By William M. Weintraub and Burton A. Mitchell

Estate and Gift Tax Planning for Copyright Owners

The intersection of tax and copyright laws creates unusual planning scenarios

The disposition of intellectual property presents unique challenges and opportunities for estate planners, most of whom are not fully informed about copyright law. In the disposition of intellectual property, both tax and nontax issues can be more complex than for other, more common assets, such as marketable securities, real estate, and closely held business interests. These differences are critical for songwriters, playwrights, authors, and others for whom copyrights are their principal assets.

In estate planning for copyright holders, the practitioner must work with the already complex income, gift, and estate tax rules, together with an overlay of the completely unrelated set of rules governing the ownership and disposition of copyrights. This mixture is further muddled by the recent change in federal tax law[1] that reduces the maximum estate and gift tax rate between 2002 and 2009,[2] increases the amount of property that may be transferred free of estate tax at death between now and 2009,[3] repeals the estate tax entirely in the year 2010[4] (but substitutes a carryover basis regime), and finally, repeals the repeal of the estate tax, the rate reductions, and exemption increases after 2010.[5]

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The 1976 Copyright Act,[6] which became effective on January 1, 1978, establishes the rules for copyright protection for works of authorship.[7] Prior to that date, the Copyright Act of 1909 generally governed the protection of copyrights. Under the 1976 Act, registration of a copyright is not necessary for protection of a work subject to the act; protection is automatically extended whenever the works are created. However, registration of copyrights is necessary to enforce protectible rights.

Section 106 of the 1976 Copyright Act generally gives the owner of a copyright the exclusive right to do, and to authorize others to do, the following:

1) Reproduce the work in copies or phono records.

2) Prepare derivative works based upon the work.

3) Distribute copies for phono records of the work to the public by sale or other transfer of ownership, by rental, lease or lending.

4) Perform the work publicly, in the case of literary, musical, dramatic and choreographic works, pantomimes, and motion pictures and other audiovisual works.

5) Display the work publicly, in the case of literary, music, or dramatic and choreographic works, pantomimes and pictorial, graphic or sculptural works, including the individual images of motion picture or other audiovisual work.

6) In the case of sound recordings, to perform the work publicly by means of a digital audio transmission.[8]

A work that is not for hire that is created on or after January 1, 1978, is protected from the date of its creation for a period that equals the author's life plus an additional 70 years.[9] If the work was created by the joint effort of two or more authors who do not work for hire, the term lasts for 70 years after the last surviving author's death.[10]

The term for works made for hire or for anonymous or pseudononymous works (unless the author's identity is revealed in copyright office records) is 95 years from publication or 120 years from creation, whichever is shorter.[11] The same rules generally apply to works created before January 1, 1978, except that in no case does the term of a copyright for pre-1978 works expire before December 31, 2002.[12] For works published between January 1, 1978, and December 31, 2002, the copyright does not expire before December 31, 2047.[13]

For works originally created and published or registered before January 1, 1978, the original copyright protection endured for a term of 28 years, subject to a renewal term of 28 years. The 1976 Act, together with other changes in the law, provide a total renewal term of 67 years. This provides for total protection, including the original 28-year term, of 95 years.

A work made for hire is treated differently for both tax and copyright purposes. A work made for hire is a work prepared by an employee within the scope of employment or a work specifically ordered or commissioned for certain specific purposes.[14] The period of protection of a work for hire is not related to the life of the author. Instead, the copyright protection lasts for a period that expires upon the earlier of 75 years from the year of first publication or 100 years from the date of creation.[15]

The 1976 Copyright Act provides that the author has an absolute right to terminate the grant of either an exclusive or nonexclusive transfer or a license of a copyright at any time during a five-year period beginning 35 years after the grant.[16] If the author is deceased, this right passes to the surviving spouse, children, or grandchildren of the author, but the right cannot be transferred by will.[17]

The right of termination reserved to the author or to the author's spouse or issue raises a number of highly technical tax questions. In general, the analysis of gifts, sales, and other transfers for tax purposes is ordinarily based upon the irrevocable nature of such transactions. The right to terminate the grant of any interest in a copyright therefore raises problems that most tax planners do not ordinarily address. These issues may include the valuation of the right to terminate, the inclusion of assets in the estate of a decedent possessing the right to terminate, and

the effect, if any, on certain intended irrevocable transfers, such as charitable gifts and marital trusts.

