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Income, Estate, and Gift Taxation of Entertainment Assets

IN THE ENTERTAINMENT INDUSTRY, complex deals are often the result of opaque contracts that use terms interchangeably. It is not unusual for these contracts to imply a preferential income, estate, or gift taxation treatment for entertainment assets that is simply not applicable. The Internal Revenue Code does not make it any easier to decipher the treatment of entertainment-related assets. Attorneys thus need to be aware of some of the benefits and burdens inherent in entertainment assets and other income streams—such as participations, residuals, and royalties—as they relate to income, estate, and gift taxation, and especially as they bear on various tax planning techniques.[1]

Participations, residuals, and music royalties are sometimes confused with copyright royalties. The main difference is that the former are simply a right to share in a future payment stream generated by the recipient's participation in a movie or television show.[2] Copyright royalties, on the other hand, are income resulting from the exploitation of an ownership in part or all of the underlying copyrights.

Copyrights are now created by federal statute and not through common or state law. The duration of a copyright for works created after January 1, 1978, is governed by the 1976 Copyright Act. The term of a copyright begins from the work's fixation in a tangible form and depends on who created the copyright.[3] The term is life plus 70 years for an individual and is the shorter of 95 years from publication or 120 years from creation if the work is created by an employee in the scope of employment or in a work-for-hire capacity.[4]

The foundational issue of which form of business entity to use or hold copyrights has an impact on the terms of the copyright as well as important tax implications. Among a C corporation, an S corporation, or a limited liability company, the LLC is generally the preferred entity for owning entertainment assets because it is largely subject to a single level of tax, capital gains flow through to its members, and it provides the ability to separate management from ownership.

C corporations should almost never be used to own entertainment assets[5]—except as loan-out corporations[6]—because of the risk of the double taxation of nondeductible distributions (such as reasonable salary expenses). Currently, the maximum federal corporate tax rate is 35 percent while the California corporate tax rate is 8.84 percent. C corporations will frequently pay significant compensation to shareholders to reduce the double level of tax. However, when C corporations distribute part or all of their after-tax income to their shareholders as a nondeductible dividend, the dividend is currently taxed at the shareholder level at the preferential federal dividend tax rate of 15 percent and at the California state rate of 10.3 percent. Due to the current fiscal crisis in federal and state budgets, these rates have become the subject of intense debate and may increase. In addition, long-term capital gains incurred by a C corporation are taxed at the higher, regular ordinary income rates and not the reduced capital gains rates available to individuals. Finally, C corporations are subject to an additional corporate level tax in the case of personal holding companies.[7]

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Upon the death of a shareholder of a C corporation, the heirs receive a step-up in the basis of the stock to its fair market value for income tax purposes. However, the C corporation itself does not receive a step-up in the basis of the assets it holds. Therefore, all appreciation in the assets and any subsequent appreciation in the stock is generally taxable on a later sale.

While S corporations generally avoid significant entity level taxation (although California does impose a 1.5 percent corporate level tax, with an $800 minimum payment), they have other drawbacks. First, an S corporation may not include any foreign or entity share-

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holders,[8] may not have more than 100 shareholders, and can have only one class of stock. Second, if the S corporation is created by a conversion from a C corporation, any built-in gains of the C corporation[9] may be taxed at the corporate level if the underlying assets are sold within 10 years of the conversion. Third, for S corporations that were formerly C corporations, S corporation status will terminate if the S corporation has accumulated C corporation earnings and profits and has passive income exceeding 25 percent of gross receipts.[10] The death of a shareholder of an S corporation generally has the same results as for a C corporation.

Two other issues should also be kept in mind. First, shareholders generally do not receive basis in their stock for their share of the S corporation's liabilities, which can increase the overall amount of taxes paid. And, second, when assets are sold by the S corporation the gain may constitute ordinary income while the liquidation of the S corporation may result in a capital loss. Having ordinary income and a capital loss can be particularly troublesome because an individual can only deduct $3,000 of capital losses against ordinary income in any given year. Moreover, stock of an S corporation is subject to the "income in respect of decedent" rules.

The disadvantages of both corporate entity forms leaves limited liability companies that elect to be treated as a partnership as the preferred choice. These entities are pass-through in nature for federal and state tax purposes, meaning they are not subject to income tax at the entity level. (California, does, however, impose an entity-level gross receipts tax on LLCs of up to approximately $12,000.) There are no limitations on the types of eligible owners. Unlike S corporations, partnerships may have foreign investors and entities as owners. In addition, special tax allocations are generally allowed, except for family limited partnerships. The ability to provide for special allocations of income and expenses often makes it easier for LLCs and partnerships to attract needed capital. LLCs and partnerships are not typically used as loan-out entities since entertainment companies will generally withhold income and employment taxes from payments to them.

