Part I

Section 165.--Losses

26 CFR 1.165-1: Losses.
(Also § 1.165-2)

Rev. Rul. 2004-58

ISSUE

May a taxpayer deduct the cost of acquiring and developing creative property as a loss under § 165(a) of the Internal Revenue Code in the situations described below?

FACTS

X is a corporation that files returns on a calendar year basis for federal income tax purposes. *X* is engaged in the trade or business of producing motion pictures. As part of that trade or business, *X* routinely incurs costs to acquire and develop creative property such as screenplays, scripts, treatments, story outlines, motion picture production rights to books, plays, and other literary works, and similar property for purposes of potential development, production, and exploitation. The type of rights *X* acquires in creative property varies from property to property and may include exclusive rights of ownership or limited exploitation rights, and may include rights for the entire remaining copyright term of the property or rights for a limited period of time.

X ultimately sets for production only a small percentage of the creative property that *X* acquires. Most of the creative property that *X* sets for production is set within three years of *X*'s acquisition of the property. However, *X* does set some property for production that *X* has held for longer than three years. Additionally, *X* may sell to a third party *X*'s rights to a creative property not set for production. *X* does not discard, release to the public domain, or otherwise dispose of the creative properties not set for production or sold. Generally these properties are retained indefinitely.

In order to preserve the properties in a condition that allows for future use, *X* maintains facilities for storing creative property retained but not set for production. *X* retains these properties for various reasons, including, but not limited to, the following:

1. To exercise *X*'s ownership or other contractual rights at any time in the future by, among other things,

a. selling or setting a property for production if, for example, the subject matter becomes more popular or the writer becomes well known;

b. preventing or defending against a possible future copyright infringement lawsuit; and

c. keeping competitors from developing the property; and

2. To maintain good relations with the seller of the property.

For financial accounting purposes, *X* applies generally accepted accounting principles (GAAP) to the cost of acquiring and developing creative property. For creative property that has not been set for production, *X* recognizes a loss for financial accounting purposes in the earliest of: (1) the year in which *X* decides not to set the property for production; (2) the year in which *X* sells or otherwise disposes of the property; or (3) the third year following the year in which *X* acquires the property.

Situation 1

In 2003, *X* purchases the exclusive rights for the remainder of the copyright term to script *a*. In 2004, an *X* executive decides that *X* will not set script *a* for production. In accordance with *X*'s financial accounting practice, in 2004 *X* writes off for financial accounting purposes the cost of acquiring and developing script *a*. Although *X* writes off the cost of script *a* for financial accounting purposes and does not set script *a* for production, *X* retains all rights to script *a* indefinitely.

Situation 2

In 2003, *X* purchases limited exploitation rights to use screenplay *b* in the production of a motion picture. Under the terms of the purchase agreement, all of *X*'s rights in screenplay *b* expire if screenplay *b* is not set for production within four years from the date of the agreement. *X* executives do not make a specific decision not to set screenplay *b* for production, but screenplay *b* is not set for production by the time *X*'s rights in screenplay *b* expire in 2007. In accordance with *X*'s financial accounting practice, in 2006 *X* writes off for financial accounting purposes the cost of acquiring and developing screenplay *b*. Although *X* writes off the cost of screenplay *b* for financial accounting purposes and does not set screenplay *b* for production, *X* continues to retain exploitation rights to screenplay *b* until 2007, at which time those rights expire. *X* does not attempt to renew, extend, or otherwise reacquire any rights to screenplay *b*.

Situation 3

In 2003, *X* purchases motion picture rights *c*, the exclusive rights to produce motion pictures based on a particular novel, from *A*, the author of the novel. Under the terms of the contract, *A* has an option to reacquire motion picture rights *c* if *X* does not set them for production within two years of acquisition. In 2005, *X* decides not to set motion picture rights *c* for production in the foreseeable future. *X* informs *A* that *A* has the right to reacquire the rights pursuant to the option. *A* contacts other studios to determine if they are interested in acquiring motion picture rights *c*, but is unable to find another studio to purchase the rights for a satisfactory price. Therefore, *A* declines to exercise the option. In accordance with *X*'s financial accounting practice, in 2005 *X* writes off for financial accounting purposes the cost of acquiring and developing motion picture rights *c*. *X* retains motion picture rights *c* indefinitely.