Lifetime Transfers versus Transfers at Death

Planning for the disposition of copyrights often involves trade-offs between income tax benefits and estate tax benefits; that is, between lifetime gifts and transfers at death. The starting point for any analysis or planning is the recognition that copyrights are not capital assets in the hands of their creators.[18] This tax rule vastly restricts lifetime estate planning opportunities for creators of copyrights, particularly as the tax on estates declines between now and 2009 and then disappears altogether in 2010. (This rule does not apply to works made for hire. Because the owner of the copyright of a work made for hire would not be the taxpayer whose personal efforts created the copyright, the copyright may qualify as a capital asset.[19])

Many estate planning techniques implemented during the lifetime of an individual are designed to remove the future appreciation of an asset from an individual's estate. Typically, the trade-off for the removal of future appreciation is a carryover of the tax basis of the asset transferred. That is, the transferor's tax basis becomes the tax basis for the transferee. In contrast, if the asset remains in a transferor's estate, the full value of the asset is included in the estate, but the transferee's tax basis is stepped up to reflect the fair market value of the asset as of the date of death or, when appropriate, six months after the date of death. As a result, the transferee can sell the asset at the value established in the estate without incurring a gain for appreciation that took place before the transferor's death.

This trade-off often produces favorable results because the estate tax rate historically exceeded the gift tax on a lifetime transfer plus the income tax on the sale of an asset (the basis often being zero). Further, most estate taxes must be paid within nine months of the date of death. In contrast, the recipient of a lifetime transfer can control the timing of the income tax by deciding when to sell the property.

The following example illustrates the tax benefit—prior to the change in the estate tax law—of removing an appreciating asset from an estate: Assume that in 2001, a parent gave away an asset with a fair market value of $675,000 to a child and avoided paying a gift tax by utilizing all of the parent's lifetime credits. At the time of the gift, the parent had a tax basis in the asset of $100,000. The parent anticipated that the asset would appreciate to at least $2 million before the parent's death. The transfer of the asset in 2001 will remove the asset and all appreciation of the asset from the parent's estate. Therefore, under the old law (assuming that the asset was worth $2 million at the date of the parent's death), the parent would avoid a 55 percent tax on appreciation of $1,325,000 (the appreciation after the gift). This would result in tax savings to the parent's estate of approximately $730,000.

Because the asset was transferred as a gift, the child has a tax basis in the asset of only $100,000 and will have to pay income tax on the asset's appreciation at the time he or she sells or otherwise disposes of the asset. Assuming an effective income tax rate on capital gains for a California resident of 25 percent, the child would eventually pay income tax of approximately $475,000 upon a sale of the $2 million asset, assuming that capital gains rates apply.

If the parent had not made a gift of the asset to the child during the parent's lifetime, the parent would have incurred an additional $730,000 of estate tax on the appreciation of the asset. However, the child would have avoided the income tax of approximately $475,000 on the sale of the asset because the child would get a step-up in basis of the asset to $2 million, the fair market value of the asset included in the parent's estate. Since the estate tax on the appreciation of the asset exceeded the income tax resulting from the sale of the asset, the lifetime transfer of the asset produced substantial tax savings.

However, if the gift asset was a copyright, the tax payable by the child upon the sale of the copyright would not be eligible for capital gains treatment. Instead, a copyright retains its status as a noncapital asset in the hands of the child because the child's tax basis is determined by the parent's tax basis.[20] While the lifetime transfer removes future appreciation from the parent's estate, it does not avoid the income tax on the built-in gain on the date of transfer or the income tax on any appreciation thereafter. This appreciation would be taxed at the combined federal and state rate for ordinary income (45 percent for California residents in the highest tax bracket), or approximately $900,000, an amount substantially greater than the savings derived by removing the appreciation from the taxpayer's estate.

Even if by 2007 there were no built-in gain as of the date of the lifetime transfer, tax rates on estates will not be much higher than rates on ordinary income. Tax planning may thus favor retention of a copyright in the estate of the creator so that beneficiaries will get a step-up in basis of, and thereby avoid ordinary income tax rates on, the built-in gain. More important, since the beneficiaries' basis in the copyright would not be determined by the deceased creator's basis, the copyright would convert to a capital asset. Accordingly, any future appreciation would be taxed at the presumably lower capital gains rates. These benefits are obtained at the cost of inclusion of the copyright in the creator's estate, making it subject to estate tax rates that are approximately equal to income tax rates.

