



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/08/99	Bill No:	SB 331
Tax:	Sales and Use	Author:	Wright
Board Position:		Related Bills:	

BILL SUMMARY:

This bill would do the following:

- Exclude from the terms “sale” and “purchase” the granting of a right to reproduce or copy a two- or three-dimensional image, as specified.
- Require the California Research Bureau to submit a report to the Legislature by 01/01/2004 that includes the cost of the exclusion and the number of transactions covered by the exclusion in calendar years 2000 to 2002.

ANALYSIS:

Current Law:

Under existing law, the sale of tangible personal property for consideration is subject to tax unless that property is specifically exempted or excluded from the computation of tax. The sales tax is based on the total gross receipts of retailers for the sale of tangible personal property, without any deduction on account of the cost of materials used, labor, or services that are a part of the sale of the property. “Sale” is defined in Section 6006 to include, among other things, any transfer of title or possession for consideration. Therefore, when tangible personal property is transferred, such as a photograph, even temporarily, to a person and a charge is made granting the person the right to reproduce the tangible personal property (such as in a newspaper), the entire charge is subject to tax. However, in order for tax to apply, there must be a tangible item of property transferred. Therefore, if a photograph, for example, is transferred modem to modem, no tax would apply to that transfer.

Under existing law, when a sale of tangible personal property includes a charge for an intangible right to reproduce that property, the entire charge is generally subject to tax. This interpretation has been supported by case law. Specifically, in the matter of *Simplicity Pattern Company v. State Board of Equalization* (1980) 27Cal.3d 900, the Supreme Court held that the transfer of certain master film negatives to be used for reproduction purposes was a sale of tangible personal property and that the tax on the transfer was measurable by what the taxpayer received for the property as a whole, without any deduction for amounts paid for the intellectual or other intangible components.

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There are some exceptions to the general law that imposes tax on the entire transaction amount without a deduction for the intangible element of the transfer. For example, under Sections 6011(c)(10) and 6012 (c)(10), "sales price" and "gross receipts" do not include the amount charged for intangible personal property transferred with tangible personal property under a "technology transfer agreement" in which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest. Another example includes the exemption under Section 6362.5 attributable to the amounts paid for the copyrightable, artistic or intangible elements in connection with the sale and purchase of master tapes and records. With regard to this exemption, only the actual tangible personal property incorporated into the tape or record is subject to tax.

Proposed Law:

This bill would do the following:

1. Add Section 6010.20 to the Sales and Use Tax Law to exclude from the terms, "sale" and "purchase," the granting of a right to reproduce or copy a two- or three-dimensional image. The bill would specify that the exclusion would not apply to:
 - a transfer of title or possession of tangible personal property embodying the image,
 - the amount charged for the granting of the right to reproduce or copy the image if that amount is not separately stated, as specified,
 - any transfer of reproductions or copies of the image produced, printed, or manufactured under the grant, as specified.
2. Require the California Research Bureau to submit a report no later than 01/01/2004 that specifies the cost of the exclusion and the number of transactions covered by the exclusion in calendar years 2000 through 2002.

The provisions of the bill would become operative on the first day of the calendar quarter commencing more than 90 days after the bill becomes effective.

Background:

A similar measure was considered during the 1997-98 Legislative Session. That measure, SB 664 (Wright), upon which the Board had a neutral position, was held in the Assembly Appropriations Committee.

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COMMENTS:

1. **Purpose of the bill.** According to the author's office, this bill is intended to clarify that sales and use tax does not apply to charges for the intangible right to reproduce images. The sponsor of this measure is the Graphic Artists Guild.
2. **Board does not obtain precise data on these transactions for purposes of the report.** In order for the California Research Bureau to effectively prepare the report required by this measure, it would be necessary for that Bureau to obtain precise data on every transaction exempted by this measure for a 2-year period. However, the bill does not require affected taxpayers to provide the Bureau with any information. Since the Board does not maintain the data that would be required to prepare such a report, consideration should be given to including provisions that require any taxpayers claiming the exemption provided in this measure to submit the necessary information to the Bureau.

COST ESTIMATE:

Costs would be incurred in notifying affected taxpayers and Board staff, amending applicable regulations, and answering inquiries. These costs are estimated to be \$20,000.

