

NEWSLETTER

An Entertainment Industry Organization



SONGWRITERS AND PUBLISHERS SCORE TAX BREAKS IN 2006

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The President's Corner

David Hirshland

Welcome to our special pre-Turkey Day extravaganza featuring all you need to know about reversions and taxes! We hope you enjoy this evening's panel and we hope you can join us for our annual Holiday Party on December 11 at Cafe Cordiale. It's always a great opportunity to see old friends and celebrate another year of successful copyrighting.

Best wishes for a warm holiday season,
David Hirshland President

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 at an extremely favorably 15% rate, in lieu of regular personal income tax rates ranging as high as 35%. Thus, under the new law, a seller of eligible self-created musical compositions or copyrights in musical works

can save a bundle in taxes. In related music-industry legislation, buyers of such property can elect to write off the purchase price over a five-year amortization schedule. The gist of the provision enables music publishers who buy copyrights to take a tax deduction for the purchase price (including songwriter advances) ratably over five years. Let's take a closer look at those favorable new laws.

Capital Gains Treatment for Self-Created Musical Works

Under prior law, copyrights, literary, musical or artistic compositions, letters or memoranda or similar property were not considered "capital assets" in the hands of its creator. Thus, a songwriter who sold his or her own songs paid "ordinary" income tax rates (up to 35%). Conversely, the same songs in the hands of the music publisher who bought those copyrights were considered tax-favored "capital assets." Not only could the music publisher take a tax deduction for the cost of acquiring the copyrights (as an amortized yearly percentage of the purchase price), but the subsequent resale of such copyrights would be at a tax favored capital gains rate of 15%

Introduction.

The Tax Increase Prevention and Reconciliation Act of 2005, signed into law on May 17, 2006, offers significant tax planning opportunities for both songwriters and music publishers. The potential tax breaks for songwriters are especially groundbreaking. For the first time self-created musical compositions or copyrights in self-created musical works may electively be treated as capital

(provided the songs had been held by a non-corporate publisher for at least the 1-year long-term capital gains period). The new law sought to redress this imbalance in tax rates between songwriters and publishers. To quote from the Congressional Committee 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."

Be forewarned that songwriters seeking to take advantage of the favorable tax capital gain rate must pay careful attention to both the effective and termination dates of the new law. Special capital gains treatment applies only for sales occurring in taxable years beginning after the effective date of the new law. Although this law took effect on May 17, 2006, a songwriter's next tax year would begin on January 1, 2007. *This is a real trap for the unwary!* A songwriter selling a catalog before 2007 would incur federal tax rates up to 35%, while postponing the sale until 2008 could save up to 20% in taxes! In addition, this favorable capital gains rate is set to expire on December 31, 2010 (so

sales made on or after January 1, 2011 don't qualify for the better rate, unless Congress extends this law). Moreover, the new capital gains rate is not automatic! A songwriter selling compositions held more than 12 months must affirmatively elect the lower tax rate (sounds like a no-brainer unless you want to voluntarily reduce the national debt).

The new law 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.

The new law also fails to address what music assets in addition to self-created songs qualify as "capital assets," only stating that both

self-created "musical compositions" and "copyrights in musical works" qualify for elective capital gains treatment. Thus, royalty and other income from the exploitation of musical compositions is not eligible for reduced capital gain rates. However, the term "copyrights in musical works" is intuitively more expansive than "musical compositions," and could include copyrights in self-created sound recordings (which, of course, would be recordings of "musical compositions"). This distinction can have real financial impact upon an artist selling both self-created master recordings and the underlying self-created musical compositions embodied therein. For example, an artist might sell a library of existing recordings concurrently with the copyrights in the underlying musical compositions to a film-TV music production house. Again, this author believes that the transfer of such master recordings constitutes the sale of a copyright in a self-created musical work, but the new law is silent on this point.

Just when the 1-year holding period for long-term capital gains treatment begins can also be an interesting question. Obviously, the 1-

year period begins from creation of the work for a songwriter who always retained ownership. But what about situations where a songwriter (or heirs) have rights to reclaim previously granted copyrights under the termination provisions of Sec. 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 Sec. 203 (such right would then be "vested"). Such notice must be given not less than 2 nor more than 10 years prior to the effective date of termination. Once the termination provisions of Sec. 203 have been met, the copyright automatically reverts at the designated future date during the 5-years following the expiration of the 35-year grant.

Since the rights to this future reversion can be sold, does the 1-year long term capital gain period begin from the date the Sec 203 notice was

given, enabling the sale of that right to be eligible for favorable tax treatment? Or does the 1-year holding period only run from the date the copyright actually reverted? The earliest effective date for termination under Sec. 203 is January 1, 2013 (for grants made on January 1, 1978). However, the favorable capital gains provisions discussed above expire on December 31, 2010 (unless extended). Only if the sale of a future reversion is considered the sale of a copyright in a musical work would the songwriters (or heirs) be eligible for reduced tax rates on sales made 1 year after complying with the Sec. 203 termination provisions. Otherwise, the 1-year long-term capital gain holding period would only commence from the date of actual copyright reversion, providing no tax relief. Congress would then need to significantly extend or abolish the current law's expiration date of December 31, 2010 in order for copyrights that begin reverting in 2013 to become eligible for long-term capital gain treatment.

Five-Year Amortization Period for Musical Works.

The new law also provides a favorable 5-year amortization schedule for eligible musical works and copyrights. Under prior law, the cost of acquiring a musical copyright generally had to be amortized and deducted over the period that the song was projected to generate income under the "income forecast" method (the actual computations can get complicated and won't be addressed here).

Under the new law, any expenses paid or incurred by a taxpayer after December 31, 2005 in creating or acquiring any "applicable musical property" can be amortized over the 5-year period beginning with the month during which the property was "placed in service" (for example, when a song gets exploited). Both songwriters who incurred expenses creating "applicable musical property" and music publishers who acquire them can take advantage of the new 5-year schedule. To illustrate, assume a music publisher paid \$1,000,000 for applicable musical property on January 2, 2006 and places it in service on January 31, 2006. Provided the 5-year amortization election is made, the publisher would get to deduct \$200,000 as an

expense for 2006 (and a like amount for 2007-2010). The term "applicable musical property" is defined as any musical composition (including any accompanying words) or any copyright with respect to a musical composition that is depreciable under the income forecast method. Presumably this means that sound recordings are not eligible for the 5-year amortization schedule.

Conclusion.

The new law has lowered tax rates for songwriters who sell their catalogs after December 31, 2006, provided such songs were held more than one year. In addition, music publishers buying such songs can recover the purchase price over an elective 5-year period for acquisitions made after December 3, 2005.

Since the effective dates for tax incentives afforded sellers and buys of catalogs are different, sellers must carefully structure their sales to avoid needlessly overpaying taxes.

The new law also raises questions about what constitute self-created musical works eligible for favorable capital rates. Does it include sound recordings and/or vested future

reversion rights? Hopefully, the IRS will provide rulings that favorably resolve these issues. In the meantime, these new tax incentives will undoubtedly provide a powerful stimuli to the music publishing market.

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