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TREATMENT OF COPYRIGHT ROYALTIES FOR PURPOSES OF PERSONAL HOLDING COMPANY TAX

JANUARY 25 (legislative day, JANUARY 22), 1960.—Ordered to be printed

Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 7588]

The Committee on Finance, to whom was referred the bill (H.R. 7588) to amend the Internal Revenue Code of 1954 which respect to the treatment of copyright royalties for purposes of the personal holding company tax, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Page 3, line 14, after the period insert:

> This paragraph shall not apply to compensation which is rent within the meaning of paragraph (7), determined without regard to the requirement that rents constitute 50 percent or more of the gross income.

Page 5, line 17, strike out "1958." and insert "1959."

I. SUMMARY OF THE BILL

This bill amends the Internal Revenue Code to provide that personal holding company income is not to include income from copyright royalties under certain conditions. Personal holding companies in general terms are closely held corporations, the bulk of whose income is passive in nature or received from certain specified types of investment sources. Such companies, in addition to the regular corporate income tax, are subject to a tax of 75 to 85 percent on their undistributed personal holding company income. The bill excludes copyright royalties from the definition of personal holding company if—

(1) they (exclusive of royalties received from works of shareholders) represent 50 percent or more of the gross income of the company;

(2) other personal holding company income, apart from copyright royalties (except royalties received with respect to work of shareholders owning more than 10 percent of the company's stock), and also apart from dividend income received from corporations in which the company has a 50 percent or more stock interest which themselves meet these same tests, is not in excess of 10 percent of the gross income of the company; and

(3) business expense deductions allowable to the company, other than salaries or royalties paid to shareholders, equal to at least 50 percent of the gross income of the company.

Copyright royalties are defined as compensation with respect to copyrights protected by the U.S. Government, or protected by the laws of other countries as a result of international treaties, etc., or interests in these copyrights. They also are to include payments with respect to these copyrights received from performing rights societies or organizations. Your committee has also added a sentence to make it clear that this new provision is not to apply to compensation, such as that for the use of motion picture films, etc., which has by the Treasury Department been classified as rents rather than royalties. This bill, as amended by your committee, is effective with respect to taxable years beginning on or after January 1, 1960.

The Treasury Department does not object to this bill and its statement is attached as an appendix to this report.

II. GENERAL STATEMENT

The personal holding company tax has been developed as a device to prevent the avoidance of the application of the individual income tax in the case of investment income by the formation of a corporation by a relatively small group of individuals and the transfer of the investment holdings to this corporation.

The attention of your committee, however, has been called to an area where this tax has or may become applicable to a type of operating business. The business referred to is that of music publishers. At one time the principal markets for music were orchestras, the legitimate stage, vaudeville, and the sale of sheet music. At that time, although some royalty income was obtained from the use of the music by orchestras, the legitimate stage, and vaudeville, the principal source of income was from the sale of sheet music. Although this royalty income was classified as personal holding company income, the companies clearly were not subject to the personal holding company tax, since the bulk of their income was obtained from the sale of sheet music which was not so classified.

More recent developments, however, have tended to shift the source of income of the music publishing companies from the sale of sheet music to royalty income. In part this is due to the fact that radio, motion pictures, and television, and the expansion in the use of phonograph records have increased the royalty income derived from song copyrights. In part it is also due to the fact that the more extensive use of performing rights societies has increased the royalty income received from the live performances of songs by orchestras and others in hotels, nightclubs, theaters, and in television. In addition, this more extensive use of songs has tended to shorten their lives, decreasing the income received from the sale of sheet music. As a

result of these technological and other changes in the music publishing industry, publishers today receive much of their income from royalties with the result that some of them are either classified as personal holding companies or run a substantial risk of being so classified in the near future.

Despite the fact that most music publishers today obtain the bulk of their income from copyright royalties, they are not passive investment-type organizations. In most cases in order to secure the success of musical compositions they must incur substantial expenses for advertising and promotion. Your committee has been informed that these expenses generally exceed 50 percent of the gross income of these businesses (not taking into account amounts paid to stockholders as compensation or royalty payments). Thus, it seems clear that although the form of income of these publishers has shifted from sheet music sales to copyright royalties, they are, nevertheless, still operating companies and, therefore, should not be subjected to the personal holding company tax.

To cover the types of cases described above, as well as other cases in which copyright royalty income may be the principal source of income of an operating business, your committee has added a provision to the definition of personal holding company income which excludes from this category copyright royalties if certain conditions are met. First, to give assurance that the companies involved are truly operating companies, copyright royalties are to be excluded from personal holding company income only if the trade or business expenses of the company (apart from payments to stockholders as compensation or royalties), offset half or more of the gross income of the company. Second, to make sure that this does not exclude from the personal holding company category any company which has any appreciable amount of other personal holding company income, the bill provides that the exclusion for copyright income is to be available only where apart from copyright royalties (except royalties received with respect to works of shareholders owning more than 10 percent of the company's stock), and apart from dividends from corporations in which the company has a 50 percent or more stock interest, not more than 10 percent of the gross income of the company is personal holding company income. Third, copyright royalties (apart from those derived from works of shareholders) must represent 50 percent or more of the company's gross income.