REVENUE ESTIMATE:

There are a number of areas in which this measure would impact sales and use tax revenues.

Advertising Agencies

This measure would exclude from the sales and use tax, sales or purchases by an advertising agency that include the right to reproduce or copy a two- or three-dimensional image if the transfer occurs in California. This would include transactions involving an advertising agency receiving images from artists located outside of California when the use of the images occurred in California. The Sales and Use Tax Department conducted a study of advertising agencies, looking at their total gross receipts, their reported taxable transactions, and their sales or purchases of images that would be affected by this measure. The study investigated recent sales and use tax returns and audits of 67 advertising agencies. The study results showed that these 67 companies had total gross receipts during fiscal year 1996-97 of \$1,134.5 million, total taxable transactions of \$214.5 million, and taxable sales or purchases, that included the right to reproduce or copy a two- or three-dimensional image, of \$55.5 million. Sales and use tax revenues derived from these transactions amounted to \$4.5 million. These taxable transactions represent 5% of the total gross receipts of these advertising agencies ($\$55.5 \text{ million} / \$1,134.5 \text{ million} = 0.05$).

According to the U. S. Department of Commerce publication *1992 Census of Selected Services - California*, total 1992 receipts for advertising agencies amounted to \$1,771.3

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million. If we factor this figure by the change in the California Consumer Price Index to a 1996-97 level, we get total receipts of \$1,932.5 million. We studied companies that accounted for \$1,134.5 million or 59% of this total.

If we factor the 1992 receipts to a 1999 level, again using the change in the California Consumer Price Index and assume that transactions that include the right to reproduce or copy a two- or three-dimensional image amount to 5% of this amount, we can estimate the total amount of advertising agency receipts that would be nontaxable under this measure.

1992 Advertising Agency Receipts	\$1,771.3 million
Percent Change in CCPI 1992-1999	15.0 %
Estimated 1999 Receipts	\$2,037.0 million
Percent Subject to SB 331	5%
Sales Subject to SB 331	\$101.8 million
Sales and Use Tax Revenue @ 7.92%	\$8.1 million

Commercial Art & Graphic Design

This measure would exclude from “sale” and “purchase” transfers of camera-ready art created by commercial artists and graphic designers when the transfer of that art includes the right to reproduce the image. The Sales and Use Tax Department conducted a study, similar to the one done for advertising agencies, on 50 commercial artists and graphic designers. The study results showed that these 50 companies had total gross receipts during fiscal year 1996-97 of \$259.0 million, total taxable transactions of \$145.2 million, and taxable sales or purchases, that included the right to reproduce an image, of \$116.7 million. Sales and use tax revenues derived from these transactions amounted to \$9.5 million. These taxable transactions represent 45% of the total gross receipts of these commercial artists and graphic designers ($\$116.7 \text{ million} / \$259.0 \text{ million} = 0.45$).

According to the U. S. Department of Commerce publication *1992 Census of Selected Services - California*, total 1992 receipts for commercial artists and graphic designers amounted to \$802.9 million. If we factor this figure by the change in the California Consumer Price Index to a 1996-97 level, we get total receipts of \$876.0 million. We studied companies that accounted for \$259.0 million or 30% of this total.

If we factor the 1992 receipts to a 1999 level, again using the change in the California Consumer Price Index, and assume that transactions that include the right to reproduce a two- or three-dimensional image amount to 45% of this amount, we can estimate the total amount of commercial art and graphic design receipts that would be nontaxable under this measure.

1992 Commercial Art/Graphic Design Receipts	\$802.9 million
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Percent Change in CCPI 1992-1999	15.0 %
Estimated 1999 Receipts	\$923.3 million
Percent Subject to SB 331	45 %
Sales Subject to SB 331	\$415.5 million
Sales and Use Tax Revenue @ 7.92%	\$32.9 million

Commercial Photographers

Commercial photographers that take pictures for newspapers and magazines rarely sell their photographs. Instead, they usually make a temporary transfer of the photograph and include the right to reproduce the photograph. As such, these transactions would be nontaxable under this measure. Mr. Harold Nelson, a CPA and accountant for a number of commercial photographers in California, has estimated that between 40 and 55 percent of the work done by California's commercial photographers would be shipped out-of-state and would not be currently taxable. Since nearly all of the sales made by commercial photographers involve a temporary transfer of the photograph and include the right to reproduce the photograph, it would mean that between 45 and 60 of the receipts of commercial photographers would be for work transferred in California and would therefore be nontaxable under this measure. For the purposes of this estimate, we will assume that 45% of the gross receipts from commercial photographers would be nontaxable under this bill. This is the same percentage we used for commercial artists and graphic designers and is within the range estimated by Mr. Nelson.

