



Preston v. State Board of Equalization
25 Cal.4th 197 (2001)
Application of the California Sales Tax to Intangibles

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Summary of *Preston's* Four Holdings

- A. Refund claim allegation that asset transferred was nontaxable reproductive right sufficiently raises Technology Transfer Agreement (“TTA”) copyright sales tax exclusion.
- B. Regulation 1501 manuscript exclusion is limited to textual copyrights and does not extend to copyrights on drawings and illustrations.
- C. TTA sales tax exclusion extends to any transfer of any patent or copyright interest, including artwork, if there is also the transfer of a “right to make and sell a product or use a process that is subject to that patent or copyright interest.”
- D. TTA sales tax exclusion is retroactive, despite 1994 “operative” date, because statute is explicitly stated to be clarification of existing law.

Factual and Procedural History

- A. Facts: Preston, a commercial artist, entered into two types of transactions:
 1. 1981-1993: Preston transfers original illustrations to book publishers for reproduction in children’s books, in return for cash advances and 5% royalty on book sales.
 2. 1988-1993: Preston transfers original artwork to toy manufacturer to be reproduced in rubber stamps, in return for cash advances and 5% royalty on sales.
- B. Procedural history.
 1. SBE audit finds Preston liable for sales tax on all advances and royalties from the above transactions. Preston files timely petition for redetermination and claim for refund. SBE denies Preston relief.

2. San Francisco Superior Court and California Court of Appeal deny Preston relief. Court of Appeal concludes:
 - a. Preston’s refund claim fails to adequately raise any copyright issues.
 - b. Preston’s transfer of original artwork is a fully taxable transfer of tangible property, rather than intangible property, under Regulation 1501 “true object” test. Buyers would have been unable to exploit Preston’s artwork without possession of tangible originals.
 - c. It is irrelevant that Preston only temporarily transferred the tangible artwork to the book publisher. Temporary usage of tangible personal property for a consideration is fully taxable.

Court’s First Holding: *Preston's* Refund Claim Sufficiently Raises Intangible Claims

- A. Background: Filing an SBE refund claim is a prerequisite to bringing a refund suit. The refund claim must state the specific grounds for relief. Revenue and Taxation Code (“R&TC”) sections 6932, 6094. California courts cannot consider issues not raised in the refund claim. R&TC § 6933.
- B. Preston refund claim stated:
 1. Transfers were nontaxable transfer of reproduction rights, not the transfer or sale of tangible original artwork.
 2. Transfers were nontaxable transfer of author’s manuscript, exempt under Regulation 1501.

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- C. Court concludes Preston's refund claim adequately raised her copyright claims.
1. Allegation that transfers are intangible reproductive rights sufficiently raises copyright claims.
 2. Allegation that transfers are exempt manuscripts under Regulation 1501 sufficiently raises copyright claims.
 3. Court implicitly concludes that raising a "copyright" claim automatically raises the statutory TTA provisions.

Court's Second Holding: Preston Cannot Completely Avoid Sales Tax Because Tangible Artwork was Transferred with the Intangible Copyrights

- A. Historical background.
1. California sales tax only applies to transfers of tangible personal property, not intangibles. Clearly defining the dividing line between nontaxable intangible property and taxable tangible property has proven difficult.
 - a. R&TC § 6016: Tangible personal property means personal property which may be seen, weighed, measured, felt, or touched, or which is in any way perceptible to the senses.
 - b. California case law: [Intangible] property is generally defined as property that is a right rather than physical object. *Navistar Internat. Transportation Corp. v. State Bd. Of Equalization* (1994) 8 Cal. 4th 868, 874; *Roth Drug, Inc. v. Johnson* (1936) 13 Cal. App.2d 720, 734.
 2. California has had difficulty separating nontaxable intangible property from taxable tangible property used to memorialize or convey an intangible property right. Transactions have generally been held either (i) entirely taxable, with the intangible property folded into and taxed as part of the tangible personal property, or (ii) entirely nontaxable, with the tangible property deemed incidental.
 - a. 1945 – Regulation 1501: The "true object" test.