Contributions and distributions of property to LLCs and partnerships are generally tax-free. The ability to move property into and out of these entities in a tax efficient manner is a key strength as business circumstances change and members/partners come and go.[11] It is important to note that some entertainment assets (e.g. participations and residuals) may not constitute property for purposes of these nonrecognition provisions. Finally, when a partner dies, the income tax basis of his or her share of the assets of the partnership can be stepped up to their fair market value on the date of the partner's death.

An important concept to keep in mind when dealing with entertainment assets are the income in respect of decedent (IRD) rules. Generally, when a person dies, his or her heirs receive a fair-market value basis in the decedent's assets. This tax basis can then typically be used to offset part or all of any potential gain arising from the sale of the assets. Therefore, absent a special rule, certain assets, such as participations in movies or television shows, would escape taxation completely. The IRD rules apply differently to sales of copyrights as opposed to licenses of copyrights, even though the payments streams may be the same.

Congress's answer to this potential tax avoidance is the concept of IRD. For individuals, IRD includes income to which the decedent had a contingent claim at the time of his or her death.[12] For S corporations, IRD includes income received by the S corporation that would be IRD if received by an individual or estate directly.[13] The IRD rules also apply to certain payments to deceased partners in the context of LLCs or partnerships.[14]

The fair-market value of the remaining expected future income that would constitute IRD will be included in the decedent's estate for estate tax purposes, and the basis of the assets that generate IRD are not stepped up to their fair-market value in the hands of the estate or the beneficiaries. In addition, there is no basis step-up for the portion of S corporation stock, LLC, or partnership interests attributable to IRD property held by such entities. When part or all of the remaining IRD is received by the beneficiaries of the estate, those beneficiaries will have to include the amounts as income for income tax purposes. Thus, IRD is effectively subject to both estate and income tax. However, the beneficiaries may claim an income tax deduction for the portion of the estate tax that is attributable to this income.

Capital Gains and Ordinary Income

Capital assets are generally property other than inventory or property held for sale in the ordinary course of business or trade, business property subject to depreciation, and specified self-created assets. There is an exception to the self-created asset exclusion for musical compositions or copyrights in musical works that allows the creator to elect to have them treated as capital assets. This election is available to individuals, LLCs, partnerships, and S corporations.

Long-term capital gains are gains from the sale of a capital asset held by a taxpayer for more than 12 months. For self-created property, such as musical copyrights, the holding period begins when the work is created. Short-term capital gains earned by individuals are subject to tax at the regular ordinary income tax rates, while long-term capital gains earned by individuals are subject to tax at more favorable rates, usually 15 percent for federal income tax purposes. However, capital gains earned by C corporations are subject to tax at the higher corporate rates and not the more favorable long-term capital gains rates applicable to individuals. As a result, copyrights that are capital assets should not be held by C corporations, since a sale of the copyrights would result in a corporate level tax plus an additional tax at the shareholder level. If the copyrights had been held by an individual or pass-through entity, the gain would be taxed only once and only at the favorable long-term capital gains rates.

In many cases, transfers of copyrights can be structured as either a sale or a license. That choice can have significant differences for income tax, IRD, and estate tax purposes. In the case of a sale of a copyright that qualifies as a long-term capital asset by an individual, an LLC or partnership with individual members, or an S corporation, the gains will be taxed at the lower capital gains rates.[15] This will be true even if the sale proceeds are payable over a number of years.[16] However, the income to be received after the death of the creator constitutes IRD, which would be included in the creator's estate. As IRD property, the basis of the expected future income[17] would not be stepped up to its fair market value on the date of death. This will result in higher taxes if the income stream is later sold. Conversely, in the case of a license of a copyright, the royalty or license payments will be taxed at the higher, ordinary income rates. Unlike a sale, however, the future income payments will not constitute IRD and the basis of the copyrights will be stepped up to their fair-market value, thereby reducing the taxes to be paid in a future sale of the copyrights. Thus, the owner of copyrights is faced with a choice of having the payments from the exploitation of the copyrights taxed at the lower capital gains rates, but at the expense of having the remaining payments fall within the unfavorable IRD rules with no basis step-up upon the creator's death.

Copyright Terminations

Copyrights are unusual assets because, under the 1976 Copyright Act, the creator enjoys an absolute, nonwaivable right to terminate a transfer.[18] The right to terminate a previous copyright assignment or license can be a valuable right for the creator (especially since the

right of termination does not require any repayment of the consideration originally received in exchange for the assignment or license of the copyright). Terminating the prior assignment or license can allow the creator to relicense the copyright at potentially higher and better terms than the first assignment. It can also be a source of frustration when implementing the creator's transfer taxes plan, since the post-mortem termination right is available to the creator's "statutory heirs," who may circumvent the creator's intended disposition of the copyright.