When the estate tax is repealed in 2010, an entirely different set of considerations could apply. The scheduled elimination of the estate tax is accompanied by the application of carryover basis rules for beneficiaries of an estate. While the law as drafted provides a partial step-up in the basis of assets, the amount of the step-up is limited to $3 million for a sur-

The Valuation of Copyrights

While there is no simple method for determining the value of a copyright, there are a number of factors that should be considered. Principal among these are the income stream available to the holder of a copyright and the term of the projected income stream. Obviously there are many factors that could affect the projected income stream. Moreover, the term of the copyright and the termination rights of the creator raise some interesting questions in the evaluation of copyrights.

First, for copyrights created before January 1, 1978, renewal rights are granted to the creator or the creator's surviving spouse and children. Thus, under the old law, the creator or the creator's heirs could reclaim the value of the copyright. For example, if the creator transferred rights to the renewal term of a copyright other than by will before 1978, the heirs can recapture the rights to the copyright by terminating prior grants. For a transfer after 1978, the right to terminate the transfer exists during a five-year period which starts at the end of 35 years after the transfer. The grant may be terminated by serving notice on the grantee during a specified notice period, which is more than two years but less than ten years before the termination date stated in the notice.

These rules can affect the valuation of copyrights. Therefore, in valuing a copyright, an appraiser will have to take into account the value of the reversionary interest in the rights previously granted by the owner of the copyright.**—W.M.W. & B.A.M.**

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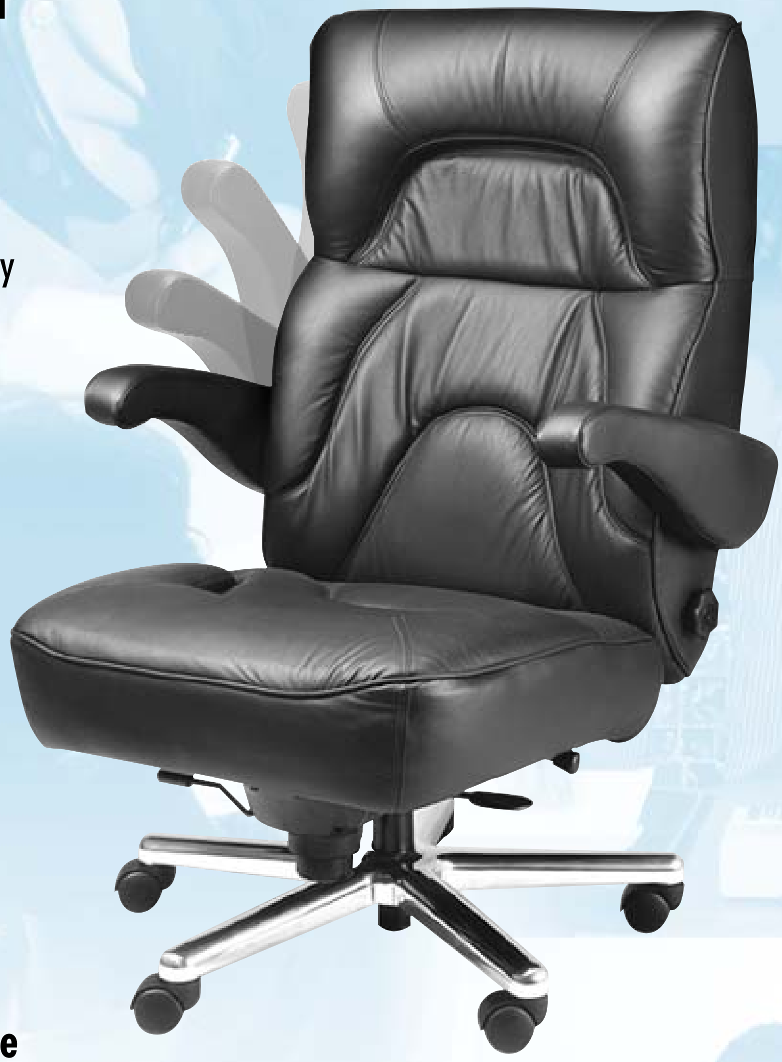

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viving spouse and $1.3 million for other beneficiaries (which could also include a surviving spouse).[21] If these rules apply, the copyrights held by the estate of a deceased taxpayer would be the most likely to receive the step-up in basis for two obvious reasons. First, without the step-up in basis, any gain on the subsequent sale of the copyrights would be taxed at the higher ordinary income tax rates, and second, by applying the substituted basis rules of IRC Section 1014,[22] the copyrights would then become capital assets for the beneficiary.