LAW AND ANALYSIS

Section 165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(b) states that the amount of the deduction for a loss is the adjusted basis as provided in § 1011. *See also* § 1.165-1(c) of the Income Tax Regulations.

Section 1.165-1(b) provides that, to be allowable as a deduction under § 165(a), a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event, and, except as provided in § 165(h) and § 1.165-11, actually sustained during the taxable year. Section 1.165-1(d)(1) provides that a loss is treated as sustained during the taxable year in which the loss occurs, as evidenced by a closed and completed transaction, and as fixed by an identifiable event occurring in such taxable year.

Section 1.165-2(a) allows a deduction under § 165(a) for a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, when such business or transaction is discontinued or when such property is permanently discarded from use therein. Section 1.165-2(a) further provides that the taxable year in which a loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

Section 165 losses have been referred to as abandonment losses to reflect that some act is required that evidences a taxpayer's intent to permanently discard or discontinue use. *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396, 402 (3d Cir. 1990). To establish the abandonment of an asset for purposes of § 165, a taxpayer must show both (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *CRST, Inc. v. Commissioner*, 92 T.C. 1249, 1257 (1989), *aff'd* , 909 F.2d 1146 (8th Cir. 1990); Rev. Rul. 93-80, 1993-2 C.B. 239. A deduction is not allowable if a taxpayer intends to hold and preserve property for possible future use or to realize potential future value from the property. *A.J. Indus.*, 503 F.2d at 670. Abandonment of an intangible property interest should be accompanied by some express manifestation. *Citron v. Commissioner*, 97 T.C. 200, 209 (1991). *See also Echols v. Commissioner*, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their 75% partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

The "identifiable event" required by § 1.165-1(b) and (d)(1) "must be observable to outsiders and constitute 'some step which irrevocably cuts ties to the asset.'" *United Dairy Farmers, Inc. v. U.S.*, 267 F.3d 510, 522 (6th Cir. 2001) (quoting *Corra Resources, Ltd. v. Commissioner*, 945 F.2d 224, 226 (7th Cir. 1991)). Mere non-use of an asset is not sufficient to establish an act of abandonment. *Standley v. Commissioner*, 99 T.C. 259, 272 (1992), *aff'd without published opinion*, 24 F.3d 249 (9th Cir. 1994); *Jones Beach Theatre Corp. v. Commissioner*, T.C.M. 1966-100. Similarly, internal communications or decisions within a taxpayer's organization are not sufficient affirmative acts of abandonment. *See Corra Resources*, 945 F.2d at 226.

A taxpayer need not relinquish legal title to property in all cases to establish abandonment, provided there is an intent to abandon and an affirmative act of abandonment. *See Echols*, 935 F.2d at 706; *Middleton v. Commissioner*, 77 T.C. 310, 322 (1981), *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982). Retention of bare legal title to property does not preclude a deduction under § 165(a) in certain cases in which property has become worthless. *See Helvering v. Gordon*, 134 F.2d 685, 689 (4th Cir. 1943), *acq.*, 1951-1 C.B. 2; *Rhodes v. Commissioner*, 100 F.2d 966, 970 (6th Cir. 1939); Rev. Rul. 54-581, 1954-2 C.B. 112. In such cases the courts have adopted the rule that a taxpayer may claim a loss on property without being required to divest legal title if the taxpayer does not intend to hold the property and the taxpayer proves by identifiable events that the property has become worthless. *A.J. Indus.*, 503 F.2d at 670. The taxpayer's conduct in regarding the property as worthless and not intending to preserve or hold it may be the practical equivalent of abandonment. *See id.*; *Lockwood v. Commissioner*, 94 TC 252, 258 (1990) (leaving master recordings on a closet shelf instead of storing in a necessary climate-controlled environment was tantamount to throwing them in the trash).