Copyright termination rights generally are available during a five-year window that begins 35 years after the assignment or license of the copyright.[19] While the termination right cannot be waived by the creator or statutory heirs, the creator may be able to transfer a copyright not subject to the termination right of the creator's statutory heirs by transferring the copyright through the creator's last will and testament.[20] This is a narrow exception and significantly limits the creator's ability to transfer a copyright in accordance with his or her wishes.

For copyright termination purposes, the creator's statutory heirs include the creator's surviving spouse (if any), the creator's surviving children, and the children of a predeceased child of the creator (the creator's grandchildren), if any.[21] If there are surviving children or grandchildren, the surviving spouse receives 50 percent of the termination right and any subsequent sale or relicensing proceeds that are produced as a result of the exercise of the termination right. If there are no surviving children or grandchildren, the surviving spouse receives 100 percent of the termination right and resulting proceeds. The creator's surviving children and grandchildren receive the other 50 percent (or 100 percent if there is no surviving spouse) to be divided among them in per stirpital shares.[22] If the creator is deceased, the termination right must be exercised by a majority of the statutory heirs holding the termination right as determined by their percentage of ownership.[23] The exact procedure for the termination is cumbersome, so creators or their statutory heirs should consult with competent intellectual property law and estate counsel to ensure that the termination right is successfully exercised.

The creator's surviving spouse, referred to in the 1976 Copyright Act as the "widow" or "widower," is defined as "the author's surviving spouse under the law of the author's domicile at the time of his or her death, whether or not the [surviving] spouse has later remarried."[24] The continuation of the surviving spouse's rights after remarriage increases the potential for conflict among the heirs, as the surviving spouse will not hold sufficient ownership in the termination right to exercise it alone if there is a surviving child or grandchild of the creator.[25]

After a successful exercise, the holder(s) of the termination right (the creator or the statutory heirs) can exploit the copyright for the remainder of the copyright term. In practice, this often includes selling or licensing the copyright back to the assignee from whom the copyright was reacquired—presumably at a higher price than the original contract to take into account the increased value and recognition of the copyright since the original acquisition. As an absolute owner, however, the holders are free to assign or license the copyright to a new third party or chose to allow the copyright to be unused.

The presence of the copyright termination right can be problematic for a creator who wishes to gift, sell, or transfer a copyright to an individual other than the creator's statutory heirs. It is probably wise to assume that any lifetime transfer of a copyright provides no protection from the termination right of statutory heirs. Even a lifetime gift to a member of the statutory heirs, such as the creator's spouse or children, does not protect the transferee, as the identity of the creator's statutory heirs (including the surviving spouse) may not be determinable until after both the creator's death and the exercise period for the termination right begins.

While the termination rights are not waivable, creators and their legal advisers who do not wish to use a limited-purpose will, may instead use an incentive structure that encourages statutory heirs to decline to exercise their termination rights. It is not uncommon for lifetime gifts in trust or testamentary bequests to be conditioned on certain events, such as surviving the decedent or attaining a certain age. Similarly, gifts in trust or bequests to statutory heirs of other assets could be conditioned upon the statutory heirs not exercising their termination rights with respect to the previously transferred copyrights (i.e., through the use of a no-contest clause). However, there is a possibility that a court might conclude that the use of a no-contest clause is void as being contrary to the public policy established in the 1976 Copyright Act.

The one limited statutory exception permitted by the Copyright act to waive the termination right and thereby circumvent the exercise of a termination right by statutory heirs, is to transfer the copyright by last will and testament. In California, however, testamentary transfers by will are generally not recommended because of the requirements for probating the will, which involve a lengthy and expensive court process. To avoid probate, many individuals in California choose to create revocable living trusts through which they transfer assets at death. Unlike a will, a court need not be involved in the transfer of assets held by a trust, avoiding both the delay and expense as well as the publicity that occurs when an individual dies and the assets are probated through a will.

Under California state law, a living trust is a will substitute for all purposes of testamentary transfers.[26] However, there does not appear to be any authority under the 1976 Copyright Act to extend the benefit of waiving termination rights for testamentary transfers by will to revocable living trusts or other state-recognized will substitutes. Accordingly, a creator has to choose between disposing of the copyrights either by will involving a public probate, or by a living trust without a public probate but risking that the statutory heirs will unwind the transfer.

