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Songwriters Continue to Score Tax Breaks

By Michael R. Morris

Favorable tax law changes enacted in 2006 continue to offer significant tax planning opportunities for songwriters. These tax breaks for songwriters were ground-breaking, permitting self-created musical compositions or copyrights in self-created musical works to be effectively treated as capital assets. Why does this matter? Because gain upon the sale of a long-term capital asset (i.e., an asset held more than 12 months) is generally taxed 0%, 15% or 20% based on the taxable income rate - in lieu of regular personal income tax rates which can go as high as 37%. Thus, a seller of eligible self-created musical compositions or copyrights in musical works can save a bundle in taxes. And, buyers of these rights can elect to write off the purchase price over 15 years, enabling music publishers to take a tax deduction for the purchase price of copyrights, constituting a business ratably over 15 years. Let's take a closer look at how these favorable tax laws work.

Elective capital gains treatment for self-created musical works

A "capital asset" is defined in the negative, so that specifically enumerated types of property get "non-capital" asset treatment under the Internal Revenue Code (IRC), and all other assets are treated as capital assets. Pursuant to IRC Sec. 1221(a)(3), the excluded categories of property are: stock in trade or other property includible in inventory; property held primarily for sale to customers; real and certain depreciable property used in the taxpayer's trade or business; supplies used or consumed in the taxpayer's trade or business; patents, inventions, copyrights, literary, musical, or artistic compositions or similar property held by a taxpayer whose efforts created such property; accounts or notes receivable acquired in the ordinary course of trade or business for services or from sales of inventory; property that is part of an identified hedging transaction; commodities derivatives held by dealers; and certain U.S. government publications.

For purposes of the foregoing exclusion, Treas. Reg Sec. 1.12211 (c)(3) provides in part that "property is created in whole or in part by the personal efforts of a taxpayer if such taxpayer performs literary, theatrical, musical, artistic, or other creative or productive work which affirmatively contributes to the creation of the property, or if such taxpayer directs and guides others in the performance of such work." Consequently, under IRC Sec. 1221(a)(3), copyrights, literary, musical or artistic compositions, letters or memoranda or similar property are not considered "capital assets" in the hands of its creator. Thus, a songwriter who sold his or her own songs, like an artist selling a painting, would, absent a favorable election, pay "ordinary" income tax rates. Conversely, the same songs in the hands of the music publisher who bought those copyrights would be considered tax-favored "capital assets." Under IRC Sec. 197, a music publisher buying music copyrights constituting a trade or business (like the purchase of a catalog of songs), can take a tax deduction for the cost of acquiring the copyrights as a yearly percentage of the purchase price over a 15-year period. And the subsequent resale of such copyrights would be at a tax favored capital gains rate (provided the songs had been held by a non-corporate publisher for at least the 1-year long-term capital gains period).

Congress sought to redress this imbalance in tax rates between songwriters and publishers, stating in a report: " ... it is appropriate to allow taxpayers to treat as capital gain the income from a sale or exchange of musical compositions or copyrights in musical works the taxpayer created." H.R. Rep. No. 109-304, at 51 (2005). S.1100, entitled "Songwriters Capital Gains Tax Equity Act," was introduced in the Senate on May 23, 2005 by Sen. Jim Bunning (KY) and was co-sponsored by Orin G. Hatch (UT), Barbara Boxer (CA), Kent Conrad (ND), Lamar Alexander (TN) and Richard Durbin (IL). It was enacted into law in 2006. The only explanation offered by Congress is the legislative history cited above. It is, however, well documented that this legislation was a consequence of significant lobbying by the Nashville Songwriters Association International. The intent of this bill was

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to place songwriters on the same tax-favorable playing field as music publishers who potentially could sell copyrights at reduced capital gain rates. To quote Rep. Marsha Blackburn, R-Tenn., a major proponent of this legislation: "When a songwriter sells a catalog, that is like a small-business owner selling his business. A small-business owner would pay capital gains. A songwriter (before the tax-law change) would pay ordinary income tax."

Accordingly, IRC Sec. 1221(b)(3) provides that the sales of musical compositions or copyrights in musical works sold by a taxpayer whose personal efforts created them are eligible for elective capital gains treatment. Initially, this favorable capital gains election for self-created musical works was set to expire on Dec. 31, 2010, but fortunately for songwriters, this didn't happen. However, this lower capital gains rate is not automatic! A songwriter selling compositions held more than 12 months must affirmatively elect under IRC Sec. 1221(b)(3) to have such self-created musical works treated as capital assets to get taxed at the lower tax rates (sounds like a tax "no-brainer").