According to the U. S. Department of Commerce publication *1992 Census of Selected Services - California*, total 1992 receipts for commercial photographers amounted to \$182.4 million. If we factor the 1992 receipts to a 1999 level, using the change in the California Consumer Price Index and assume that transactions that include the right to reproduce a two- or three-dimensional image amount to 45% of this amount, we can estimate the total amount of commercial photographer sales that would be nontaxable under this measure.

1992 Commercial Photographer Receipts	\$182.4 million
Percent Change in CCPI 1992-1999	15.0%
Estimated 1999 Receipts	\$209.8 million
Percent Subject to SB 331	45%
Sales Subject to SB 331	\$94.4 million
Sales and Use Tax Revenue @ 7.92%	\$7.5 million

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Royalty Payments for Two- or Three- Dimensional Images Reproduced for Retail Sale

This measure would exclude from “sale” and “purchase” royalty payments for two- or three-dimensional images reproduced for retail sale. Based on information reported on tax returns from gift and art-goods stores in California, it is estimated that 1999 California retail sales of two- or three-dimensional images reproduced for retail sale will amount to \$775.1 million. Assuming that California represents 12% of the nationwide sales of such items, U. S. sales of images reproduced for retail sale are estimated to be \$6.5 billion. These would include sales of both limited and open edition collectibles and prints. Limited edition means that only a specified number have been made and they are signed and numbered. Representatives of the Graphic Artists Guild state that these limited edition collectibles are sold by the artists and that these sales do not involve a transfer of reproduction rights. They further state that most open edition collectibles are created with art either produced in-house, which would produce no sale of artwork and no royalty payment, or art purchased with a one time payment that includes no royalties. They estimate that perhaps only 15% of open edition agreements offer royalty payments.

The Graphic Artists Guild estimates that half of the retail sales of collectibles would be for open edition collectibles. They further estimate that California firms account for only 6% of the nationwide market in open edition collectibles.

According to a California retailer of collectible plates and figurines, the amount of royalty payments included in the sales price of these items varies from 1% to 10%, with 3% being a reasonable overall average.

We estimate the total amount of royalty payments for works of art reproduced for retail sale to be as follows:

1999 U.S. Sales of Collectibles	\$6,500.0 million
Open Edition Collectible Sales	\$3,250.0 million
% of Sales with Royalties	15%
Sales with Royalties	\$487.5 million
% Produced by California Artists	6%
Sales by California Artists	\$29.25 million
Royalty Payments @ 3%	\$877,500
Sales and Use Tax Revenue @ 7.92%	\$69,000

Greeting Cards

This measure would exclude from “sale” and “purchase” the transfer of images for reproduction on greeting cards, when the transfer includes the right to reproduce a two- or three-dimensional image. The Graphic Artists Guild has provided some figures on the U. S. greeting card market. According to the *New York Times* (November 20, 1997), the greeting card market in the United States amounts to \$7 billion annually. This

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market is dominated by three companies, none of which are located in California. These three companies account for 84% of the total market. California companies, according to *The Artist's Market*, account for approximately one quarter of the remaining 16% percent or 4% of the total U. S. market. This amounts to \$280 million. From information on audits, the Board has found that transfers that include the right to reproduce a two- or three-dimensional image represent 7% of these sales. If the transfer of the image occurs in California, then the transaction would be taxable currently and would be nontaxable under this measure, regardless of where the artist is located and regardless of where the final sale of the greeting card occurs.