Transfer Tax Planning Opportunities

Although the termination rights of statutory heirs create practical limitations on gift and estate planning with copyrights, a copyright creator or the owner of other entertainment assets should consider several transfer planning techniques. Generally, the same gift planning techniques that are available for any asset (such as outright gifts, gifts in trust, sales of partial interests that take advantage of lack of marketability and control discounts, etc.) are available for entertainment assets.[27] It should be noted that many of the normal transfer tax planning techniques become more challenging in the case of copyrights because of their limited life, which has an impact on their valuation.

One common vehicle for the lifetime transfer of an asset is the charitable remainder trust. However, since the charitable income tax deduction is limited to the tax basis in the asset rather than the full fair market value of the asset, entertainment assets are generally a poor choice for funding a charitable remainder trust.

For holders of entertainment assets who would prefer to benefit individuals rather than charitable organizations, there are two common transfer tax planning techniques to consider: a sale to an intentionally defective grantor trust and a grantor retained annuity trust.

A sale to an intentionally defective grantor trust[28] involves 1) the creation of a trust for the intended beneficiaries, 2) an initial gift of cash by the donor to the trust, and 3) a sale of the entertainment asset from the donor to the trust. The purpose of this transfer is to remove the future appreciation and income stream of the entertainment asset from the donor's estate for estate tax, but not income tax, purposes.[29] The gift and subsequent sale may be structured so that the donor either gifts the entire purchase price, which is then

returned to the donor in the sale, or gifts a smaller amount as a down payment with the balance of the sales price satisfied by a promissory note issued from the trust to the donor. The use of a promissory note allows the donor to receive some ongoing payments in the form of interest income payable from the income stream generated by the entertainment asset. Current, historically low interest rates allow the donor to transfer more value to the trust than would otherwise be feasible.

Like a charitable remainder trust, a grantor retained annuity trust involves a transfer by a donor to a trust that retains a current income stream, in this case for the benefit of the donor, with the remainder of the assets in trust passing to or for the benefit of individuals selected by the donor at the end of a set term. Many favor the grantor retained annuity trust for transfer tax planning because it allows them to retain a current income stream from the entertainment asset that is generally larger than the interest income payable from the intentionally defective grantor trust sale. However, valuing copyrights and other entertainment assets can often be more difficult than valuing other assets.

For lifetime gifts to a qualified charitable organization,[30] the donor of an entertainment asset generally receives an income tax deduction for contributions of the entertainment asset. The amount of the charitable income tax deduction is generally equal to the fair market value of the donated entertainment asset at the time of the contribution. However, in the case of self-created copyrights (other than self-created musical copyrights), patents, trademarks, and certain other property, the amount of the income tax deduction is reduced by the amount of any long-term capital gain.[31]

Notwithstanding the above, donors of qualified intellectual property, such as self-created musical copyrights, to a qualified charitable organization can claim significant income tax deductions under IRC Section 170(m). Annual charitable income tax deductions are available for a 120-month period in an amount equal to the income generated by the charity from the exploitation of the musical copyright, multiplied by a decreasing factor.[32] This annual charitable income tax deduction can be extremely beneficial to the donor, especially if significant income is generated by the musical copyrights during the 120-month period. Note that certain record keeping requirements must be satisfied by the charitable organization in order for the donor to qualify for the deductions under Section 170(m).[33] In addition, to qualify under Section 170(m), the donor may have to transfer his or her

entire interest in the musical copyright to the qualified charitable organization; a transfer of a partial interest in a musical copyright would generally not qualify.

While entertainment assets and income streams can present unique challenges for income and transfer tax planning purposes, many strategies are available to minimize adverse income, gift, and estate tax consequences and maximize preferential treatment. They require, however, careful planning that integrates corporate law, estate and gift planning, and income tax planning to achieve the desired objectives. A team approach by the advisers is required to make sure the best results are obtained for the client. ■

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[1] California also recognizes an entertainment asset referred to as the "right of publicity," which protects an individual's right to control the commercial use of his or her name, likeness, or personal characteristics. CIV. CODE §3344. As an entertainment asset, the right of publicity has similar income, gift, and estate tax planning issues, but along with trademarks and service marks are beyond the scope of this article.

[2] These payment streams are deferred compensation payments that are subject to I.R.C. §409A. A discussion of the taxation of deferred compensation under §409A is beyond the scope of this article, but suffice it to say that when deferred compensation is present there are very technical and complex rules that must be complied with, lest the service provider be subjected to severe income tax penalties at both the federal and state levels.