Effective Feb. 7, 2011, the IRS issued regulations addressing the time and manner for electing capital asset treatment for self-created musical works. Pursuant to Treas. Reg. Sec 1.1221-3, an election under IRC Sec. 1221(b)(3) is made separately for each musical composition (or copyright in a musical work) sold or exchanged during the taxable year. An election must be made on or before the due date (including extensions) of the income tax return for the taxable year of the state or exchange. The election is made on Schedule D, "Capital Gains and Losses," of the appropriate income tax form (for example, Form 1040, "U.S. Individual Income Tax Return;" Form 1065, "U.S. Return of Partnership Income;" Form 1120, "U.S. Corporation Income Tax Return") by treating the sale or exchange as the sale or exchange of a capital asset, in accordance with the form and its instructions. An election described in IRC Sec. 1221(b)(3) is revocable with the consent of the Commissioner. To seek consent to revoke the election, a taxpayer must submit a request for a letter ruling under the applicable administrative procedures. Alternatively, an automatic extension of 6 months from the due date of the taxpayer's income tax return (excluding extensions) is granted to revoke the election, provided the taxpayer timely filed the taxpayer's income tax return and, with this 6-month extension period, the taxpayer files an amended income tax return that treats the sale or exchange as the sale or exchange of property that is not a capital asset. Accordingly, creators of musical compositions and copyrights in musical works selling such rights are reminded that an affirmative election is necessary to take advantage of favorable capital gains rates.

IRC Sec. 1221(b)(3) does not define what constitutes a self-created "musical composition" or a self-created "musical work." For example, if one songwriter contributed lyrics and another music to a composition, should there be any tax difference? Probably not. But what if a writer's existing poem became the lyrics of a song to which another writer contributed the melody? That song would generally be covered by a single copyright, and in this author's opinion, the sale of that song should entitle the creators of both the lyrics (i.e. the poem) and the melody to favorable capital gains treatment, even though the sale of the stand-alone poem would not qualify.

Holding period for reversion rights?

When the one-year holding period for long-term capital gains treatment begins can be an interesting question. Obviously, the one-year period begins from creation of the work for a songwriter who always retained ownership. But what about when a songwriter (or heirs) has rights to reclaim previously granted copyrights under the termination provisions of 17 U.S.C. §203(a) of the Copyright Act? For example, grants made after 1977 of rights in a copyright may be terminated at any time during the 5-year period beginning 35 years after the date the original grant was executed. The right to the subsequent reversion of a previously transferred copyright gets triggered by the songwriter (or statutorily prescribed heirs) providing timely notice and making the proper filing under 17 U.S.C. §203 (such right would then be "vested"). This notice must be given not less than two nor more than 10 years prior to the effective date of termination. Once the termination provisions of 17 U.S.C. §203 have been met, the copyright automatically reverts at the designated future date during the five-years following the expiration of the 35-year grant.

The threshold question is whether the future reversion rights held by a songwriter to the copyright in a musical work constitutes an interest in a copyright for purposes of IRC Sec. 1221(b)(3). The Copyright Act states that a "[c]opyright owner with respect to any one of the exclusive rights comprised in a copyright refers to the owner of that particular right." 17 U.S.C. §101. Consequently, ownership of termination rights afforded an author under 17 U.S.C. §203 should, in this author's opinion, qualify as a copyright interest in a musical work. However, the I.R.S. has issued no pronouncements or guidance on this issue.

Assuming reversion rights to musical copyrights qualify for elective capital gain treatment, and since such rights can be sold, when does the one-year long term capital gain period begin for purposes of elective capital gain treatment under IRC Sec. 1221(b)(3) once the termination rights are exercised? If the songwriter's reversionary right is regarded as an interest held by the songwriter following the date the copyright in a song was transferred to a music publisher, then the capital gain period would have commenced on the date the copyright was conveyed, since the songwriter always retained the right to this future reversionary interest. In that regard, taxpayers who hold future interests generally start their holding period upon acquisition of such future interests, not upon the reversion date. *See Helvering v. Gambril*, 353 U.S. 11 (1941). And, the holding period of contract rights generally commences at the time of execution of a written contract. *See Meldon v. Commissioner*, 225 F.2d 469 (3d Cir. 1955).

However, if a songwriter giving notice of copyright termination is not eligible to make an immediate sale of the reversion right and claim elective capital gain treatment, it seems the oneyear holding period should at least run from the date notice was given under 17 U.S.C. §203 and the termination rights vested. That would result in the sale of such a right to be eligible for capital gain treatment one-year after the reversion rights vested. The earliest effective date for termination under 17 U.S.C. §203 was Jan. 1, 2013 (for grants made on Jan. 1, 1978). If the sale of a future reversion is considered the sale of a copyright in a musical work, the IRS has yet to issue guidance on whether a songwriter can make an immediate sale of such rights (when such rights vested) or must wait one year following termination notice under 17 U.S.C. §203 in order to claim elective capital gain treatment under IRS Sec. 1221(b)(3).