We estimate the total amount of royalty payments for artwork done in connection with greeting cards to be as follows:

1999 U.S. Sales of Greeting Cards	\$7,000.0 million
% Produced by California Companies	4%
Sales by California Companies	\$280.0 million
Royalty Payments @ 7%	\$19.6 million
Sales and Use Tax Revenue @ 7.92%	\$1.6 million

Book Publishing

This measure would exclude from "sale" and "purchase" the transfer of images for reproduction in connection with book publishing. The Graphic Artists Guild was unable to provide any exact figures on the percentage of the book publishing industry represented by California companies. They believe that California book publishing companies account for less than the normal 12% that California represents of total U.S. population. According to the U.S. Department of Commerce publication, *1992 Census of Manufacturers*, the total value of shipments by book publishers in the United States amounted to \$16,731.1 million in 1992. The value of shipments for California book publishers amounted to \$1,194.9 million, or 7% of the national total. If the transfer of the images occurs in California, then the transactions would be taxable currently and would be nontaxable under this measure, regardless of where the artist is located and regardless of where the final sale of the book occurs. From information on audits, the Board has found that transfers that include the right to reproduce a two- or three-dimensional image represent 7% of these sales. If we factor the 1992 receipts to a 1999 level, using the change in the California Consumer Price Index and assume that 7% of these sales would be subject to the provisions of SB 331, we can estimate the total amount of book publishing receipts that would be nontaxable under this measure.

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1992 California Book Publishing Receipts	\$1,194.9 million
Percent Change in CCPI 1992-1999	15.0 %
Estimated 1999 Receipts	\$1,374.1 million
Percent Subject to SB 331	7 %
Sales Subject to SB 331	\$96.2 million
Sales and Use Tax Revenue @ 7.92%	\$7.6 million

Character and Trademark Licensing

This measure would exclude from “sale” and “purchase” royalties paid for character and trademark licensing when the royalties are paid in conjunction with a transfer that includes the right to reproduce a two- or three-dimensional image. Neither the Board of Equalization nor the Graphic Artists Guild could find any reliable information regarding the number of transfers of images involving the payment of royalties in connection with character and trademark licensing. The market for items that use these character and trademark designs is quite large. According to the magazine, *Advertising Age*, 1995 national sales of these items amounted to \$70 billion. The Graphic Artists Guild believes that most, if not all, of the transactions that include the right to reproduce images in conjunction with the manufacture of these items occur outside of California. We have been unable to find any information to verify this. We will continue to research information regarding such transactions. However, it is our belief that the amount of such transactions would not materially affect the order of magnitude of the estimate of the revenue effect of this measure.

Revenue Summary

The revenue impact from excluding from “sale” and “purchase” transfers that include the right to reproduce a two- or three-dimensional image would be as follows:

Type	1999 Sales (millions)	Revenue @ 7.92% (millions)
Advertising Agencies	\$101.8	\$ 8.1
Commercial Art & Graphic Design	415.5	32.9
Commercial Photographers	94.4	7.5
Royalty Payments	0.9	0.07
Greeting Cards	19.6	1.6
Book Publishing	96.2	7.6
Trademark Licensing	<u>not available</u>	<u>not available</u>
Total	<u>\$728.4</u>	<u>\$ 57.7</u>

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The revenue effect on the various levels of government imposing sales and use taxes in California would be as follows:

	<u>Revenue Effect</u>
State loss (5%)	\$36.4 million
Local loss (2.25%)	16.4 million
Transit loss (0.67%)	<u>4.9 million</u>
Total	<u>\$57.7 million</u>

Qualifying Remarks

Reliable information regarding transactions that would be affected by this measure was difficult to obtain. In some cases, neither the Board of Equalization nor the Graphic Artists Guild were able to uncover such information. The information regarding royalty payments for works of art reproduced for sale, greeting cards and book publishers is less than definitive. Especially in the greeting card and book publishing areas, there is a good possibility that some of the transactions included in these estimates are also included in the estimates for commercial art and graphic design. We have no information upon which to base an estimate of how much double counting there might be. However, the majority of the revenue loss estimate is based on a study of actual sales and use tax returns and actual revenues paid by advertising agencies and commercial artists and graphic designers. We feel therefore, that the \$57.7 million figure shown above is a reasonable estimate of the revenue effect of this measure.

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