"The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of

a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service.

"Similarly, an idea may be expressed in the form of tangible personal property and that property may be transferred for a consideration from one person to another; however, the person transferring the property may still be regarded as the consumer of the property. Thus, the transfer to a publisher of an original manuscript by the author thereof for the purpose of publication is not subject to taxation. The author is the consumer of the paper on which he has recorded the text of this creation. However, the tax would apply to the sale of mere copies of an author's works or the sale of manuscripts written by other authors where the manuscript itself is of particular value as an item of tangible personal property and the purchaser's primary interest is in the physical property."

- b. 1980 – *Simplicity Pattern*: Narrowing of the "true object" test with the "physically useful in manufacturing" test.

In *Simplicity Pattern Co., Inc. v. State Bd. Of Equalization* (1980) 27 Cal.3d 900, *Simplicity* sold its copyrights to educational film strips and recordings, conveying the copyrighted material to the buyer on master tapes and film negatives. The Court concluded that it was irrelevant that the buyer's true object of the transaction was the intangible copyrighted material. Since the master tapes and film negatives used to convey the copyright rights were physically useful as printing plates in the manufacturing process, the master tapes and negatives were distinguishable from the nontaxable manuscript in Regulation 1501. The Court concluded the value of the copyrights should be folded into the master recordings and negatives and the entire transaction subjected to sales tax.

In *Capitol Record, Inc. v. State Bd. of Equalization* (1984) 158 Cal. App. 3d 582 and *A&M Records, Inc. v. State Bd. of Equalization* (1988) 204 Cal.App. 3d 358, the *Simplicity* analysis was reaffirmed for master tapes conveyed from recording artists to record companies. Since the master tapes were physically useful as printing plates in the manufacturing process, the entire royalty stream flowing from a record company to a recording artist was subject to sales tax.

- c. 1994 – *Navistar*: Narrowing of the "physically useful" test by making it inapplicable to trade secrets, concluding that the trade secret rights

cannot be separated from the tangible personal property conveying the rights.

Navistar sold its trade secrets of turbine engine technology to a third party buyer, thereby providing the buyer the necessary intangible rights to reproduce turbine engines for sale to the public. The drawings conveying the trade secrets were used only as a means of conveying the intangible, never used in manufacturing operations, and not physically useful. Nevertheless, the Court concluded that the intangible trade secrets could not be separated from the tangible means of conveyance which caused the entire transaction to be subject to tax.

B. Court concludes that Preston's conveyance of tangible artwork along with her copyright prevented the transaction from being entirely exempt.

1. Regulation 1501 and the true object test is inapplicable as this is not a service contract.
2. Regulation 1501 manuscript example is inapplicable as these are illustrations rather than manuscript text.
3. Preston's tangible original artwork was physically useful in the manufacturing process. The Court agrees with the lower courts that it would have been impossible for the book publishers and toy manufacturers to reproduce Preston's copyrighted ideas without the physical drawings.
4. Even if Preston's tangible original artwork had not been physically useful, since tangible personal property was transferred along with an intangible property right, *Navistar* prevents Preston from avoiding sales tax.

C. Justice Kennard's dissent: Preston's entire transaction should be respected as tax free transfer of a copyright on an inconsequential Regulation 1501 manuscript.

1. Regulation 1501 indiscriminately applies to an entire manuscript, text and illustrations. The majority would illogically make the Regulation 1501 manuscript exception dependent on whether the author's manuscript included any illustrations.
2. Preston's illustrations were no more physically useful in manufacturing a book than text in a

manuscript. Without the text in a manuscript, it would be impossible to publish the book. Whether text or illustrations, the paper used to convey the intangible serves no useful function other than a vehicle of conveyance and it therefore should be ignored.

