The Author's Dilemma

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Notes

THE AUTHOR'S DILEMMA

Thousands of words have been written about the tax discrimination against authors as compared with inventors and other tax-paying citizens. It is the purpose of this paper to trace the steps of this area of tax law as applied to copyrighted works from its inception to the present; to explore its course through both legislative and case law development. At the finale, the reader should know specifically what the law is at present and how it has developed, but he will grope for sound reasons why it is so, without success. If he becomes incensed because of the author's dilemma, he may find some consolation in the section which points up the few things an author can do to partially relieve his harsh tax burden in the years in which he realizes some financial success.

Constitutional Justification

The author's plea for equal rights with his brother inventor is well-founded indeed. In fact, it derives from that most eminent of legal foundation, the United States Constitution. Congress is empowered by the Constitution "To promote the Progress of Science and useful Arts by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." It should be noted that in the order of mention in this constitutional provision the word "Authors" precedes "Inventors" and "Writings" precedes "Discoveries." It is difficult to believe that the drafters of the Constitution, many of whom were men of great minds and literary accomplishment, intended that the rights and privileges of literary creators should be subordinated to anyone. Unfortunately, the seed planted therein, meant to bear fruitful results, has instead resulted in a thistle which consistently becomes longer and sharper and will continue to do so until the author commences to kick against the pricks.

The philosophy behind this constitutional grant of favor is very simple. By encouraging individual effort with personal gain, the entire public will benefit from production of scientific and literary

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\[\text{\footnotesize*This paper was submitted in the Nathan Burkan Memorial Competition, sponsored by the American Society of Composers, Authors and Publishers.}\]

\[\text{\footnotesize1 The word "authors" is used in its generic sense to describe all creators of copyrightable works.}\]

\[\text{\footnotesize2 U.S. Const. art. I, 8, cl. 8.}\]
achievements. But in order that the individual creator be encouraged, he must not be deprived of his personal gain. "Income arises from the author's efforts to exploit his creation and it is with this phase of the copyright system that the income tax deals."3 Diminishment of the author's income means diminishment of the constitutionally intended incentive to create, and there is no greater diminisher than a harsh and unfair tax.

The Author's Needs

In pointing out the discrepancies existing between the tax treatment accorded to patents and that accorded to copyrights, a well-known practicing lawyer wrote with striking candor:

When authors achieve a favorable tax result, however, Congress sees only a loophole that must be plugged at once. Apparently, authors don't need incentives the way inventors do; or, alternatively, we as a nation do not particularly value what they have to contribute. Either way, Congress has in the tax field reformulated the policy inherent in the Constitution and has reached alarming results.4

Authors and inventors are both in a peculiar boat, taxwise. They may work for years on a particular project without reaping any financial success during those years. If they are finally able to market a successful work, they may receive most of the compensation in one tax year. Therefore, under the present sharply graduated personal income tax rates, their actual realized net income is considerably less than that of other taxpayers who earned the same amount in the same period of time. The most feasible means of alleviating this "bunched income" inequality is to allow authors and inventors capital gains treatment on the income from their productions rather than subjecting them to the tax rates on ordinary income. It is in their efforts to obtain this treatment that their status as brothers in creativity has ended. The inventors have achieved a great deal of success while authors have met with dismal failure. In fact, they have become the Jacob and Esau of Congressional consideration—the one it loved and the other it hated.

The Law Prior to 1950

Prior to 1950 the Internal Revenue Code did not expressly prescribe the tax treatment of patents, copyrights, and similar property. Capital gains treatment could be obtained only where the copyright or similar item was considered under the general provisions of the

statute as a "capital asset" which had been "sold or exchanged."\textsuperscript{5} Under the "capital asset" requirement, the taxpayer had to qualify as an "amateur" author or inventor. This requirement was considered satisfied if there was a sale of only one invention, as a result of taxpayer's spare time work.\textsuperscript{6} This meant that in order to get capital gains treatment for income derived from the sale of patented or copyrighted works, the sale or transfer must not have been of property held primarily for sale to customers in any trade or business.

