The Tax Implications of the International Disposition of Music Catalogs

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>> Introduction

Copyright income leads to taxation, both in national and cross-border situations. It might fall under the normal tax rules, but sometimes there are special rules and rates applicable. Following the structure of the book, this article will discuss the tax implications of first copyright income in general and then of the sale, assignment, and collateralizations to others, which might lead to other tax consequences.

National Tax Rules

Tax is levied by national tax authorities, not only from resident taxpayers but also very often from non-residents. Resident and non-resident taxpayers are treated differently.

Residents must report their world-wide income and can get relief for foreign income or taxation. On the other hand, non-residents are taxed for income sourced in that state, if applicable. Most states tax non-residents on their source copyright income, but some states believe this is not needed because non-residents do not make enough use of public facilities that they should contribute to the state's budget.

Copyright income will lead to business income when the copyright holder is actively exploiting the copyright. But if the person receiving the copyright income is a natural person and using the asset only passively while waiting for the income resulting from the use of the copyright, this income will be personal. Most often, states have different tax rules and rates for business and personal income.

Some states have special tax rates (or exemptions) for copyright income, such as Ireland and Belgium, but this is not very common. These special tax rates most often only apply to residents.

The sale, assignment and collateralizations of copyright often lead to a considerable profit, which can be seen as the cash value of the future income stream. This gives certainty to the seller, while the buyer gets the opportunity to exploit the copyright in such manner that it will bring in more than what has been paid to the seller. For the seller, this action is very often not considered normal business or personal income, but as a capital gain on the asset. Some states have lower tax rates for such capital gains. This might be one reason the seller enters into such a sale, assignment or collateralization of the copyright. For example, the USA has a top marginal federal income tax rate of 38% on regular copyright income, but a special fixed tax rate of 20% for the sale of the future rights.

Tax residence is in most states based on a house, apartment or other fixed place of living. Some states combine this with the presence during a minimum number of days during the year or with a fixed employment status with an employer in the state.

When these situations do not apply, the recipient of the copyright income is considered a non-resident.

Bilateral Tax Treaties

In cross-border situations, various tax conflicts may arise, such as:

- residence status: when a person or company has houses or offices in two or more states, the copyright income will be taxed in both states as resident's income, which means full double taxation.

- elimination of double taxation: when there is residence in only one state, then double taxation may occur in the situation when the source state charges a source withholding tax and the residence state taxes the worldwide income.

This double taxation will obstruct the appetite to work internationally.

To take away this double taxation, states have started to conclude bilateral treaties in the early 1900s. In these treaties they determine the residence state of the person or company, they divide the taxing rights among each other, and they provide relief for double taxation. The international community has come up with initiatives to harmonize these bilateral tax treaties, first in 1963 with the OECD Model Tax Convention on Income and Capital and later in 1968 with the UN Model Double Taxation Convention for the states not being members of the OECD. The UN Model mostly follows the OECD Model, but also has its exceptions. States are willing to follow the recommendations from both Model Tax Conventions in their bilateral negotiations. However, only these bilateral agreements have binding effect, not the OECD and UN models, although their Commentaries on the various treaty articles can be used as guidelines for treaty interpretation.

Additionally, states may have their Models, such as the USA with the US Model Income Tax Convention, which was updated in 2016. Most US tax treaties have been drawn up after this Model, which is often no different than the OECD and UN Model.
The main recommendations of the OECD, UN and US Model Tax Conventions are the following:

a. Residence (Article 4) is only a matter in situations where persons or businesses have houses or offices in both states. Article 4 specifies that only one state can be the residence state, which is the state where the vital interests are (personal) or where the place of effective management is (business). If this cannot be determined, the two states will enter into a mutual agreement procedure to come to a solution because Article 4 holds that only one state should be the residence state.

b. Business profits (Article 7) are only taxable in the state of residence, unless when the foreign company has a permanent establishment ("PE") in the other state. Without a PE, there should be no tax on the income of a company coming from the other state. That state should then allow an exemption at source for the non-resident company.

c. Royalties (Article 12) are also only taxable in the residence state, unless when these royalties arise through a PE in the other state. If not, then the source state needs to allow a tax exemption. Most states follow this recommendation, but some want to keep a percentage from the royalties as contribution to their state's budget and negotiate in their bilateral tax treaties a low WHT rate, between 5% and 20%.

d. Capital gains (Article 13) are also only taxable in the residence state of the recipient of the capital gain, unless when the gain comes from immovable property, held directly or indirectly through a partnership or shares in a company, or when the gain comes from a PE in the other state, because then the allocation rules for the underlying assets apply. This means that most often a capital gain on royalties most often follows the allocation rule for royalty, which is sole taxation in the residence state, unless when a percentage for the source state has been agreed in the treaty.