A deduction for worthlessness under § 165 is allowable only if there is a closed and completed transaction fixed by identifiable events establishing that the property is worthless in the taxable year for which the deduction is claimed. § 1.165-1(b) and (d)(1). Although the taxpayer is not required to be an "incorrigible optimist," *United States v. S.S. White Dental Manufacturing Co.,* 274 U.S. 398, 403 (1927), a mere diminution in the value of an asset is not sufficient to establish worthlessness. *Proesel v. Commissioner*, 77 T.C. 992, 1006 (1981). Assets may not be considered worthless, even when they have no liquidated value, if there is a reasonable hope and expectation that they will become valuable in the future. *See Lawson v. Commissioner*, 42 B.T.A. 1103, 1108 (1940); *Morton v. Commissioner*, 38 B.T.A. 1270, 1278 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940); Rev. Rul. 77-17, 1977-1 C.B. 44.

Abandonment and other transactions that divest the taxpayer's title are identifiable events that support a closed and completed transaction. Additionally, identifiable events may include "other acts or events which reflect the fact that the property is worthless." *Proesel*, 77 T.C. at 1005. To the extent that the transactions do not include divestitures of title or abandonment, the essential element for tax purposes is that a particular event destroyed the potential value and usefulness of the asset to the taxpayer. *See Echols*, 950 F.2d at 213 (partnership's insolvency, third party developer's default, and inability of partners to restructure the underlying debt were identifiable events that evidenced worthlessness); *Corra Resources,* 945 F.2d at 226-27 (loss realized in the year in which coal mining lease expired); *George Freitas Dairy, Inc. v. United States*, 582 F.2d 500, 502 (9th Cir. 1978) (cancellation of production quota contract was identifiable event that evidenced the closed and completed transaction); *Proesel*, 77 T.C. at 998-99, 1006-07 (finding insufficient evidence of worthlessness despite unsuccessful attempts to sell or find distributor for a motion picture by contacting all major studios and major independent distributors; however, contract to produce the motion picture could have been found worthless upon settled litigation with respect to breach of contract or demonstration that litigation would be fruitless); *Oak Harbor Freight Lines, Inc. v. Commissioner*, T.C.M. 1999-291 (an act of Congress rendered motor carrier authorities worthless because all rights associated with the authorities were eliminated); *Springfield Productions, Inc. v. Commissioner,* T.C.M. 1979-23 (testimony by taxpayer's president that film was worthless because taxpayer had unsuccessfully submitted it for sale or distribution to all major studios and small distribution companies was not substantial proof of worthlessness); *Golden State Towel and Linen Service, Ltd. v. United States*, 179 Ct. Cl. 300, 310 (1967) (finding that it is only when all or a substantial, identifiable, vendible portion of a customer list is terminated permanently, either through extraneous causes or the sudden and involuntary inability of the owner to serve them, that a tax loss may be claimed, and then only if the loss may be adequately measured.)

A taxpayer's treatment of the costs of acquiring property for financial accounting purposes does not control the treatment of those costs for federal income tax purposes. *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-44 (1979).

X has not performed an affirmative act of abandoning creative property merely because: (1) an *X* executive decides not to actively pursue the development or production of the property, *see Corra Resources*, 945 F.2d at 226; (2) *X* does not set the property for production within three taxable years of acquiring that property (notwithstanding that it is unlikely that *X* will ever set for production property that *X* retains for three years or more), *see Standley*, 99 T.C. at 272; and (3) *X* writes off for financial accounting purposes the cost of acquiring and developing the property, *see Thor Power Tool*, 439 U.S. at 542-44. Although the above facts may be relevant factors to consider, an affirmative act to abandon must be ascertained from all the facts and surrounding circumstances, *Citron*, 97 T.C. at 210. *X* retains creative properties for potential future exercise of ownership or other contractual rights, whether by sale or use, or to enforce those rights by preventing *X*'s competitors from using the property. In fact, *X* does sell or set for production some creative property after writing off the costs of such property for financial accounting purposes and having made a decision not to set the property for production. These facts are inconsistent with an intent to permanently abandon property and with an affirmative act of abandonment, both of which are required for an abandonment loss deduction under § 165(a).