For purposes of this new provision the term "copyright royalties" means compensation for the use of, or right to use, copyrights in works protected by copyrights issued under title 17 of the United States Code (other than secs. 2 or 6) and to copyrights protected by the laws of other countries as a result of international treaties, etc. It also includes payments from any person for performing rights in such copyrights. Thus, the provisions of the bill will apply only to federally secured copyrights and will not apply to such royalties as those for the use of trademarks, franchises, or common law copyrights.

The attention of your committee was called to the fact that the version of the bill passed by the House might unintentionally treat as copyright royalty income, amounts which have long been interpreted as being rents, such as motion-picture films or television films (including those electronically recorded on tape). The effect of this

might be to subject to personal holding company tax what has previously been classified as rental income and which, where it represents 50 percent or more of the gross income, is not treated as personal holding company income. Therefore, your committee added a sentence providing that the new provision is not to apply to compensation which would be treated as rent to which section 543(a)(7) would apply if there were no 50-percent gross income limitation in that provision.

Your committee has also amended the House version of the bill to advance the effective date of the bill 1 year so the bill will have only prospective application. Thus, this new provision will apply only to taxable years beginning after December 31, 1959.

It is estimated that this bill will result in a negligible revenue loss.

III. APPENDIX—STATEMENT OF TREASURY DEPARTMENT

TREASURY DEPARTMENT,
Washington, October 22, 1959.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

MY DEAR MR. CHAIRMAN: This is in response to a request for the views of this Department on H.R. 7588, passed by the House of Representatives August 18, 1959, to amend the Internal Revenue Code of 1954 with respect to the treatment of copyright royalties for purposes of the personal holding company tax.

1. Position of the Treasury Department

The Treasury Department would not object to the enactment of H.R. 7588. We have been informed that the primary purpose of this bill is to provide relief from the personal holding company tax for certain operating companies in the music publishing business. In our opinion H.R. 7588 will accomplish this limited objective without permitting certain tax benefits which do not seem desirable but which would have been permitted under certain bills introduced during the 85th Congress.

The Bureau of the Budget has advised that there is no objection to the presentation of this report.

2. Explanation of the bill

H.R. 7588 would amend the section of the code relating to personal holding company income by adding a new paragraph under which copyright royalties would be excluded from personal holding company income if three conditions are met: (1) Such copyright royalties (other than those received for the use of copyrights created by any shareholder) must constitute 50 percent or more of the gross income; (2) personal holding company income, other than copyright royalties (exclusive of those received for the use of copyrights created by a shareholder who owns more than 10 percent of the corporation's outstanding capital stock) and dividends from 50 percent or more owned corporations (which also meet the three conditions) cannot be more than 10 percent of the gross income; and (3) the deductions allowable under section 162 (other than compensation for personal services by shareholders and royalties to shareholders) must constitute at least 50 percent of the gross income. In determining these three condi-

tions, "copyright royalties" would be defined to include compensation however designated for the use of, or right to use, copyrights secured under title 17 of the United States Code (other than by reason of sec. 2 or 6 thereof), and to which copyright protection is also extended by the laws of any country other than the United States by virtue of any international treaty, convention or agreement, or interests in any such copyrights (including payments for performing rights). The term "shareholder" would include any person who owns stock within the meaning of section 544 of the code which contains the constructive stockownership rules.

Other provisions of the bill would make conforming changes to the personal holding company income sections of the code, and would make the amendments of the bill applicable with respect to taxable years beginning after December 31, 1958.

3. Legislative history

The personal holding company provisions, first enacted in 1934, were developed to prevent the avoidance of income tax on individuals by means of the formation of closely held corporations to which were transferred the individuals' investments and services or talents. In addition to the regular corporation income tax, personal holding companies are subject to a special tax of 75 percent of the first $2,000 of undistributed personal holding company income plus 85 percent of such income in excess of $2,000. A corporation may, however, avoid the imposition of the personal holding company tax by actual or consent distributions of its personal holding company income. The personal holding company provisions have been modified over the years since 1934, but the fundamental purpose has not been altered by succeeding Congresses.

Personal holding company income is, in general, that income which is received from certain types of investment and personal service sources as specified in the code. Although the legislative history of the personal holding company provisions indicates, as a general rule, an intent not to apply such penalty tax to a true operating company, an operating company is not ipso facto excluded from the classification as a personal holding company and there is no indication that a true operating company could, or should, never be classified as a personal holding company.

