ALM LAW JOURNAL NEWSLETTERS

Entertainment LAW & FINANCE®

Volume 22, Number 4 • July 2006

Songwriters Gain from Change in Tax Law

By Denise Stevens, John Arao and John Beiter

Tax-treatment and copyright-reversion issues are among the most complicated concerns songwriters and music publishers face. This article examines a recent change in federal tax law regarding the sale of musical compositions as well as related tax and reversion issues.

Tax-treatment and copyright-reversion issues are among the most complicated concerns songwriters and music publishers face. This article examines a recent change in federal tax law regarding the sale of musical compositions, as well as related tax and reversion issues.

The Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222, 120 Stat. 345 (2006)) (the Act) was signed into law by President Bush in May. The new Act includes the provisions of a bill entitled the Songwriters Capital Gains Tax Equity Act, introduced by Rep. Ron Lewis (R-KY) in the House of Representatives and by Sen. Jim Bunning (R-KY) in the Senate. It is the culmination of the Nashville Songwriters Association International's (NSAI) 5-year effort to address the disparate tax rates historically paid by publishers versus those paid by songwriters upon the sale of a music catalog.

The Act amends Sec. 1221 of the Internal Revenue Code of 1986, enabling the election of capital-gains treatment for certain self-created musical works (*eg*, a song catalog when sold by the songwriter), commencing with sales that occur in taxable years after the date of enactment. The change applies only to proceeds from the sale or exchange of a copyright in a musical work; royalty and fee income generated from its exploitation will remain ordinary income. Overall, these favorable tax changes appear likely to encourage the transfer of song catalogs, as well as investment in music publishing, during the effective term of the relevant provisions of the Act, which begins Jan. 1, 2007 and is set to expire at the end of the 2010 tax year.

Prior to the change, a songwriter was required to treat the sale of the copyright in his or her musical work as ordinary income and consequently had to pay taxes at the applicable marginal rate — currently as high as 35%, exclusive of taxes on self-employment income. However, when a music publisher or other party who wasn't the creator sold its interest in the copyright, capital-gains treatment was (and remains) available at a much lower tax rate — currently 15% for individuals, provided that the 1-year holding period requirement of IRC Section 1222, defining long-term capital gain or loss, was satisfied.

Under old business models from the 1920s and 1930s, songwriters typically sold their songs outright to music publishers with no ongoing entitlement to royalty or fee income. The resulting income was deemed compensation for services rendered and therefore recognized as ordinary income for tax purposes. However, music publishing evolved during the mid-1900s as markets for songs expanded and songwriters increasingly entered into co-publishing deals with music publishers. Alter-natively, many songwriters began acting as their own publishers by directly licensing the exploitation of their songs. Today, most songwriters are at least akin to business partners with a music publisher, with each incurring and/or bearing the burden via recoupment of certain expenses, such as administration and demonstration-recording production costs. Consequently, the unfairness of the disparate tax treatment upon the sale of the resulting catalog asset came into clearer focus.

The Act also provides a benefit to purchasers of song catalogs by adding an election to amortize acquisition costs and expenses paid or incurred after Dec. 31, 2005 over a 5-year period. Prior law provided generally for longer amortization periods, such as the election of the "income forecast" method or the 15-year straight-line "safe harbor" method. The new law is likely to stimulate investment in music publishing catalogs due to the potential to write off the acquisition expense more quickly.

The Act may also aid songwriters in their succession planning by reducing barriers to the granting of lifetime gifts of copyrights, because the capital-gains election is now also made available to the recipient of a gift from a songwriter. Previously, such a gift recipient not only acquired the songwriter's (often zero) tax basis, but also the non-capital asset tax character of the copyright. The recipient would therefore have been forced to report ordinary income on any sale of such gifted property. Accordingly, there appears to have been some incentive to defer passing of the copyright until after death of the songwriter. The successor then enjoyed not only a stepped-up tax basis to market value, but also the potential to claim capital gains upon the sale, given that the successor neither received a carryover basis nor was the "creator" of the copyright. Under the Act, copyrights given by a songwriter during his or her lifetime are no longer necessarily tainted with the non-capital asset characterization, thereby enabling potential enjoyment of the capital-gains tax rate upon the sale of the gift by the recipient.

Denise Stevens and **John Beiter** are entertainment industry attorneys at Loeb & Loeb LLP in the firm's Nashville office. Stevens (615-749-8300; dstevens@loeb.com) was instrumental in assisting the firm's pro bono client, the Nashville Songwriters' Association International, in drafting the Songwriters Capital Gains Equity Act discussed in this article. **John Arao** is a partner in the Tax Group of Loeb & Loeb's Los Angeles office. Loeb & Loeb intern, **Rebekah Shulman**, provided valuable research assistance for this article.

Before finalizing the bill introduced as the Songwriters Capital Gains Tax Equity Act, legislative staff added language to preserve existing provisions of the tax code designed to guard against excessive valuation of charitable contributions. Accordingly, for musical-composition property in the hands of a songwriter, or recipient of a non-charitable gift from a songwriter who donates the property to a charity, the charitable-contribution tax deduction is limited to the lesser of fair-market value or tax basis, as was the case under prior law.

