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Press Release

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For Immediate Release

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Supreme Court Says No to Tax on Artists' Copyright

SAN FRANCISCO, April 5— In a four to three decision on Monday, April 2, the California State Supreme Court ruled in favor of illustrator Heather Preston, in her case, Preston v. State Board of Equalization (BOE). Preston challenged California's right to require that sales tax be collected on the licenses of reproduction rights to her artwork and subsequently used by her clients to produce rubber stamps and children's books. While the seven justices unanimously agreed with Preston's position that the copyright licenses had been wrongly taxed under California law, the majority concluded that the transactions constitute "technology transfer agreements." The decision means that a fair rental value for the artwork or computer disks transferred for the purpose of accessing the copyright interest is subject to tax. The Court remanded the matter of determining the value of the "rental" portion of Preston's transactions to the lower court. The case resulted from a random audit of Preston by the BOE in 1993.

"The BOE has been calling my case frivolous for seven and a half years," said Preston, "but we did our best to keep our dignity. It's to the Court's credit that they went back to the beginning and took a close look at the case. I thank them with all my heart."

In an unusual twist, the three dissenting justices opposed the majority only in that they wanted to go further -- arguing that the transactions should be exempt entirely.

"If Heather Preston and her attorney, Nick Blonder hadn't fought this to the end, there would have been no vehicle for this victory," said Daniel Abraham, Guild attorney throughout the tax effort and primary author of the Guild amicus curiae brief. "This was our last shot."

"Although the justices disagreed on some issues," Preston's attorney, Nicholas Blonder, commented, "all seven concluded that payments received by an artist for the licensing of a copyright interest are not subject to sales or use tax. This effectively ends the Board's long-standing practice of applying tax to all royalties received by an artist."

"The state got their head handed to them in a big way," said attorney Eric Miethke, California counsel for the Graphic Artists Guild and a co-author of the amicus curiae brief filed in the case. "Guild members should feel vindicated by the Court's ruling. We've been saying all along that tax should not be applied to the copyright -- that at most only the rental value of the disk should be taxed -- which is an infinitesimal amount."

"This is a clear victory for us," said Lloyd Dangle, the Guild's National Vice President, and organizer of the Guild's California tax effort. "It finally provides the BOE with the impetus to treat the intellectual property created by illustrators, photographers, and graphic designers properly. We've been waiting a long time for this."

The Graphic Artists Guild's Northern California Chapter has been pursuing sales tax reform for artists through the California State Legislature and the California Board of Equalization since 1996. Miethke says that as a first step, all Guild members and other affected artists may choose to file protective claims for refunds for a 3-year period, for the full amount of sales tax remitted on their transactions.

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On April 5, 2001, the California Supreme Court ruled in favor of illustrator Heather Preston in her case, *Preston v. Board of Equalization (BOE)*. The Court ruled that Preston's licenses of the rights to reproduce her artwork had been wrongly taxed under California law. Below is our understanding of how sales tax will apply to illustrators, designers, and photographers in the aftermath of this ruling.

Important note: this ruling very recently announced. This information is accurate to the best of our knowledge, but frequent updates will be provided. Please check the Guild website: www.gag.org

WHAT DOES THE RULING IN PRESTON V. BOE MEAN FOR ARTISTS?

Artist's copyright licenses are no longer subject to sales or use tax in California

The Court's ruling invalidates and effectively ends the Board of Equalization's long-standing practice of taxing reproduction rights to artwork. The Court clearly ruled that Preston's sales of reproduction rights to her clients, which were subsequently used to produce children's books and rubber stamps, meets the definition of a "technology transfer agreement" under California law.

In technology transfer agreements, the portion of the sale attributable to the transfer of a copyright interest or patent is not subject to sales or use tax.

If tangible artwork or media, such as a disk, is transferred for the purpose of accessing the copyright interest, only a fair rental value for the temporary transfer is subject to tax. Sales of tangible artwork for its own sake will still be taxable.

Can the Board of Equalization Appeal the Supreme Court Ruling?