The second requirement—that the capital asset be "sold" or "exchanged"—presented another hurdle. The difficulty developed in two areas of commercial practice—transfer of rights on a royalty basis and transfer of less than all rights, i.e., limitation to a particular medium or geographical area. "Where the question was whether a sale had taken place under the capital gains provisions of the tax laws, however, the courts generally answered that anything less than a transfer of the 'complete bundle of rights' resulted in a license, not a sale."\textsuperscript{7} But in \textit{Edward C. Myers}\textsuperscript{8} the court held that an agreement whereby the inventor transferred his interests in an invention to a buyer in consideration of five percent royalty, was a sale of a capital asset within the meaning of section 117 (a) of the Internal Revenue Code.\textsuperscript{9} However, the Internal Revenue Service announced in 1950 that it would consider royalties as ordinary income, thereby withdrawing its acquiescence in the \textit{Myers} decision.\textsuperscript{10} It was the Commissioner's conclusion that the income realized in \textit{Myers} was derived from the creator's personal service and skill, hence, ordinary income.

\textit{Loophole Plugging}

In 1948, the first major step of Congressional "loophole plugging" was triggered by the sale of \textit{Crusades in Europe} by Dwight Eisenhower. He sold the manuscripts for a lump sum and was permitted capital gains treatment. The Revenue Act of 1950 added what are now sections 1221(3) and 1231(b)(1)(C).


For the purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(3) a copyright, a literary, musical, or artistic composition or similar property, held by—

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\textsuperscript{5} Bittker, Federal Income, Estate and Gift Taxation 415 (2d ed. 1958).
\textsuperscript{6} Edward C. Myers, 6 T.C. 258 (1946).
\textsuperscript{7} Note, supra note 3, at 377.
\textsuperscript{8} 6 T.C. 258 (1946).
\textsuperscript{9} Now Int. Rev. Code 1221, 1222.
(A) a taxpayer whose personal efforts created the property, or
(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

Thus, literary property was specifically excluded from the capital asset definition.

The Internal Revenue Code of 1954, section 1231(b)(1)(C), excludes from the definition of property used in the trade or business "a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221." This section rules out a possible "quasi-capital asset" definition of copyright and patents under section 1231. The result of this enactment is clear. From 1950 to 1954, neither professional nor amateur authors were allowed capital gains treatment on the sale of their writings while amateur inventors were granted such allowance. The trend toward discrimination was thus established.

_Discrimination Complete_

The cases indicate that prior to 1950 there was little if any distinction made between inventors and authors. But with passage of the 1950 Amendment their paths diverged. The trend reached its logical culmination in the Internal Revenue Code of 1954 which accorded to professional as well as amateur inventors capital gains status for the proceeds from sale of their inventions.

Int. Rev. Code, § 1235. _Sale or Exchange of Patents._

(a) General.—A transfer (other than by gift, inheritance, or device) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or
(2) contingent on the productivity, use, or disposition of the property transferred.

This legislation prompted this remark—"... it would be very difficult indeed, today, to set up the sale of a patent interest by the creator of the patent which wouldn't qualify for capital gains treatment, even as it is impossible to set up a sale of a copyright interest by the creator of the copyright that would qualify."\(^{11}\)

It should be noted that section 1235 assures the transferor of a patent interest capital gains treatment even if his compensation

\(^{11}\) Pilpel, _supra_ note 4, at 272.
is received through a royalty arrangement. This is a direct endorsement of the Myers decision and a rejection of the Revenue Service's contrary view as expressed in Rev. Rul. 55-58. The Myers view was again upheld in F. H. Philbrick. But in Authur M. Young, patent royalty payments received pursuant to an agreement whereby all patent interests were assigned for the period of the agreement were held not received from a transfer of "all substantial interests." The court defined substantial rights in a patent as "generally the exclusive rights for a term of 17 years to make, use, and vend the patent throughout the United States and territories thereof."