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e. mIncome from employment (Article 15) can also be the source of the copyright income. Both Models determine that this income is taxable in the residence state, unless the employment is exercised in the other state, which is most often the case.

f. Income for entertainers and sportspersons (Article 17) is taxable in the state of their entertainment and sports activities. This article sets aside the allocation rules of Article 7 (business profits) and Article 15 (employment), which means that Article 17 has priority over those articles. But royalties and other copyright income should be connected directly to performances to fall under Article 17.

g.Elimination of double taxation (Article 23) can be divided in two parts:

- When only the residence state has the taxing right, the source will exempt the income. However, some states want an exemption procedure to be completed, including a confirmation from the residence state that the taxpayer is taxable there.
- When the source state has the taxing right, the residence state will tax the income as part of the worldwide income, but it should allow a tax exemption or credit to eliminate double taxation. Continental European states mostly use the exemption method for active income (from business and employment) and the credit method for passive income (royalties, interest and dividend), while most Anglo-Saxon states only use the tax credit method to compensate for the foreign tax.

Royalties in Tax Treaties

Central for copyright income is Article 12 OECD and UN Models (Royalties) and the other articles are exceptions to the main rule. Under Article 12, foreign copyright income is normally only taxable in the residence state of the copyright owner, unless it is included in a PE of the copyright owner in the other state. If so, the other state has the right to tax the copyright income. This will then be taxed in both states and the residence state must allow a tax credit to eliminate double taxation.

It might also be that the source state has included a low withholding tax rate in the bilateral tax treaty with the residence state, as already described in the previous paragraph. Then the copyright owner has to apply for this low rate in the other state and can claim a tax credit for this low withholding tax against his tax obligation in his residence state.

The OECD, UN and US Models have the same definition of the term "royalties, which is:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

This means that music and other entertainment related payments coming from the use of (copy)rights fall under this Article 12.

Priority of Tax Treaties Over National Tax Law

It can easily happen that the allocation under a bilateral tax treaty can be in conflict with a national tax rule. Most states have a national source withholding tax on outgoing royalties but agree in their bilateral tax treaties that only the residence state has the right to tax the royalty income. In that case, the tax treaty is stronger and sets aside the national tax rule, which means that the source state will allow a tax exemption when it is clear that the beneficial owner of the copyright is resident of the treaty partner state.

This is in line with the principles of international taxation, under which states have broad national tax rules, which can be restricted by bilateral tax treaties to avoid double taxation.

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Relief for Double Taxation

It is important when only the residence state has the taxing right because the tax treaty follows the OECD and UN Models for royalties, which is a foreign withholding tax in the source state (based on national law there) and cannot be compensated with a foreign tax credit. If this happens, the copyright owner must apply for a tax refund in the source state based on the exemption from the treaty. Thus, it is far better to apply for exemption in advance of the payments (and withholdings).

If a low withholding tax rate for the source state has been agreed, the residence state must allow a foreign tax credit to eliminate double taxation. However, this will not be more than the low tax rate from the tax treaty, which means that the copyright holder still has to be careful that the normal source tax rate has been brought down to this lower treaty rate. If not, then partial double taxation will result, which is not taken away by the tax treaty.

Copyright Sold, Assigned or Collateralized Across Borders

Copyright which is sold, assigned or collateralized leads to capital gains on the copyright and therefore Article 13 OECD, UN and US Models is applicable. This article gives an exclusive taxing right to the residence state, which is the same result as for royalties under Article 12 OECD, UN and US Model. Only the residence state will have the taxing right for the big sum arising from one of theses actions, which is only different when the income might come up in a PE of the beneficial owner of the copyright in the source state.

Additionally, an exemption application procedure may be required to take away the national withholding tax in the sources state in which the payment for sale, assignment or collateralizations arises. Same as with Article 12, the residence state will not allow a foreign tax credit when foreign tax is withheld in conflict with Article 13 of the tax treaty between the two states.