Furthermore, *X* is not entitled to a worthlessness deduction in the absence of evidence of a closed and completed transaction fixed by an identifiable event establishing worthlessness. A creative property that *X* acquires may not be presumed worthless simply because *X* does not set that property for production, either by a specific internal decision or by inaction, as these are not identifiable events that irrevocably cut ties to the asset. *See Corra Resources*, 945 F.2d at 226. In addition, the facts indicate that the creative properties that *X* retains after writing off their costs for financial accounting purposes are not worthless to *X*. *X* maintains proper storage facilities for the properties, thereby preserving the properties in a condition that allows for future exercise of ownership or other contractual rights. By retaining its rights in a property, *X* can prevent a competitor from exploiting that property or prevent or defend against potential copyright infringement lawsuits. In some cases, *X* retains creative property to maintain good relations with the seller from whom *X* acquired the property. Finally, *X* retains some property in the hope that the property will have future value if the subject matter becomes more popular, if the writer becomes better known, or for various other reasons. These facts indicate that *X* has an intention to hold and preserve property because of a bona fide belief that the property has value due to the possibility that the property will be of future use. Thus, without an identifiable event that destroys the potential value and usefulness of the property to *X*, the property may not be considered worthless.

In *Situation 1*, an *X* executive's decision in 2004 not to set script *a* for production, the write-off for financial accounting purposes, and the fact that the script has not been set for production by the end of 2004 do not constitute affirmative acts of abandonment of script *a* for purposes of § 165(a), nor are they identifiable events evidencing a closed and completed transaction establishing worthlessness. To the contrary, *X*'s retention of script *a* in order to keep the potential to exercise ownership or other contractual rights in the future is evidence that the script is not worthless. Thus, in the absence of any affirmative act of abandonment or showing of worthlessness in 2004, *X* may not deduct in that year as a loss under § 165(a) the cost of acquiring and developing script *a*.

In *Situation 2*, the facts do not indicate an affirmative act of abandonment or identifiable events evidencing a closed and completed transaction establishing worthlessness until 2007. *X* may deduct *X*'s adjusted basis in screenplay *b* under § 165(a) in 2007 because *X*'s rights to screenplay *b* expire in that year. *See* Rev. Rul. 81-160, 1981-1 C.B. 312. In the absence of any affirmative act of abandonment or showing of worthlessness in an earlier taxable year, *X* may not deduct in any earlier taxable year as a loss under § 165(a) the cost of acquiring and developing screenplay *b*.

In *Situation 3*, the facts do not indicate an affirmative act of abandonment or identifiable events evidencing a closed and completed transaction establishing worthlessness. *X*'s notification to *A* of *A*'s right to reacquire motion picture rights *c* pursuant to the contract between *X* and *A* does not constitute an affirmative act of abandonment by *X* of motion picture rights *c* for purposes of § 165(a). Rather, *X* is merely complying with its contractual obligations. When *A* declines to exercise its option, *X* continues to retain motion picture rights *c* in order to keep the potential to exercise its ownership or other contractual rights in the future. Furthermore, *A*'s failure to exercise the option to reacquire motion picture rights *c* does not establish that those rights are worthless in 2005. That *A* was unable to find another studio to purchase motion picture rights *c* at a satisfactory price is also insufficient to establish the worthlessness of motion picture rights *c* in 2005. *See Proesel*, 77 T.C. at 998-99, 1006-

07. Neither of these acts is an identifiable event establishing that motion picture rights *c* are valueless in 2005 and without reasonable expectation of future value. *X*'s retention of motion picture rights *c* in order to keep the potential to exercise ownership or other contractual rights in the future is evidence that the script is not worthless. Thus, in the absence of any affirmative act of abandonment or showing of worthlessness in 2005, *X* may not deduct in that year as a loss under § 165(a) the cost of acquiring and developing motion picture rights *c*.

HOLDING

A taxpayer may not deduct the costs of acquiring and developing creative property as a loss under § 165(a) if the taxpayer does not establish an intention to abandon the property and an affirmative act of abandonment, or identifiable event(s) evidencing a closed and completed transaction establishing worthlessness.

DRAFTING INFORMATION

The principal author of this revenue ruling is Joy Spies of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Spies at (202) 622-5020 (not a toll-free call).