As will be later noted, the Internal Revenue Service finally acquiesced in the Myers case as to patents in 1958. Then in 1960, the Service announced that it would apply the same principle to copyrights. Therefore, at present a transfer of exclusive rights to a copyrighted work is to be treated as a sale, even though payments are measured by a percentage of the receipts or by the volume of sales. This final ironic touch means that the Revenue Service at last accepts the theory of the divisibility of copyright, but such acceptance is too late to be of value to the plagued authors because now, as has been pointed out, under the so-called Eisenhower amendment, copyrights do not qualify for capital gains treatment in the hands of their creators.

Present Status

A look at some fairly recent cases will reflect the present tax status of the author with respect to his copyrighted and similar works. Most of these cases involve attempts to gain capital asset treatment for works not actually copyrightable but none the less "similar" properties such as motion picture characters and rights to family privacy. In a line of cases since 1954, capital gains treatment has been consistently denied. One of the most prominent was the case of Stern v. United States involving a sale of rights to the character called "Francis," the talking mule. The creator of the character sold to Universal Pictures all his "right, title, and interest" for a consideration of $50,000, plus 5% of the net profits from photoplays based on the character. This "sale" was effective only for a period of two years and unless a picture was made within this "commitment period" the property would revert to the seller. The court, applying

12 27 T.C. 846 (1956).
14 Authur M. Young, supra note 13, at 858.
the liberal construction of Myers called this transaction a "sale," not just a license. It further concluded that the property was not held by taxpayer for sale to customers in the ordinary course of business because taxpayer was primarily a publisher, not a writer. Therefore, the first two hurdles were successfully cleared. The final hurdle—the 1950 amendment excluding from capital gains treatment income from the sale of "a copyright; a literary, musical, or artistic composition; or similar property"—proved fatal. The taxpayer argued ingeniously that "Francis" was not "similar property," but rather an "intellectual conception," not subject to copyright. However, the court said: "It is this court's view that the character Francis, irrespective of its susceptibility to copyright, is 'a literary composition' and as such the income from the sale thereof is not entitled to capital gains treatment." 19

In Runyon v. United States, 20 the son of the eminent sports writer, Damon Runyon, gave to a producer the "license" to "produce, release, distribute and exhibit" a motion picture based on Runyon's life. The court denied taxpayer capital gains treatment on the income and held (1) that under New York law no right of privacy exists on behalf of the son of a deceased person, and (2) even if such right did exist, there was no "sale" of such "property right" in this case—merely a "limited right" transfer. In other words, the court is now using the "bundle of rights" concept to deny capital gains to non-copyrightable and non-invention type transactions.

It is interesting to note in two other cases with similar facts to Runyon—except the favorable treatment was sought for inventors—the court held that a provision for termination in the event of failure to perform does not prevent a transfer of a patent from being an absolute sale. But in the Runyon case, such a provision was considered sufficient to preclude a "sale." At any rate, the present situation clearly discriminates against authors and creators of copyrighted works and similar works by denying them the same taxpayer status enjoyed by inventors. Such a policy eludes explanation.

It may be a sound argument indeed that the pre-1950 distinction between amateur and professional authors should have been elim-
Taxation on the income received from the sale of literary property should not depend on the status of the creator. However, it is submitted that in light of the need to encourage literary creativity, the desired solution was not to harshly burden all writers and creators but rather relieve both classes from such burden. The same problem faced Congress with respect to inventors until 1954. But the step made to correct that discrepancy was in the opposite direction from the one made in 1950. Instead of eliminating capital gains treatment entirely for both professional and amateur inventors, as was done with respect to copyrighted works, capital gains treatment was allowed to both classes of inventors. Why? Clearly Congress has arbitrarily decided that the constitutional provision favoring treatment encouraging to, first, authors, then inventors, no longer need be heeded except as applies to inventors. Surely, this is a most unfortunate decision. In a country where reading is becoming a lost art among many segments of our population, where crime and juvenile delinquency is on rampant increase, where educational methods and accomplishments are daily proving insufficient, the creators of free individual thought must be encouraged. A leading writer has stated:

Apparently, our Senators and Representatives in their anxiety to foster the development of offensive and defensive weapons in this age of the atom, have forgotten that much of invention is based on the knowledge contained in writings which are the subject of copyright rather than patent. Moreover, it may well be that our greatest need today is, in the words of Adlai Stevenson, for “the know-why of ethics to catch up with the know-how of science”; and here our help comes from what has been known and thought and is reflected in writings and the arts, not from what has been or is being tangibly produced.22

This statement is equally true today as when written in 1955.

What can be done about this dilemma? One writer, in an attempt to arouse the author's indignation, said: “... authors themselves are largely responsible for their present sad plight. Although authors possess the skill and eloquence necessary for effective advocacy, they have been altogether too inactive and ineffectual in regard to their own tax treatment.”23 The writer points out that from 1950 to 1954, inventors were very active in presenting their view before the congressional hearings preceding revisions of the Revenue Code. During this same period, authors were largely inactive. Therefore, in order to alleviate their present burden, authors must organize their efforts to bring about effective pressure on Congress. They truly hold the pens with which they could write their own bill of favored tax treat-

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22 Pilpel, supra note 4, at 276.
ment. Through the medium of nationwide publicity, they have the
skill and means to alert and arouse an indignant public—their readers.
Readers and authors are voters, and when the voters speak with
decisiveness, Congressmen listen. But until such time when a sane,
fair and consistent tax policy is effectuated in keeping with the con-
stitutional policy of encouraging creative development, authors and
dealers in copyrights should be fully appraised of their rights and
remedies as they stand under the present law.

Literary property can, in some limited circumstances, produce
income taxable as capital gains rather than ordinary income. But,
the irony is that such treatment can never be obtained by the indi-
vidual creator. It also appears that a donee of such creator is also
denied capital gains treatment. The explanation for this discrimina-
tion among different classes of copyright holders is that capital gains
is not available to those whose personal efforts create the copy-
righted property. This is understandable. But, as has been pointed out,
the personal efforts of authors no more results in ordinary income
than does the personal efforts of inventors or scientists. The discrim-
ination is unwarranted!

In determining just when the sale of a copyrighted work results
in a capital gain, it should be noted that some general requirements
must be met first. These requirements are that the particular trans-
action must be considered a “sale or exchange” and the property
must not have been held primarily for sale to customers in the or-
dinary course of trade or business. We have said that a donee of the
creator cannot receive capital gains treatment because his base in the
property is the same as the creators, and such allowance to the donee
would only result in a device of easy evasion. On the other hand, the
author or creator’s estate and his legatees may receive capital gains
treatment because their base is computed at the death of the creator.

Another group to which capital gains is available, are purchasers
of copyrighted works. This group, known as commercial users, must
satisfy the Treasury that they bought the property as an investment,
and not to hold for sale to customers. Two 1954 cases indicate the
court’s acceptance of this view.24

The other “user” group are called “creator users” and is composed
of numerous individual artists engaged in a corporate creation. The
problem presented by such productions was evidently not consid-
ered by Congress and no decisions regarding it have been handed
down. However, the Treasury has indicated that property created