Determining the Holding Period

One issue arising out of the Act that may require clarification is the determination of the holding period — *ie*, for calculation of the 1-year long-term capital gains holding requirement of IRC Sec. 1222 — of a copyright recovered by a songwriter (or a songwriter's heirs) pursuant to the termination-of-transfer provisions of the Copyright Act. For example, under Sec. 203(a) of the Copyright Act, a songwriter or songwriter's heirs may, by sending notice within specified time limits and under specified conditions, elect to terminate certain post-1977 grants by the songwriter of rights in a copyright, effective during a period of 5 years from the end of 35 years after the date of execution of the original grant. Although the right to receive the future return of the granted rights "vests" in the songwriter (or the applicable heirs) upon the sending of notice, the reversion does not become effective until after a 2-10-year period following delivery of such notice.

Usually, the holding period of a capital asset is computed from the date of acquisition. The holding period of rights in a copyright covered by a terminated grant ought to begin no later than the date following the effective date of the reversion. But on the earlier vesting date, a songwriter may have commenced the counting of the holding period of rights that qualify for an election under IRC Sec. 1221(b)(3), or which may otherwise qualify as a capital asset under the analysis discussed below. This issue is certainly uncharted territory in that the applicable holding period wasn't previously relevant to the sale of a copyright by a songwriter.

Examining potentially analogous property rights may be useful in considering the character of a reverted copyright prior to the effective date of the reversion. Given that the vested "right" to future receipt of a reverted copyright interest may be sold prior to the effective date of the reversion (albeit under limited circumstances under Sec. 203(b)), it is apparent that the vested right constitutes some form of property right. Is this property right acquired upon vesting in the nature of an option? Or perhaps it is so closely related to the property to be ultimately recovered on the reversion's effective date that it rises to the level of the recovered property itself, as in the case of a remainder interest in property.

A factor distinguishing the provisions of Sec. 203 from the operation of an option is that once the notice and related filing requirements of Sec. 203 are met to effect the vesting of the right to receive the future reversion of a copyright covered by a terminated grant, no further "exercise" or other affirmative action is necessary to trigger the actual return of the copyright. This vested right solely awaits the passage of time to ripen into possession.

It is well established that property obtained through exercise of an option is "acquired" for purposes of measuring the federal tax code's holding period when the option is exercised, not when the option is granted. But two separate holding periods may be relevant: The option itself has a holding period that runs from the date of its grant; and the property that is the subject of the option, the holding period for which doesn't begin until it is acquired pursuant to the exercise of the option. Given that the holding clock starts anew upon exercise of the option, the sale of property acquired upon option exercise prior to satisfaction of the 1-year holding requirement would then be treated as short-term capital gain or loss. If these rules were determined to be applicable to the sale of musical compositions, a recovered copyright interest sold after the effective date of a reversion must have been held for at least 1 year before qualifying as a long-term capital asset.

The Act may also aid songwriters in their succession planning by reducing barriers to the granting of lifetime gifts of copyrights.

One approach often utilized for opportunities to sell property for which a taxpayer holds an option for more than 1 year is for the taxpayer to sell the option itself, rather than to exercise the option and then immediately sell the optioned property. This way, the resulting gain could be considered long-term capital gain rather than short-term gain. The determination of the application of such rules may provide incentive for a motivated seller of a terminated interest to pursue negotiation with the original grantee, rather than wait the year following the effective date of reversion before exploring the open market.

Vested Remainder Interest Analogy

A vested remainder interest is a property right that hasn't yet ripened into full ownership and possession. For such remainder interests, the holding period for long-term capital-gain eligibility generally begins upon the vesting of the interest and continues without interruption upon the taking of possession of the property. In *Helvering v. Gambrill*, 313 U.S. 11 (1941), the U.S. Supreme Court found, in interpreting a holding-period rule under the Revenue Act of 1928 for capital gains and losses, that property held by a taxpayer included not only full ownership but also any interest, such as property that a taxpayer received as a remainder under a trust, whether vested, contingent or conditional. Accordingly, if a vested remainder interest were determined to be the applicable analogy, the calculation of the holding period for the rights covered by a terminated copyright grant would begin upon the vesting date, with "possession" to ripen upon the later effective date of the reversion. Consequently, sale of the terminated copyright interest immediately following the effective reversion date would qualify the seller to claim long-term capital-gain treatment of the proceeds, rather than require the seller to wait out the 1-year holding period.

Because resolution of the holding-period issue may influence the timing of further transfers of reverted copyrights, it may be appropriate for a future technical corrections bill or a Treasury ruling. However, the capital-gains provision of the new Act is currently only effective for sales or transfers on or before Jan. 1, 2011, which is prior to the first possible effective date of Jan. 1, 2013, for a termination of transfer under Sec. 203. Accordingly, capital-asset characterization of such reverted copyright interests in the hands of the creator beyond this expiration date will presume that the applicable provisions of the new act are renewed or extended for the relevant period. Assuming such renewal, resolution of the holding issue will be particularly relevant to the sale by the creator of reverted rights initially sold or exchanged during the first 1-year period following the effective date. Unless the holding period relates back to the vesting date, the proceeds from such a sale couldn't qualify for long-term capital-gain treatment. A determination that the holding date doesn't begin until after the effective date of copyright reversion may influence a delay in the resale of the reverted copyright interests.