[3] Different rules and terms apply to copyrights created before January 1, 1978, which are governed by the 1909 Copyright Act. The differences between the 1909 and 1976 Copyright Acts are significant, especially concerning the terms of the copyrights, and creators should carefully review the creation date of their copyright to confirm which copyright act applies. This article focuses on copyrights created after January 1, 1978.

[4] I.R.C. §302.

[5] This would apply to assets such as copyrights, trademarks, service marks, and other assets that may appreciate in value during the time they are held by a C corporation.

[6] In tax planning for participations and residuals, C corporations or S corporations are commonly used as loan-out corporations to reduce the risk that entertainment companies will withhold income and employment taxes from payments for services rendered.

[7] I.R.C. §541.

[8] Certain trusts or single-member LLCs may be shareholders of an S corporation.

[9] A built-in-gain will arise if the fair market value of the C corporation's assets are higher than their tax bases on the date the C corporation converts to an S corporation.

[10] I.R.C. §1362(d)(3).

[11] *See generally* I.R.C. §§721, 731.

[12] *See generally* I.R.C. §691 and Treas. Reg. §1.691(a)-1(b)(3).

[13] I.R.C. §1367(b)(4).

[14] I.R.C. §753.

[15] The current long-term capital gains tax rate for individuals is 15%. Barring legislative action, the 15% preferential rate will expire on December 31, 2012. The resulting rate would be 20%.

[16] Note that if payments are received over a number of different tax years, a portion of the capital gain will be recharacterized as interest income and taxed at the higher ordinary income tax rates. I.R.C. §453A(c).

[17] Note that the basis of the stock of an S corporation attributable to IRD assets held by the S corporation would also not be stepped up to fair market value.
[18] 17 U.S.C. §203(a). Under the 1976 Copyright Act, termination rights are not extended to copyrights for works made for hire. Trademarks, patents, participation rights, and other entertainment-related assets do not have a statutory termination right or comparable interest. In practice, contracts or assignments for other entertainment-related assets rarely include termination rights, as such provisions would reduce the value of the assets to the assignor.
[19] 17 U.S.C. §203. If the assignment of the copyright included the right of publication of the copyrighted materials, the window begins at the earlier of 35 years from publication of the copyrighted material or 40 years from execution or grant of license for the copyright.
[20] 17 U.S.C. §304(c).
[21] 17 U.S.C. §203(a)(2)(A).
[22] *Id.*; 17 U.S.C. §203(a)(2)(B). If there are no statutory heirs, the termination right is exercised by the appropriate fiduciary of the creator's estate. 17 U.S.C. §203(a)(2)(C).
[23] 17 U.S.C. §203(a)(2).
[24] 17 U.S.C. §101.
[25] This is in addition to the conflict that may already exist if the surviving spouse is not related to the creator's issue who hold the balance of the termination right.
[26] A trust may be created for any purpose that is not illegal or against public policy, including the disposition of property at death. *See* PROB. CODE §15203. Property transferred to a trust is no longer owned by the transferor and is not distributable by the transferor's will or as part of the transferor's estate. *See* PROB. CODE §§6101 and 6400.
[27] Note that transfers of participations, residuals, and royalties raise assignment of income and I.R.C. §409A issues that should be carefully considered before any transfers. In addition, they may not constitute "property" and thus may not qualify for certain tax-free transfers. I.R.C. §351, 721.
[28] An intentionally defective grantor trust is an irrevocable trust that qualifies as a grantor trust for income tax purposes, which means that although the trust is a separate legal entity, the donor is responsible for all income tax burdens and benefits of the trust on the donor's individual income tax return.
[29] Note that in President Obama's 2013 Fiscal Year Budget Proposal, released earlier this year, the administration proposed new tax treatment for grantor trusts, including that grantor trust assets would be included in the grantor's estate for estate tax purposes and distributions from a grantor trust would be treated as a gift. This proposal would apply to grantor trusts created on or after the date of enactment. *See* General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, Feb. 13, 2012, *available at* http://www.treasury.gov/resource-center/tax-policy/pages/general_explanation.aspx.
[30] An organization that is exempt from taxation under I.R.C. §501(c)(3).
[31] I.R.C. §170(e)(1); I.R.C. §1221(a)(3).
[32] For the first 2 years of the 12-year period, the donor may deduct an amount equal to 100% of the income generated by the qualified charitable organization from the musical entertainment asset. Thereafter, the percentage decreases by 10% each year, until years 11 and 12, during which time the donor may deduct only 10% of the income generated by the musical entertainment asset. I.R.C. §170(m).
[33] The donee charitable organization is required to file an annual information return (which includes the net income generated from the property received). *See generally* I.R.C. §6050L(b) and Internal Revenue Service Form 8899, Notice of Income From Donated Intellectual Property.