24 James M. Fidler, 20 T.C. 1081 (1953); Fred MacMurray, 21 T.C. 15
(1954).
by these corporations would not be considered the result of personal efforts. In regard to this position the law has taken, a leading New York copyright lawyer said in 1955: "It is difficult to see how any concession to the only two groups of people who can today claim capital gains treatment for copyrights can in any way operate as an incentive to living authors. . . ." This statement properly evaluates the existing situation. Even these small groups who were able to get capital gains treatment were discriminated against to a certain extent. In the case of copyrights, unlike patents, capital gains was not allowed if the consideration for the sale of the copyright was (1) measured by a percentage of receipts from sale, performance, exhibition or publication of the work, (2) measured by the number of copies sold or performances given, or (3) paid for over a period generally coterminus with the grantee's use of the work. However, this view was terminated by the ruling of 1960 acquiescing in the Myers decision. This represents a development in the law slightly favorable to holders of copyrighted property and it is hoped that this is the beginning of a long-needed favorable trend.

Recent Developments

There are other methods by which the author may obtain some small relief from the burden of bunched income. The first is a spread-forward of income arrangement, available to both patent and copyright owners. This method was approved in a case involving a general agent of a life insurance company. It allowed retired insurance agents to report only that commission income actually received within the taxable year for tax purposes, irrespective of when the company collected the commissions for them. Therefore, using this case for authority, copyright owners could choose to be paid in fixed sums or royalty percentages over a number of years. This arrangement approaches the concept of the installment sale used by former President Truman in 1953, upon which he obtained a ruling approving an installment sale of his memoirs.

The spread-back provision is contained in Section 1302 of the Code. Under that provision, copyright proprietors receiving income from such work may spread the income therefrom back over a period of three years if the work was produced over a 24 month period.

The most recent development in this area was enacted in the

26 Pilpel, supra note 4, at 273.
28 Oates v. Commissioner, 207 F.2d 711 (7th Cir. 1953).
1964 Revenue Act. With respect to taxable years beginning after 1963, a new averaging device has been provided to ease the tax bite on taxpayers having unusual fluctuations in income. It replaces the old provisions which allowed averaging for certain types of income including income from inventions or artistic work. The plan is very complicated, and is applied by way of a new formula, different from previous averaging concepts in that it does not require recomputation of prior years' taxes. The formula is as follows:

1. Calculate excess of current year's income (computation year) over 133⅓% of average annual income of four preceding years (average base period income). This results in "averageable income," which must be over $8,000 for the section to apply.

2. Compute tax on 1/5 the averageable income.

3. Multiply amount of tax computed in step 2 by five. This gives total tax on averageable income.

4. Total tax equals the sum of the tax on the 133⅓% of the average base period income and the tax on the averageable income.

For example, under this new formula, an author who earns $7,500 per year during 1960-1963, and who earns $40,000 in 1964 by selling a copyrighted work not subject to capital gains, would realize a tax savings of at least $4,080. There appears to be no discrimination in this new 1964 provision.

Conclusion

Authors and creators of copyrighted works and similar property have consistently been subjected to unwarranted discrimination by Congressional policy and judicial decision as reflected respectively by the tax laws of the United States and their subsequent interpretation. This discrimination has been effected by denying to authors capital gains treatment on income received from the sale of such property, while allowing inventors and owners of patent interests to report income received from the sale of their products as capital gains. Such a policy is contrary to the spirit of the Constitution of the United States, Art. I, Section 8, which provides Congress with power to encourage both authors and inventors, thereby indicating on its face that both groups, not just inventors, should be so encouraged. It is further submitted that such encouragement to writers is a paramount necessity to the national interest and the public welfare.

Though the position of authors and creators of copyrighted works at present can easily be characterized as one of "dilemma," there is
some evidence of a slightly favorable trend. The trend is discernible through three developments: (1) the reduction of the work period required for spreading income from thirty-six to twenty-four months, (2) the 1960 Revenue Service acquiescence in the Myers decision as it applies to copyrights, and (3) the 1964 Revenue Act's averaging device. The interest in and need for continued creative production, should be manifested by an aroused public, so that this mild trend will be increased in force and effect and the unwarranted discrimination against authors be ended, once and for all.

Tommy W. Chandler