Holders of copyrights who are not the creators of the copyrights can generally minimize the estate and gift taxes in transferring copyrights in the same methods used in transferring other capital assets. This may involve the use of family limited partnerships, transfers to grantor retained annuity trusts, or sales to defective grantor trusts. However, for creators of copyrights, the planning opportunities are more limited because of the tax consequences associated with their treatment as noncapital assets. While the traditional planning techniques may be useful in removing the future appreciation in assets from an individual's estate, they do not eliminate the built-in gain or change the character of the resulting gain upon the sale.

Charitable Remainder Trusts

A charitable remainder trust—a traditional estate planning technique—can be applied effectively to minimize these problems. Basically, a charitable remainder trust is a split interest trust in which an income interest is set aside for one or more noncharitable beneficiaries and a remainder interest is set aside for a charitable beneficiary. Typically, a donor contributes assets to an irrevocable trust in exchange for the right to receive a payment, either for a designated term of years or for the life or lives of one or more individuals. The donor may establish the amount of the payment made by the trust to the donor as either a fixed annual annuity or as a unitrust payment measured by a percentage of the fair market value of the assets in the trust, valued annually. A trust that provides for the payment of an annuity is generally known as a charitable remainder annuity trust or a CRAT.[23] If the payment is in the form of unitrust, the trust is commonly known as a charitable remainder unitrust or a CRUT.[24] The annual payment to the beneficiaries from either a CRAT or a CRUT must be not less than 5 percent nor more than 50 percent of the trust assets.[25] In both cases, the value of the remainder to the charitable beneficiaries must be at least 10 percent of the initial net fair market value of property transferred to the trust.[26]

Unitrust payments from a CRUT can take a variety of forms, the most basic of which is a fixed percentage of the net fair market value of the assets, valued on an annual basis. However, in many cases, the trust may not have sufficient liquid assets to make a payment to the donor each year. In order to avoid using principal to make payments, the terms of the trust can limit the payment to the lesser of a fixed percentage of the net fair market value of the assets or the net income of the trust.[27] Thus, if a trust has no net income during the year, the trust would have no obligation to make a payment to the donor.

Another version of CRUT payments is a net income charitable unitrust with a make-up provision under which the trust distributes to the noncharitable beneficiaries in later years sufficient income to make up for any shortfall between the unitrust amount and the net income of the trust in prior years.[28] This type of trust is known as a net income make up charitable remainder unitrust or a NIMCRUT.

Finally, another version of a charitable remainder unitrust allows a NIMCRUT to flip into a regular unitrust without any net income limitations.[29] However, the triggering event for the flip cannot be at the discretion or within the control of the trustee. The sale of unmarketable assets and changes in family relationships, such as a marriage, divorce, death, or birth of a child, will not be considered discretionary or within the control of the trustees or other persons. After the flip, the trust pays a fixed percentage of trust assets to the noncharitable beneficiary, irrespective of the income earned by the trust each year.

A NIMCRUT with a flip provision can prove useful to the creator of a copyright. For example, assume that a 65-year-old creator owns a copyright that is expected to appreciate in the future. It is possible that the death of the creator will cause dramatic appreciation in the value of the copyright. Currently the royalty that the creator receives from ownership of the copyright is relatively small, perhaps $20,000 per year. Based upon the current royalty stream, the value of the copyright is estimated at $200,000. The creator is not married but has a 40-year-old daughter whom the creator would like to benefit. The creator can manage the copyright during his lifetime but anticipates that the copyright will be sold and would like the proceeds held for both his benefit for the remainder of his life and for the benefit of his daughter for the remainder of her life. However, the creator does not want to reduce the proceeds available for investment by paying income tax at ordinary rates.

The creator can establish a CRUT by contributing the copyright and providing a 6.5 percent unitrust payment, subject to a net income limitation.[30] Each year after the trust is established, the copyright is valued. The creator receives the lesser of the income of the trust or the unitrust payment of 6.5 percent of the value of the copyright. If the copyright dramatically appreciates in value (typically because of an increase in the royalty stream), the creator will receive larger unitrust payments. On the other hand, if, for any reason, the trust receives little or no income during any year, the net income limitation would apply to reduce the trust's obligation to pay the creator. If the copyright is sold, the trust would flip to a regular unitrust providing for annual payments of 6.5 percent of the trust assets for the remainder of the life of the creator and his daughter.

