Royalty Exchange

All Access Investor Insights

July 2018

Tax Benefits of Music Royalties

Tax planning is a critical part of any investment strategy. And while most investors are familiar with the tax implications of traditional assets and securities, few understand the unique tax treatment of Intellectual Property derived royalties.

A useful analog to understanding royalty assets might be Real Estate.

For nearly a decade, my tax advisors have encouraged me to buy real estate. Are they sophisticated investors who understood that real estate had bottomed and wanted me to ride the trend?

Not at all. In fact, they argued that as a high-income earner taxed in the highest bracket, market performance should be a secondary consideration. They claimed the tax benefits of owning real estate would have a material impact on my *taxable* income, leaving far more of the money I earned where it belonged… in my bank account and not Uncle Sam's.

In a nutshell, the tax code allows investors to depreciate property over a number of years. And, the depreciation offsets income, which reduces the income considered taxable by the IRS. Often this can have a dramatic effect on an individual's total tax burden, explaining why my advisors urged me to go this route.

It turns out that music royalty investors can benefit from some of the same favorable tax treatment enjoyed by real estate investors. Music royalties are a depreciable asset, much like real estate. This means the cost of acquisition can be amortized, offsetting the income produced and reducing overall tax liability.

IMPORTANT: Every individual situation and every royalty stream is a bit different. Neither I nor anyone at Royalty Exchange is authorized or qualified to offer tax advice. So it is critical that you discuss these issues with your tax advisor to accurately apply them to your unique situation.

That said, we put together this guide to share our understanding of the tax treatment of the music royalty assets commonly sold on our platform.

Royalty Exchange offers two different types of royalty investments:

1. buying a royalty-generating asset directly through an auction.
2. buying units of a Private Syndicate special purpose vehicle.

Directly Owned Royalties

For royalties acquired directly through an auction, the payor of the royalty payment will issue a 1099 for any year royalties are paid greater than $10. From the 1099, you'll have to report the royalty income on your 1040. If you hold the royalties in a business, all income and amortization is reported on your Schedule C. Amortization is calculated and reported on Form 4562.

Private Syndicate Investments

In Private Syndicates, investors aren't buying the asset directly. Instead, you're buying an equity interest in an LLC that acts as a SPV (Special Purpose Vehicle) whose sole purpose is to hold the asset and facilitate distributions to investors. Income is paid throughout the year from the SPV to investors in conjunction with the royalty payments received. The SPV will issue a K-1 to investors each year reporting the necessary income and amortization details.

Unlike real estate, both types of music royalty investments are considered "intangible" assets. Amortization of intangibles is governed primarily by sections 197 or 167 of the Internal Revenue Code. However, section 197 does not apply to the direct purchase of copyrights, or any interest in them. Section 197 only applies to copyrights (or interests of) acquired in connection with the purchase of a trade or business.

So for our purposes, we'll stick with section 167. There are two amortization methods available under section 167.

- **Straight-line method:** Under this method, simply divide the cost of the royalty by the number of years of its useful life. With royalties, we typically use 10 years.
- **Income forecast method:** Under this method, each year's depreciation deduction is equal to the cost of the asset, multiplied by a fraction. The numerator of the fraction is the current year's net income, with the denominator the total income anticipated from the royalty through the end of the 10th taxable year after it was acquired. Since the anticipated income may change based on actual results over the time you own the asset, you'll need to update your income forecast every three years.

Straight-Line Method

To calculate amortization on a straight-line basis, divide the cost by 10 years, and apply the result to each year's amortization. In other words, 1/10th of the cost of the royalty is amortized each year for 10 years.

Here's an example of how a straight-line amortization method might look like. For this example, the purchase price is $1,000, the expected royalties over 10 years is $1,200, and the variable earnings per year are listed each year in the "Cash Flow" row:

Year	0	1	2	3	4	5	6	7	8	9	10	
Purchase Price	-1,000											
Expected Royalties		100	110	120	130	140	140	130	120	110	100	1,200
Annual % of Expected		10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	
Amortization		-100	-100	-100	-100	-100	-100	-100	-100	-100	-100	
Royalties Paid (Cash Flow)		100	110	120	130	140	140	130	120	110	100	
Net Taxable Income		0	10	20	30	40	40	30	20	10	0	

For Private Syndicate shareholders:

- This deprecation benefit is spread out among all equity holders based on their ownership share. So an investor holding 5% of a Private Syndicate SPV would receive 5% of the annual depreciation benefit.
- The depreciation will offset the majority of the income earned for the next decade. Cash distributions offset by depreciation are non-taxable and considered "return of capital."

Royalty Exchange

Income Forecast Method

The Straight-Line method is simpler, but another approach available to royalty asset investors is the Income Forecast Method.

To calculate amortization under the Income Forecast method, you would multiply the price you paid for the royalty stream by a custom fraction. The numerator of this fraction is the amount of anticipated income the royalty stream would earn in a given year. The denominator is the total anticipated income you expect the royalty will receive over 10 years.

For example, let's say you acquired a royalty stream for $1000, and it earned you $100 in 2018, and you expect it to generate $1,200 over 10 years. The formula for 2018 depreciation would then be:

$\$1200 \text{ X } \frac{\$100}{\$1200} = \$83$

Here's an example of how this might look using the same royalty income schedule used in the Straight-Line method example above.

Variable Income												
Year		0	1	2	3	4	5	6	7	8	9	10	
Purchase Price	$	(1,000)											
Expected Royalties			$ 100	$ 110	$ 120	$ 130	$ 140	$ 140	$ 130	$ 120	$ 110	$ 100	$ 1,200
Annual % of Expected			8.3%	9.2%	10.0%	10.8%	11.7%	11.7%	10.8%	10.0%	9.2%	8.3%	100.0%
Amortization			$ (83)	$ (92)	$ (100)	$ (108)	$ (117)	$ (117)	$ (108)	$ (100)	$ (92)	$ (83)	$ (1,000)
Royalties Paid (Cash Flow)			$ 100	$ 110	$ 120	$ 130	$ 140	$ 140	$ 130	$ 120	$ 110	$ 100	$ 1,200
Net Taxable Income			$ 17	$ 18	$ 20	$ 22	$ 23	$ 23	$ 22	$ 20	$ 18	$ 17	

Note: Under a "look-back" rule, you would still have to pay (or be entitled to receive) interest if the actual royalty earnings differ substantially from the estimates used in applying the income forecast method (more than 10%). This interest is computed at the end of the third and tenth years. A hypothetical underpayment or overpayment of tax is computed for each prior year, based on a substitution of the recomputed depreciation for the depreciation actually taken. Interest on the hypothetical underpayment or overpayment, computed at the rates for overpayments of tax (compounded daily), must be paid by the taxpayer to the IRS or vice versa.

What this means for you
As you can see, the amount of taxable income is far less than cash flow generated by the royalty stream.

For instance, for every $100 of regular income you receive, you're taxed at a rate of about 40%, which means $60 of that ends up in your pocket.

With royalty assets that benefit from the amortization offset, only a small portion of that $100 in income is considered taxable. As illustrated in the Income Forecast table above, in the first year only $17 of $100 is taxable. At a 40% tax rate, that'd reduce your tax due from $40 to about $7.

Combined with the opportunity for high yields at relatively lower risks, the tax treatment described here illustrates why music royalty assets are one of the most attractive investment opportunities available to investors today.

Again, please review this information with a tax advisor or attorney to ensure these details are appropriate to your individual situation.

If you have any additional questions, please feel free to reach out directly.

Best regards,

Matt Smith
CEO @ RoyaltyExchange