The Treasury Department opposed an earlier version of the bill (H.R. 5478, introduced in the 1st sess. of the 85th Cong.) in a report to the House Ways and Means Committee, dated July 18, 1957, on the grounds that the terms used in the bill were too general and might permit avoidance of the personal holding company tax by many corporations to which the tax should appropriately apply. A revised bill (H.R. 8960, introduced in the same session) met some of our earlier objections, and was passed by the House of Representatives on August 16, 1957. However, the Department continued to study this matter and became concerned that the bill might still permit certain tax benefits which do not seem desirable. Therefore, we reported to your committee on January 28, 1958, that we were opposed to the enactment of H.R. 8960. H.R. 7588 appears to have met all of our objections to H.R. 8960.

4. Comments on the bill

(*a*) *Policy.*—Prior studies have been made regarding the amendment of the personal holding company provisions to provide relief from the personal holding company tax for corporations engaged in the music publishing business. It appears that a reasonably favorable showing has been made that some music publishers are operating companies and should not be subjected to the personal holding company tax merely by reason of the fact that their chief source of income consists of "copyright royalties." (See H. Rept. No. 1047, 85th Cong., 1st sess., on H.R. 8960.) It was pointed out that recent developments have tended to shift the source of income of music publishers from the sale of sheet music (which is not personal holding company income) to royalty income (which is personal holding company income), a shift that is due in part to the fact that radio, motion pictures, and television, and the expansion in the use of phonograph records have increased the royalty income derived from song copyrights, and in part to the fact that the more extensive use of the services provided by performing rights societies has increased the royalty income from live performances of songs by orchestras and others in hotels, night clubs, theaters, and in television. As a result of technological and other changes in the music-publishing industry, publishers today receive much of their income from royalties but, despite that fact, it is contended that most music publishers are not passive investment-type organizations.

Our principal objection to H.R. 8960 was that it would apparently have been possible for a composer of a song to incorporate and, by incurring costs in promoting the song equal to more than 50 percent of his gross income from the song, avoid both the personal holding company tax and the higher personal income tax rates that might be applicable if he did not incorporate. H.R. 7588 meets this objection by excluding royalties received from copyrights or works created by any shareholder from the 50 percent or more of gross income test.

Along this same line H.R. 7588 strengthens the requirement that personal holding company income, other than copyright royalties, be not more than 10 percent (5 percent under previous bills) of the gross income of a music-publishing company. The 10 percent test has been strengthened by providing that royalties received from copyrights or works created by a significant shareholder (owning more than 10 percent of the total outstanding stock of the corporation) shall be included in determining whether 10 percent or less of the gross income of the company constitutes personal holding company income. In view of this strengthened provision, we do not object to the relaxing of the 5 percent test to 10 percent to take care of those situations where, because some affiliated companies would now become personal holding companies, it would be necessary for these companies to declare dividends. We are informed that the inclusion of these dividends in the income of the major music-publishing corporations would, in the instance of at least two of the largest operating companies, cause such companies to exceed the 5 percent limitation imposed by the earlier bills.

(*b*) *Revenue effect.*—Although the relatively few music publishers which will be affected by this bill have previously been classified as personal holding companies, none have been paying personal holding company tax either because of operating losses or because all personal

holding company income has been paid out in dividends. It is possible that, as a result of passage of H.R. 7588, some of these companies would not pay as much of their income out in dividends. However, because of the size of the companies involved, the potential loss in individual income tax now being paid on these dividends would be insignificant.

Sincerely yours,

JAY W. GLASMANN,
Assistant to the Secretary.

IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTIONS 543(a), 544, AND 553 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 543. PERSONAL HOLDING COMPANY INCOME.

(a) GENERAL RULE.—For purposes of this subtitle, the term "personal holding company income" means the portion of the gross income which consists of:

(1) DIVIDENDS, ETC.—Dividends, interest, royalties (other than mineral, oil, or gas royalties *or copyright royalties*), and annuities. This paragraph shall not apply to interest constituting rent as defined in paragraph (7) or to interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936.

(2) STOCK AND SECURITIES TRANSACTIONS.—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

(3) COMMODITIES TRANSACTIONS.—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This paragraph shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(4) ESTATES AND TRUSTS.—Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries); and gains from the sale or other disposition of any interest in an estate or trust.

(5) PERSONAL SERVICE CONTRACTS.—

(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(6) USE OF CORPORATION PROPERTY BY SHAREHOLDER.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only only to a corporation which has personal holding company income for the taxable year, computed without regard to this paragraph and paragraph (7), in excess of 10 percent of its gross income. *For purposes of the preceding sentence, copyright royalties constitute personal holding company income.*

(7) RENTS.—Rents, unless constituting 50 percent or more of the gross income. For purposes of this paragraph, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under paragraph (6).