Therefore, if the copyright sold for $2 million, the creator and his daughter will have the full pretax use of the proceeds from the sale available to generate income for the rest of their lives (versus $1.2 million on an after-tax basis). Even if the proceeds do not produce income at 6.5 percent, the creator and then his daughter would each receive 6.5 percent of the value of the CRUT assets each year. Through the use of this technique, the value of the copyright will not be reduced by any income taxes or estate taxes, since the asset is not includable in the creator's estate and has been sold tax free by the CRUT.

Charitable Lead Trusts

A charitable lead trust is similar to a charitable remainder trust except that the rights of the charitable and noncharitable beneficiaries are reversed. In a charitable lead trust, a charity receives the income interest for a period of years and the noncharitable beneficiaries receive the remainder.[31] Thus, for transfer tax purposes, either gift or estate, the value of the property subject to transfer tax is the remainder interest transferred to the noncharitable beneficiaries.

Assume, for example, that a 65-year-old parent owns an asset worth $1 million. The parent wants to transfer the asset to his or her child after it provides income of $120,000 per year for 10 years to the parent's favorite charity. After 10 years, the asset, together with all rights to its income, will be transferred to the child. Under these terms, the value of the gift to the child is the difference between the fair market value of the property transferred and the value of the income interest transferred to the charitable beneficiary. Based on these facts, the value of the gift to the child would be approximately $65,000.

The benefit of this technique can be leveraged if the asset is first transferred to a limited partnership and the parent then contributes the limited partnership interest to the charitable lead trust. In this manner, the fair market value of the contribution of the partnership interest would be less than the contribution of the asset because of the discounts applicable to valuations of limited partnership interests. However, the income stream available to pay to the charitable beneficiary should remain the same. Therefore, the lead or income interest to a charitable beneficiary could be shorter yet achieve the same value of the gift of the remainder interest to the child. Based upon the previous assumptions, if the limited partnership interest was discounted by 30 percent, and assuming the same annual payment of $120,000, the term of the interest to the charity could be shortened to six years.

Use of a charitable lead trust reduces or eliminates the transfer tax cost, either estate tax or gift tax, normally imposed on the transfer of property to intended beneficiaries. However, the built-in gain on the asset transfer will remain; that is, the transferee will receive the property with a tax basis equal to the transferor's tax basis. Further, because the transferee's basis is determined by the transferor's basis, if the asset is a copyright, it will remain a noncapital asset. Therefore, a sale of the copyright would be taxed at ordinary income rates, not capital gains rates.[32]

However, if it is the intention of the transferor to retain the copyright in the family, and no sale is contemplated during the term of the copyright protection, elimination of the potential tax on a sale would be irrelevant. In that case, the problem that a charitable lead trust can successfully address is the transfer tax cost that results from the inclusion of the asset in the transferor's estate (especially if the asset appreciates in value during the transferor's lifetime).

Other Estate Planning Issues

Estate planning for copyright assets is simplified if the creator is willing to part with the expected revenue stream in the future. For example, a creator, upon creating a new copyright, the value which has not been established, can sell the copyright to a trust for the benefit of the creator's children or grandchildren. Assuming that the sale is conducted at a price equal to the fair market value of the copyright, the creator will have removed all future appreciation in the value of the copyright from the creator's estate. Additionally, because the trust will have purchased the copyright, the trust's basis in the copyright is not determined by the basis of the copyright in the hands of the creator.[33] Therefore, the copyright is not automatically excluded from the definition of a capital asset. As a result, the gain on any eventual sale of the copyright by the trust should result in a tax imposed at capital gains rates.[34]

The Internal Revenue Code includes special rules for the treatment of transfers of works of art and their copyrights that are intended to qualify for the gift or estate tax charitable deduction. In general, the IRC treats works of art and their copyrights as interests in the same property. In particular, the IRC provides that no estate tax or gift tax charitable deduction is allowed if a donor transfers a partial interest in property.[35] (Exceptions to these rules were made for transfers to certain specific split interest trusts such as CRUTs and CRATs.)