Sale of songwriter's share of performance rights

Songwriters are also more frequently entering into deals where they are selling the socalled "writer's share" of music publishing income, which includes future performance royalties collected by performance rights societies such as ASCAP, BMI and SESAC from the endusers of the music (such as radio and television stations). Such performance royalties are divided between the "publisher's share" and the "writer's share." The sale of the writer's share won't include a transfer of copyright, so the issue is whether the sale of such future income rights nonetheless is eligible for capital gains treatment. In PMTA 20070007, a 1995 Internal Revenue Service Memorandum, a Senior Technical Reviewer of the Office of Chief Counsel concluded that income paid by music publishers to a nonresident alien for the right to copy and distribute musical works was U.S.-source royalty income subject to a withholding tax. The songwriter had conveyed the copyrights in the songs to the music publisher and received the writer's share of the income which the IRS determined was royalty - and not - personal services income.

PMTA 20070007 cites *Boulez v. Commissioner*, 83 T.C. 584 (1984), in which the Tax Court observed: "[b]efore a person can derive income from royalties, it is fundamental that he must have an ownership interest in the property whose licensing or sales gives rise to the income." Id. at 590. If the writer's share of income is regarded as either ownership of a right in the underlying copyright or a retained interest in a music composition, it follows that the sale of such rights is eligible for elective capital gain treatment.

But because the songwriter's

share of royalty income is ordinary income when received, the IRS could well take a contrary position under the "substitute for ordinary income" doctrine. Under this doctrine, the lump-sum consideration substituting for something that otherwise would be ordinary income should be taxed in the same way. In both *Laterra v. Commissioner*, 439 F.3d 399 (3d Cir. 2006) and *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004), the Third Circuit and the Ninth Circuit held that the sale of rights to future lottery payments constituted ordinary income. Arguably the sale of the songwriter's share of performance royalties is distinguishable from these lottery cases and should be eligible for elective capital gain treatment, given Congress' intended favorable tax treatment of songwriters selling their rights discussed above. But absent favorable IRS guidance, there is a very real tax risk in treating such sales as within the scope of IRC Sec. 1221(b)(3).

Eligibility of self-created sound recordings?

Another unanswered question is whether the sale by a recording artist of self-created sound recordings falls within the favorable scope of IRC Sec. 1221(b)(3). Frequently the recording artist selling the master recordings is also the songwriter selling the songs, as illustrated by the highly visible sales by Bob Dylan and Bruce Springsteen. Since IRC Sec. 1221(b)(3) was enacted, the IRS has never issued any regulations or rulings defining the term "musical works" within the context of the IRC Sec. 1221(b)(3) election. The term "copyrights in musical works" is intuitively more expansive than "musical compositions," and logically ought to include copyrights in self-created sound recordings (which would be recordings of "musical compositions"). And there is no indication that Congress considered tying the term "copyrights in musical works" to the Copyright Act provisions under 11 U.S. Code §102, which has separate categories for musical works and sound recordings, so as to preclude selfcreated sound recordings embodying the recordings of a musician creating such works from eligibility for elective capital gain treatment under IRC Sec. 1221(b)(3).

The legislative history says IRC Sec. 1221(b)(3) was to place songwriters on equal footing with music publishers, in whose hands the purchase of music copyrights would be eligible for tax-favored capital gains rate (provided a non-corporate publisher held them for at least the one-year long term capital gains period). Utilizing that logic, it follows that a recording artist whose efforts created sound recordings should be entitled to the same treatment as a songwriter, since a purchaser of such sound recordings could treat them as capital assets. In this author's opinion, a recording artist should therefore be entitled to the same opportunity to make an election to treat the sale of copyrights in selfcreated sound recordings as the sale of musical works eligible for elective capital-gain treatment. If Congress wanted to limit the elective capital gains treatment for selfcreated musical works to only musical compositions, why does IRC Sec. 1221(b)(3) provide an alternative for "copyrights in music works?" IRC Sec. 1221(b)(3) could simply have been limited to musical compositions. But neither the IRS nor any court has ruled on this issue.

Conclusion

Congress has lowered tax rates for songwriters who sell their catalogs and electively take advantage of capital gains treatment, provided such songs were held more than one-year. This is in stark contrast to the higher non-capital gain tax rates paid by authors and painters who sell their literary works or paintings. In addition, music publishers buying songs can amortize the purchase price over a 15-year period.

But questions remain as to what constitutes self-created musical works eligible for favorable capital rates. Does it include sound recordings, vested future copyright reversion rights and/or the sale of the songwriter's share? The IRS has yet to provide rulings or other guidance that resolve any of these issues. In the meantime, the tax incentives afforded songwriters and publishers continue to provide a powerful stimulus to the music publishing market.