(8) MINERAL, OIL GAS ROYALTIES.—Mineral, oil, or gas royalties, unless—

(A) such royalties constitute 50 percent or more of the gross income, and

(B) the deductions allowable under section 162 (relating to trade or business expenses) other than compensation for personal services rendered by the shareholders, constitute 15 percent or more of the gross income.

(9) COPYRIGHT ROYALTIES.—Copyright royalties, unless—

(A) such royalties (exclusive of royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole, or in part, by any shareholder) constitute 50 percent or more of the gross income,

(B) the personal holding company income for the taxable year not taking into account—

(i) copyright royalties, other than royalties received for the use of, or right to use, copyrights or interests in copyrights in works created in whole, or in part, by any shareholder owning more than 10 percent of the total outstanding capital stock of the corporation, and

(ii) dividends from any corporation in which the taxpayer owns at least ~~50~~ percent of all classes of stock en-

titled to vote and at least 50 percent of the total value of all classes of stock and which corporation meets the requirements of this subparagraph and subparagraphs (A) and (C)

is 10 percent or less of the gross income, and

(C) the deductions allowable under section 162 (other than deductions for compensation for personal services rendered by the shareholders and other than deductions for royalties to shareholders) constitute 50 percent or more of the gross income.

For purposes of this subsection, the term "copyright royalties" means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code (other than by reason of section 2 or 6 thereof), and to which copyright protection is also extended by the laws of any country other than the United States of America by virtue of any international treaty, convention or agreement, or interests in any such copyrighted works, and includes payments from any person for performing rights in any such copyrighted work. For purposes of this paragraph the term "shareholder" shall include any person who owns stock within the meaning of section 544. This paragraph shall not apply to compensation which is rent within the meaning of paragraph (7), determined without regard to the requirement that rents constitute 50 percent or more of the gross income.

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SEC. 544. RULES FOR DETERMINING STOCK OWNERSHIP.

(a) CONSTRUCTIVE OWNERSHIP.—For purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 542(a)(2), section 543(a)(5), [or] section 543(a)(6), *or section 543(a)(9)*—

(1) STOCK NOT OWNED BY INDIVIDUAL.—Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

(2) FAMILY AND PARTNERSHIP OWNERSHIP.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For purposes of this paragraph, the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(3) OPTIONS.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

(4) APPLICATION OF FAMILY-PARTNERSHIP AND OPTION RULES.—Paragraphs (2) and (3) shall be applied—

(A) for purposes of the stock ownership requirement provided in section 542(a)(2), if, but only if, the effect is to make the corporation a personal holding company;

(B) for purposes of section 543(a)(5) (relating to personal service contracts), [or] of section 543(a)(6) (relating to [the] use of property by shareholders), *or of section 543(a)(9) (relating to copyright royalties)*, if, but only if, the effect is

to make the amounts therein referred to includible under such paragraph as personal holding company income.

(5) CONSTRUCTIVE OWNERSHIP AS ACTUAL OWNERSHIP.—Stock constructively owned by a person by reason of the application of paragraph (1) or (3) shall, for purposes of applying paragraph (1) or (2), be treated as actually owned by such person; but stock constructively owned by an individual by reason of the application of paragraph (2) shall not be treated as owned by him for purposes of again applying such paragraph in order to make another the constructive owner of such stock.

(6) OPTION RULE IN LIEU OF FAMILY AND PARTNERSHIP RULE.—If stock may be considered as owned by an individual under either paragraph (2) or (3) it shall be considered as owned by him under paragraph (3).

(b) CONVERTIBLE SECURITIES.—Outstanding securities convertible into stock (whether or not convertible during the taxable year) shall be considered as outstanding stock—

(1) for purposes of the stock ownership requirement provided in section 542(a)(2), but only if the effect of the inclusion of all such securities is to make the corporation a personal holding company;

(2) for purposes of section 543(a)(5) (relating to personal service contracts), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income; [and]

(3) for purposes of section 543(a)(6) (relating to the use of property by shareholders), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income[.]; *and*

(4) for purposes of section 543(a)(9) (relating to copyright royalties), but only if the effect of the inclusion of all such securities is to make the amounts therein referred to includible under such paragraph as personal holding company income.

The requirement in paragraphs (1), (2), [and (3)] *(3), and (4)* that all convertible securities must be included if any are to be included shall be subject to the exception that, where some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be included although the others are not included, but no convertible securities shall be included unless all outstanding securities having a prior conversion date are also included.

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SEC. 533. FOREIGN PERSONAL HOLDING COMPANY INCOME.

For purposes of this subtitle, the term "foreign personal holding company income" means the portion of the gross income, determined for purposes of section 552, which consists of personal holding company income, as defined in section 543, except that all interest, whether or not treated as rent, and all royalties, whether or not mineral, oil, or gas royalties *or copyright royalties*, shall constitute "foreign personal holding company income".

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