Example: the composer (beneficial owner of the copyright) lives in state A, while the buyer of the copyright is based in state B. They have agreed a direct payment of $50 million for the future stream of copyright income. State B has a national rule stating a 20% withholding tax on outgoing royalties, but the tax treaty between the two states allocates the taxing right solely to the residence state A. This means that state B should allow an exemption for the withholding tax, but can ask the composer to complete an application procedure, in which is made clear that state A is the real residence state of the composer. State A will tax the direct payment as foreign capital gains at its own terms, which might be with progressive tax rates upwards of 50%. It will not allow a foreign tax credit if the composer has not applied for an exemption in state B and the 20% withholding tax has been deducted there and paid to the local tax authorities. This double taxation is not prevented by the tax treaty.

Role of Low-Tax Jurisdictions

A composer may have moved to a low-tax jurisdiction (or is living there already for some time), such as a Caribbean island, Jersey, Guernsey or a state in the Middle East, where no income tax is levied on personal income or business profits. Most often, these low-tax jurisdictions don't have bilateral tax treaties with high-tax states, which means that the source states remain the right to tax the royalties the direct payment for the future stream of copyright income under their national rules.

In the previous example, when state A is a low-tax jurisdiction and does not have a tax treaty with state B, then the direct payment of $50 million will normally be taxed in state B at the tax rate of 20%, without the possibility of an exemption at source.

Problems with Valuation of Copyright Package

One of the reasons artists/composers want their copyright to be sold, assigned or collateralized during their life is that otherwise after their death their inheritants may have problems with the tax authorities about the valuation of the copyright package for the estate tax. When this valuation leads to an agreement, the inheritants must pay the estate tax up front, while the royalty income will come in gradually over the following years, which might lead to cash flow problems. When an investor pays a considerable amount for the copyright package, the artist/composer can pay the income tax, with which it becomes clear on the bank account what will be the estate after death for the inheritants. The money is then available to pay the estate/inheritance tax.

This is also very helpful in cross-border situations, such as when the artist/ composer and/or one or more of the inheritants are residents of another state. Valuation of an estate with a copyright package across the border involves the tax authorities of two or more states, which makes it even more complicated, while a big sum on the bank accounts is also very simple for a foreign tax inspector.

Business Income Versus Exploitation of Private Assets

It can also be under discussion whether the income from copyright is considered business income or the result of the exploitation of private assets, especially for the inheritants after the death of artist/composer. It differs from state to state which of the two leads to tax benefits. Some states have special deductions for business income, to give compensation for the extra risks that businesses incur, while other states tax personal assets with a fixed rate, which can be favourable for assets with a higher yearly return.

These variations in national tax rules can be problematic in cross-border situations with inheritants in more than one state. The qualification as business income can be tax efficient in one state, while private assets can be better in the other state.

Special Tax Breaks for Ongoing Business after Death

This discussion is also relevant for the special tax breaks for ongoing business after death, which some states have. This means that estate tax can be postponed when the inheritants continue the business of the deceased artist/composer. These tax breaks may make a strong argument against the sale, assignment or collateralization of the copyright during the life of the artist/composer. It needs to be clear whether the exploitation of copyright from an estate will qualify as an ongoing business because it can also be seen as regular private asset management and not ongoing business. This is the case in the Netherlands, where the so-called "bedrijfsopvolgingsregeling" ("business succession arrangement") can only be used when one or more inheritant actively continues the business of the deceased. It then becomes important how active the copyright will be exploited, but it will always be a weak point that the inheritants will not create new copyright.

In cross-border situations, with one or more inheritants living in another state than the deceased artist/composer, it can be complicated to use these tax breaks for ongoing business after death when the two (or even more) states do not have the same tax breaks in their national tax legislation. Such mismatches will not be repaired by a bilateral tax treaty because there is no clause in tax treaties dealing with this situation.

Conclusion

There are various tax aspects to consider when copyright is being sold, assigned or collateralized already in national situations, but even more across the border. The international rules which follow from the bilateral tax treaties are clear and set aside stricter national tax rules, although attention is needed for the application of exemptions and perhaps even refunds in the source state. Some aspects are not covered by the tax treaties and the conflicting national rules between tow or more states can lead to disappointing tax results. It is important to take into consideration when the artist/ composer is already older and prefers the copyright to be sold, assigned or collateralized before death with the aim to make the estate easier for the inheritants.