this memorandum. In any event, the terms of the amendment have no effect on our legal analysis of the issues presented.

2. [redacted] has exclusive worldwide rights to sell, distribute, market, license and promote the recordings.

3. The artist agrees to record a recording, "to the best of the Artist's ability" within [redacted] days from the contract date and to record [redacted] recording during each "Contract Year". This is specifically defined in the contract as the "Artist's 'Commitment'".

4. Paragraph 3. of the contract describes the term thereof and provides, verbatim, as follows:

> Term: It shall have an initial term of one (1) Contract Year from the date of signing shown in Section 1 hereof. Artist hereby grants to [redacted] four (4) separate options to extend the Agreement for an additional one (1) Contract Year. The options shall be automatically renewed unless written notice is given to Artist by [redacted] up to but no later than nine (9) months after the immediately preceding Record has been released. [redacted] has the right to release each Record promptly after Artist completes it, although [redacted] may delay or change the release date in order to optimize the possible commercial success of the Record, but not later than [redacted] months after delivery of the finished master to [redacted].
>
> A total of [redacted] Records will be recorded under this Agreement and all options hereunder. Of such Records, one (1) Record will be mandatory and recorded pursuant to the definition of Artist's Commitment hereunder during each option period exercised by [redacted] hereunder.

5. The "Contract Year" is automatically extended if the artist fails to honor the Artist's Commitment (i.e. if the artist does not record a record during the [redacted] day period).

6. The contract provides a detailed royalty schedule for both U.S. and foreign sales, with specified percentages paid to the artist for each such sale.

7. [redacted] agrees to pay production costs of at least $[redacted] for each record produced under the contract.

8. [redacted] agrees to pay to the artist $[redacted] as an advance royalty.

9. The production costs and advance royalty are to be recouped by [redacted] from all sales before any royalties are paid to the artist.

10. The artist is not personally liable for repayment of either the advance or any production costs incurred; [redacted] is entitled to recoup those expenses only from sales of the records.

Shortly after the contract is signed, [redacted] pays the advance to the artist. The artist is then brought into a recording studio, a master recording is produced and a commercial recording is released. Typically, the time lag from the time the advance is paid until the commercial recording is released is approximately [redacted] months, though contractually, the period is up to [redacted] year, or longer if extended.

On the tax return at issue, the taxpayer capitalized all of the costs associated with the contract (i.e. both the production costs and the advance royalty) but amortized these costs **over a [redacted]-month period** from the date the costs were incurred. This is, for the most part, akin to claiming current deductions for these costs.[3]

The Service has determined that the production costs for each record are related to the respective master recordings and that the those costs should thus be amortized over a period to be determined by reference to the income forecast method.[4] These production costs for each such master recording include payments to backup singers and studio musicians who are hired by [redacted] to work on that particular master recording. The Service is currently in the process of analyzing a statistical sample of

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[3] Of course, if the expense was incurred during the last four months of the taxable year, the taxpayer's method would result in the expense being amortized over a two-year period.

[4] I.R.C. § 167(g)(6), added by the Taxpayer Relief Act of 1997, in conjunction § 168(f)(4), provides that the income forecast method may be used to determine the appropriate depreciation deduction for expenses related to sound recordings for recordings placed in service after August 5, 1997. That statute essentially codified the prior position of the Service that sound recordings were subject to the income forecast method. Rev. Rul. 60-358, 1960-2 C.B. 68 and I.R.C. § 168(f)(4). Thus, the income forecast method is also properly applied to all of the recordings at issue in this examination. No election to exclude sound recordings from MACRS is necessary to utilize the income forecast method for property of this type. I.R.C. § 168(f)(4).

sales of past recordings for use in applying this method.[5] Though this analysis is not yet complete, it appears that the taxpayer agrees that the production costs should be amortized over a period computed with reference to the income forecast method. Thus, the Service does not seek our opinion regarding those costs.