If a work of art and a copyright are considered the same property, the transferor of one without the other would be treated as a gift of a partial interest, and, therefore, the prohibition for deducting transfers of partial interests would apply. For example, an artist who created a painting has separate property rights in both the painting and the copyright of the painting. If these are treated as the same property, the prohibition against transfers of partial interests would apply unless the creator donated both the painting and the copyright to the same beneficiary.

However, an exception is provided if a donation is a qualified contribution, which is a contribution of a work of art to an exempt organization whose use of the property is related to the purpose or function serving as the basis for the organization's exemption.[36] For example, a donation by an artist of a painting to a museum for use in public display or exhibit would generally constitute a qualified contribution. However, if it is anticipated that the museum will sell the painting, then the exception would not apply and the copyright of the painting would be treated as the same property.

These rules will not apply to an individual who does not own the copyright.[37] For example, a collector of art who does not own a copyright is not subject to the potential application of the partial interest rule. Therefore, most collectors are able to donate art or the related copyright of works of art to charitable organizations without concern over the use of the property by the charity. However, creators of copyrights must be careful in selecting the charities for their contributions. Either the property must be used by the charity towards the charity's exempt purpose or the donor must contribute the property and the related copyrights.

As these examples illustrate, the unique nature of copyrights requires tax planners to consider factors that are not present when planning with many other categories of assets. With or without the repeal of the estate tax, copyrights provide serious challenges and opportunities for both their creators and their tax advisers. ■

1 The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16.
2 I.R.C. §2001(c).
3 I.R.C. §2010(c).
4 I.R.C. §2210(a).
5 The Economic Growth and Tax Relief Reconciliation Act of 2001 §901(b). For a full analysis of the changes in estate and gift taxes introduced by this legislation, *see* Charles P. Rettig, *The Life and Death of Estate Taxes*, LOS ANGELES LAWYER, Nov. 2001, at 32.
6 17 U.S.C. §101, *et seq.*
7 Works of authorship include 1) literary works, 2) musical works including any accompanying works, 3) dramatic works including any accompanying music, 4) pantomimes and choreographic works, 5) pictorial, graphic, and sculptural works, 6) motion pictures and other audiovisual works, 7) sound recordings, and 8) architectural works. 17 U.S.C. §102(a).
8 17 U.S.C. §106.
9 17 U.S.C. §302(a).
10 17 U.S.C. §302(b).
11 17 U.S.C. §302(c).
12 17 U.S.C. §303(a).
13 *Id.*
14 17 U.S.C. §101.
15 17 U.S.C. §302(c).
16 17 U.S.C. §203.
17 No right of termination applies to a work created for hire. 17 U.S.C. §203(a).
18 I.R.C. §1221(a)(3).
19 The application of the work for hire rules is unclear when the principal shareholder of a corporation provides the work for hire to the corporation. The issue is whether in that instance the corporation would be treated as the creator, thus barring capital gain treatment. In the case of a widely held entertainment company, the corporation that acquired the work for hire produced by the efforts of many individuals would not likely be treated as the creator.
20 I.R.C. §1221(a)(3)(C).
21 I.R.C. §1022.
22 I.R.C. §1014.
23 I.R.C. §664(d)(1).
24 I.R.C. §664(d)(2).
25 I.R.C. §§664(d)(1)(A), 664(d)(2)(A).
26 I.R.C. §§664(d)(1)(D), 664(d)(2)(D).
27 I.R.C. §664(d)(3).
28 *Id.*
29 Treas. Reg. §1.664-3(a)(1)(i)(C).
30 The creator would get little income tax benefit from the contribution of a copyright to a charitable remainder trust because deductions for contributions of property that would produce ordinary income on sale are limited to the contributor's basis in the property. I.R.C. §170(e)(1).
31 I.R.C. §§170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B).
32 The value of the income tax deduction is limited to the donor's cost basis. I.R.C. §170(e)(1).
33 I.R.C. §1012.
34 If the sale of the copyright is not for full fair market value, other problems could arise. For example, a sale for less than fair market value would be characterized as a gift by the creator. As a result, a portion of the trust's basis in the copyright would be determined by reference to the basis of the creator. Upon a subsequent sale by the trust, a portion of the proceeds would not qualify for capital gain treatment.
35 I.R.C. §2055(e)(2) (for estates); §2522(c)(2) (for gifts).
36 I.R.C. §§2055(e)(4), 2522(c)(3).
37 Treas. Reg. §20.2055-2(e)(1)(ii).