3. Difficult to reconcile Kennard's *Preston* dissent with *Navistar*.
 - a. In *Navistar* a paper vehicle of conveyance for a trade secret was enough to cause the trade secrets to be folded into the paper documents and fully taxed as tangible personal property.
 - b. Kennard resurrects *Simplicity's* "physically useful" test for Regulation 1501, after it was affirmatively rejected in *Navistar*.
 - c. It is difficult to fit the Preston tangible artwork transferred for creation of rubber stamps into the manuscript example. If so, the manuscript example should be extended to the transfer of other intangibles for production of derivative toy and technology products, e.g., trade secrets for Navistar turbine engines.
 - d. Reconciling *Navistar* with *Preston* implies that a trade secret is different than a patent and copyright, and that a trade secret cannot be separated from its tangible means of conveyance.

Court's Third Holding: Preston's Agreements are Technology Transfer Agreements

- A. Background on Technology Transfer Agreements ("TTAs").
 1. Replaces "all or nothing" regime for copyright and patent transfers with a purchase price allocation between taxable tangible properties and nontaxable intangible properties. Segregation principle evolved from 1992 SBE *Appeal of Intel* decision. January 18, 1994, 1993-1995 Cal.CCH New Matters ¶ 402-675.
 - a. Intel licensed various copyrights, patents and other intellectual property rights to Burroughs and AMD to use Intel processes to produce integrated circuits, and also conveyed written information, instructions, schematics, database and test tapes.
 - b. SBE held the Intel transaction should be segregated into a taxable tangible taxable transaction, and nontaxable intangible transaction. Even though the transaction had no allocations, the SBE held the

- taxable tangible property should be allocated 200% of its direct manufacturing cost (\$33,000), with the remaining transaction proceeds allocated to nontaxable intangibles.
2. Legislation passed as AB 103 on October 8, 1993 and incorporated as sales price exclusion for use taxes (R&TC § 6011(c)(10)) and a gross receipts exclusion for sales tax (R&TC §6012(c)(10)).
 - a. Statute provides that for TTAs only the portion of the transaction proceeds allocated to “tangible personal property” is taxed.
 - b. TTA is defined as any agreement under which:
 - i. A person who holds a patent or copyright interest
 - ii. Assigns or licenses to another person
 - iii. The right to make and sell a product or use a process
 - iv. That is subject to the patent or copyright interest.
 - c. The portion of the transaction proceeds allocated to the taxable tangible personal property is statutorily set as:
 - i. Any reasonable allocation agreed to by the parties.
 - ii. The market price for the tangible personal property, absent the intangible property rights.
 - iii. 200% of the cost of materials and labor to produce the tangible personal property.
- B. Court’s analysis that Preston’s transactions are TTAs.
1. Preston owned copyrights in her original artwork and her agreements transferred a portion of her copyright right in that artwork.
 2. The agreement is a TTA since the products sold by the book publisher and toy manufacturer were “subject to” Preston’s copyrights. It is irrelevant that the book publisher and the toy manufacture could have made and sold a version of their products without Preston’s copyrighted illustrations.
 3. TTA provisions apply indiscriminately despite the fact that Preston’s copyrights are illustrations for children’s books and toys rather than “high” technology.
 - a. The statute has no limit on type of copyrights or patents.
 - b. The legislation purposely encompasses transfers of copyright or patent rights (rather than copyrights and patent rights), with the legislative history verifying it was understood that this would extend the provision to artwork and illustrations.
4. The case is remanded for Preston and the SBE to determine the proper allocation of taxable value to the tangible artwork based on the TTA specified 200% of the cost of materials and labor to produce the original artwork because:
- a. Preston’s agreements have no specific allocation to the tangible personal property and
 - b. There is no set market price for Preston’s original illustrations.
- C. Court’s revisions to existing authorities based on its TTA analysis.
1. Regulation 1540(d)(4) invalidated. It had previously said:

REPRODUCTION RIGHTS. Charges for the transfer by a tangible medium of a photograph or of finished art for purposes of reproduction are taxable even though there is no transfer of title to the person reproducing the photograph or work of art. Charges for the right to use the photograph or finished art which has been transferred by tangible medium in the production of tangible personal property are taxable. Charges for a license or copyright (such as a right to reproduce or prepare derivative works) to exploit the photograph or finished art are taxable if they are sold along with the photograph or finished or transferred by tangible media or they are sold by a subsequent contract entered into within one year of the original transfer of the photograph or finished art.
 2. Three SBE Annotations invalidated.
 - a. 295.0460 (7/8/55). Royalty payments received in connection with the retail sale of a patented machine found taxable.
 - b. 330.3540 (12/30/69). Royalty payments paid by theatrical groups for renting scripts and vocal scores found taxable.