The Service believes that the advance royalty payments, on the other hand, do not relate to any specific master recording. Rather, unlike the production costs discussed above, the Service maintains that the advance royalties relate to a separate intangible asset - [redacted]'s contractual right to receive tangible property or services. The Service thus concludes that the advance royalty payments must be amortized over a [redacted]-year period beginning on the date the payment is made (i.e. at about the time the contract is signed). The taxpayer has apparently changed its position with respect to the advance royalty payments and now appears to argue that all such payments are currently deductible, though they have not explained any specific basis for this position.[6]

DISCUSSION

Capital expenditures are not immediately deductible; such expenditures must be added to the taxpayer's basis in the capital asset with respect to which they are incurred. These expenses are taken into account for tax purposes either through depreciation or by reducing the capital gain (increasing in the loss) when the capital asset is sold or otherwise disposed of. I.R.C. § 263. If an expense is capital, it cannot be deducted as

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[5] Based upon information thus far analyzed, Revenue Agent [redacted] indicates that more than fifty per cent of the total sales to be expected from a record occur within the first year after the record is released; the remaining sales occur over many years thereafter. Based upon his analysis of this data, R.A. [redacted] indicates that application of the income forecast method would result in amortization of the production cost over a three or four year period. The amortization period would begin under this method when the recording is first released for distribution and sale. Rev. Rul. 79-285, 1979-2 C.B. 91.

[6] As Revenue Agent [redacted] points out, this would be a change in the taxpayer's method of accounting without the required consent of the Commissioner. I.R.C. § 446. Thus, for the years under examination, the taxpayer is "stuck" with the position it took on the return if the Service does not prevail on this issue.

"ordinary and necessary", either as a business expense under I.R.C. § 162 or as an expense incurred for the production of income under I.R.C. § 212. Woodward v. Commissioner, 97 U.S. 572 (1970).

If an intangible asset is not included among the intangibles subject to I.R.C. § 197 (which generally includes intangibles exchanged with the transfer of a trade or business, such as goodwill), the intangible asset may be subject to depreciation in accordance with section 167. I.R.C. § 167(f). The contractual right to receive tangible property or services is intangible property subject to amortization and depreciation in accordance with I.R.C. § 167 if the contractual right (1) is used in business or held for the production of income, (2) has a determinable useful life exceeding one year, (3) wears out, decays, or becomes obsolete, and (4) has an ascertainable basis. I.R.C. § 167; Treas. Reg. § 1.167(a)- 14(a).[7]

The basis of a right to receive a fixed amount of tangible property or services under the terms of a contract is amortized for each taxable year by multiplying the total basis by a fraction, the numerator of which is the amount of tangible property or services received during the taxable year and the denominator of which is the total amount of tangible property or services received or to be received under the terms of the contract. Treas. Reg. § 1.167(a)- 14(c)(1)(i). In this case, the contract calls for a total of [redacted] recordings, one per year. The amount of the advance to be amortized each year is thus one over five (i.e. twenty per cent).

For purposes of determining amortization, the duration of a right under a contract includes any renewal period if, based on all of the facts and circumstances in existence at any time during the taxable year in which the right is acquired, the facts clearly indicate a reasonable expectancy of renewal. Treas. Reg. § 1.167(a)- 14(c)(3)(i).[8] In the case at issue, the evidence

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[7] I.R.C. § 167(f) generally applies to intangible property acquired after August 10, 1993. Treas. Reg. § 1.167(a)-14 was recently issued to provide guidance regarding the statutory structure implemented in 1993. Thus, while that regulation by its terms applies to property acquired after January 25, 2000, it also provides the Service's interpretation of section 167(f) from the effective date forward. As such, the Service should not take a primary position inconsistent with the Treas. Reg.

[8] Again, this rule specifically relates to property acquired after January 25, 2000, which does not include the contracts under examination. However, this rule was fixed, and constituted

overwhelmingly indicates that the "one-year renewable" contract was in fact a [redacted]-year contract. Thus, the cost of the contract (i.e. the advance royalty paid to the artist as consideration therefor) must be depreciated in equal increments over the [redacted]-year life of the contract.

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse effect on privileges, including the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

Please feel free to contact the undersigned at (615) 250-5598 should you wish to discuss the above further or if you desire any further assistance regarding this matter.

BENJAMIN A. de LUNA
ASSOCIATE AREA COUNSEL (LMSB)
AREA 3

By: /s/ Kirk S. Chaberski
KIRK S. CHABERSKI
Senior Attorney (LMSB)

Attachments:
1. Cy of [redacted] dated [redacted] (with artist's identity excised)
2. Cy. of letter dated November 5, 1997 amending Attachment 1 (with artist's identity excised)

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the position of the Service, long before the years at issue. *See*, Rev. Ruls. 67-379, 1967-2 C.B. 127 and 71-137, 1971-1 C.B. 104, which discuss, respectively, professional baseball and football contracts (which were, prior to the concept of free-agency, annual contracts renewable by the team on a yearly basis). Both Rev. Ruls. hold that the practical effect of a renewable contract was to bind the player to the team for the duration of a player's career and that the contract, despite its purported "one-year" term, was an asset with a life of greater than one year.