No, the Supreme Court ruling is final. The BOE, however, will interpret the ruling in redrafting their regulations to conform with it. It will be important for industry representatives to participate in this regulatory process, which may take as long as a year. In the meantime, we anticipate there to be a great deal of confusion

and inconsistency within the BOE regarding the effects of this ruling.

Why is it called a "Technology Transfer Agreement?"

"Technology transfer" is an unusual way to describe an artist licensing rights to their artwork, but the Supreme Court ruled that it meets the definition of a "technology transfer" because the artist's copyright interest enables another party to produce something—a book or other product. Under any technology transfer agreement, the value of the patent or copyright interest is non-taxable.

How would I calculate the fair rental value of my artwork or disk?

The Supreme Court remanded this matter to the lower court, which means we will have to wait for the final word. However, there is a formula for fair rental value set by legal precedent in another case. Fair rental value equals 200% of the cost of materials plus labor.

Example:

Materials: say all of the materials used to make an illustration (paper, paint, etc.), which you intend to physically hand to your client temporarily to be scanned equals \$10. There would be no labor charges unless you hired someone to help produce your illustrations. 200% of materials and labor,

200% of \$10 = \$20 taxable rental value.

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Your invoice would look like this:

- Fees for grant of rights to reproduce XYZ illustration (copyright)
[not subject to sales or use tax] = \$5000
 - 3% royalty [also not subject to tax]
 - Fair rental value of artwork for scanning [taxable] = \$ 20
 - tax on \$20@ 8% = \$ 1.60
- total = \$5021.60

Artwork transferred to a client by remote communications (downloaded from ftp server, or emailed over the internet) is non-taxable, since the artwork is not transferred in a physical form. This exemption would continue to be in effect and eliminate the need to determine a rental value. Documentation from your client is required.

HOW TO FILE FOR A REFUND

Who can file for a refund?

Any artist who has conducted transactions in which they licensed a copyright interest in their artwork to another party to produce printed or manufactured products may file for a protective refund in the amount collected, minus the tax on the fair rental value of the work for the purpose of scanning.

The statute of limitations for filing a claim for refund is three years (Revenue and Taxation code 6902), so you would need to determine the amount of tax collected for the past three years, (from the filing date) that was attributable to the copyright transfers.

Upon receiving your refund it would be incumbent upon you to return the taxes collected to your client or whoever initially paid them.

How do I file?

Obtain a form “BOE-101” from your local BOE office, or download it from <http://www.boe.ca.gov/staxforms.htm>.

Under the section titled “Reason for Overpayment,” you would explain it like this:

The overpayment of taxes resulted from sales tax I collected on transactions in which I licensed a copyright interest to to my artwork

to clients under technology transfer agreements. My collection of sales tax was in compliance with BOE requirements at the time, but I understand they have been invalidated by a recent Supreme Court ruling in the case of Preston v. BOE.

DISCLAIMER

Attorneys for the Graphic Artists Guild have analyzed the Court opinion carefully and we believe that the Court’s intent is clear, and that the information here is accurate. The BOE will now need to respond by implementing changes to their regulations to conform with the ruling. In the meantime there may be confusion and inconsistency in the information available from the BOE, and treatment of different disciplines may vary.

The only way to receive binding information from the BOE that will protect you in an audit is to file a query letter with the BOE and receive an answer from them in writing (this is called a Section 6596 query). It is best to confirm the above information by filing your own query with the BOE, act accordingly, and keep the BOE response on file.

FILING A SALES TAX QUERY WITH THE STATE BOARD OF EQUALIZATION (BOE)

To file a query, write a letter on your business letterhead. Be sure to include your seller’s permit number. Explain the business practices in question and request explicit instructions (in writing) as to how sales tax applies. The BOE will respond with written answers in a month or two.

Keep the BOE letter on file. If you are audited, the letter will serve as protection from any contrary interpretations that your auditor may make. Send your query to:

**Audit Evaluation and Planning
MIC40
State Board of Equalization
PO Box 942879
Sacramento, CA 94279-0040**