- c. 420.0280 (7/28/75). Royalty payments paid to artist for designs used in publication of greeting cards found taxable.

Court's Fourth Holding: 1994 TTA Provisions Retroactively Applied to Preston's 1981-1993 Transactions

- A. AB 103 added TTA to R&TC in October 1993, with an April 1, 1994 operative date (Section 5). Court concludes that retroactive application is merited.
1. Section 3 of AB 103 specified statute was clarification of existing law:

It is the intent of the Legislature in enacting this act to clarify the application of the Sales and Use Tax Law to technology transfer agreements, as defined. It is also the intent of the Legislature that the amendments made by this act not create any inference regarding the application of the Sales and Use Tax Law to other transactions involving the transfer of both intangible rights and property and tangible personal property.
 2. Legislative history shows that the above language was the result of substantial debate, evidencing the legislature understood the legislation would be retroactively applied.
 3. Legislative history verifies that the statute was intended to implement the SBE's 1992 decision in *Appeal of Intel*.
 4. No Constitutional barrier to retroactive application. No due process issues. No gift of public funds. Public benefit of providing clarity and certainty and improved California business climate overrides any SBE argument for vested claim to tax revenues.
- B. Kennard dissent on retroactive application of TTAs.
1. Presumption is that statutory exemptions are only applied prospectively, which is bolstered by legislation's stated April 1, 1994 "operative date."
 2. TTA provisions are not clarification as they are substantively broader than *Intel*, which applied to only patented and copyrighted technology.

Planning Intangible Asset Transfers After *Preston*

- A. Court's retroactive application of TTA provisions prompts attempt to reconcile existing authorities into TTA regime.
1. Regulation 1501's paper manuscript fits into the TTA example as a "zero value" property because it is not physically useful in the manufacturing.
 2. *Simplicity* is viewed as being consistent with *Preston* as the value of the master recordings and film negatives subject to sales tax was only the historical cost of the tangible property; *Simplicity* is overruled to the extent it taxed more. Nevertheless, *Preston* does overrule *Capitol Records* and *A&M Records* and indicates that the subsequent legislative solution secured by the recording and film industry was unnecessary.
 3. *Navistar* was ineligible for TTA relief as it involved trade secrets rather than patents or copyrights. Yet the TTA provisions were built on *Appeal of Intel*, where the intellectual property transferred included patents, trade secrets and "other intellectual property" which presumably includes trade secrets.
- If the *Appeal of Intel* segregation principle has always been part of California law, why would it only apply to TTA designated patents and copyrights? Can taxpayers presume that they are now free to also segregate other intangibles (e.g., trade secrets) by any agreed contractual allocations, or only free to segregate out TTA designated patent and copyrighted intangibles?
- B. Court's reliance on statutory TTA exclusion counsels continued use of structured exclusions rather than broad intangible analysis.
1. Regulation 1501 limited to textual copyright transfers.
 2. Statutory exclusions for transfers of master tapes and motion picture negatives. R&TC §§ 6060(g), 6010(e), 6362.5, Regulation 1529 and 1527.
 3. Regulation 1502(f)(1) exclusion for transfers of software copyrights.

4. TTAs for copyright and patent transfers.
5. Minimizing California transfers of tangible property.
 - a. Electronic transfers.
 - b. Stock and LLC interests.
 - c. Out-of-state transfers of tangible mediums.
 - d. Carefully structuring purchase price allocations.

C. Planning TTAs.

1. Structuring a TTA Transaction. R&TC §§ 6011(c)(10), 6012(c)(10).
 - a. "Technology transfer agreement" means:
 - i. Any agreement under which a person who holds a patent or copyright interest
 - ii. Assigns or licenses to another person the right to make and sell a product or to use a process
 - iii. That is subject to the patent or copyright interest.
 - b. Structuring agreements to include reasonable allocations to the tangible personal property.
2. SBE developing Regulation 1507 on TTAs. Outstanding issues:
 - a. Requiring a written contract for technology transfer agreements.
 - b. Limiting "process" technology transfer agreements to only patent transfers, rather than patents or copyrights.
 - c. Proper computation of 200% of direct labor and material cost, and whether author's own labor should be included in computation.
 - d. Zero or minimal allocations to tangible personal property when original artwork is only transferred temporarily, and only used for computer scanning.

As technology advances, and the scope of material that can be transferred digitally expands, this entire area of law may well become marginalized.

SBE interested parties meeting on Regulation 1507 scheduled for October 10, 2001 in Sacramento.

- D. Industry proposed revisions to Regulation 1540. Advertising Agencies, Commercial Artists and Designers.

1. Charges for photography, illustration and design copyrights added to enumerated nontaxable items in Regulation 1540(b)(3).
2. Proposed revision to Regulation 1540(c) implements *Preston's* broad directive that any assignment or license of a copyright interest in artwork qualifies as a TTA.

When commercial artists, photographers, or designers enter into agreements with a client in which the artist, photographer or designer holding a copyright interest in artwork assigns or licenses to the client the right to make and sell a product that is subject to the copyright interest in the transferred artwork, such agreements are designated "technology transfer agreements."

The "right to make and sell a product" includes, but is not limited to, the right to use the artwork in the manufacturing process such as in the production of rubber stamps, books, packaging, games, posters, greeting cards, or similar products, or to exploit the artwork by reproducing it as illustrations in advertisements or publications.

"Subject to the copyright interest" means that the client would not be able to legally exploit the artwork in the contracted manner in the absence of the transfer of license or assignment of the copyright interest from the interest holder.

The application of tax to transfers of finished art transferred as part of a technology transfer agreement is governed by subdivision (d)(6).

3. Proposed revision to Regulation 1540(d)(4) and (d)(6) specify that any tangible artwork transferred as part of a TTA pursuant to 1540(c) is separated out and taxed separately based on the allocated purchase price under standard TTA provisions. As noted above, the pre-*Preston* version of Regulation 1540 provides that the entire revenue stream received from licensing of illustrations and photographs is taxed pursuant to Regulation 1540(d)(4).

- E. Industry proposed revisions to Regulation 1541. Printing and Related Arts. Proposed revision to subdivision (e)(3):

Charges for licenses for the right to reproduce illustrations (*e.g.*, drawings, diagrams, halftones, or color images), photographs, drawings, paintings, handlettering and computer generated artwork in printed matter are “technology transfer agreements” as defined in Regulation 1540 and subject to sales tax as applied in that Regulation.

- F. Industry proposed revisions to Regulation 1543. Publishers.

1. “Illustrators” and “Photographers” added to the list of “authors” covered by Regulation 1543(a)(1).
2. Proposed Regulation 1543(a)(7) defines “finished art” as follows:

Finished art means the final original art or photographic image licensed to the client for

reproduction by photo-mechanical or other processes. Finished art does not mean any copy of the final original art or photographic image produced for a mechanical or paste-up by scanning, photography, photostat, or other means for use in the actual process of reproduction by photo-mechanical or other processes.

3. Proposed Regulation 1543(a)(10) specifies that licenses of copyrights in finished art are TTAs, reiterating the language stated above for Regulation 1540(c).
4. Proposed Regulation 1543(c)(7)-(9) includes examples specifying that for artwork “TTAs” there is no allocation to the temporary transfer of tangible personal property that is scanned into the purchaser’s computer system.

SBE interested parties meeting on Regulation 1540, 1541 and 1543 scheduled for November 28, 2001 in Sacramento.

