

**STATE BOARD OF EQUALIZATION**

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February 28, 1995

Mr. --- ---
--- & --- Attorneys
--- --- ---, Suite ---
San Francisco, CA 94111-3492

Dear Mr. C---:

This is in reply to your November 2, 1994 letter regarding the application of sales tax to charges by your client for acting as a licensing agent for owners of certain intellectual property rights such as cartoon characters. You note the following facts:

“The taxpayer (‘TP’) is principally engaged in two business activities. First, TP acts as a licensing agent for the owners of certain intellectual property rights, such as cartoon characters (the ‘Properties’). TP has licensing agent agreements with at least six different owners of intellectual property rights. Although each agreement is different, in general, TP’s duties as licensing agent include:

- (i) promoting the exploitation of the Properties,
- (ii) identifying potential licensees and negotiating license agreements with such licensees,
- (iii) insuring that licensees only use artwork approved by the owner of the Properties,
- (iv) insuring that all copyright and trademark notice requirements are satisfied by licensees,
- (v) providing recordkeeping and billing services, assisting in supervising the quality of products produced by licensees, and
- (vii) developing artwork based upon the properties to be incorporated into materials used by the licensees.

“In exchange for providing these services, TP receives a fee from the owner of the Properties which is calculated as a percentage of the royalties paid to the owners of the Properties by the licensees. Since TP’s licensing agent fee income is dependent upon the volume of products sold by licensees, it is in TP’s economic interest to help licensees stimulate sales by suggesting how best to exploit the Properties.

“TP’s second principal business activity is the manufacture and sale of products incorporating Properties which are directly licensed to TP by several of the owners of the Properties. In these instances, TP earns income by selling products incorporating some of the Properties and pays a royalty to those owners of the Properties.

“The sale of products manufactured by TP is not the subject of this request for a sales tax ruling. Rather, TP requests a sales tax ruling concerning its licensing agent activities.

“1. Description of Art Department

TP maintains an art department which assists its own product development activities in connection with its direct sale of licensed products, as well as supports licensees in connection with TP’s licensing agent activities.

“TP’s ruling request concerns whether there are any sales and use tax obligations imposed upon TP in connection with its art production and design activities which support its licensing agent activities. This aspect of the licensing agent agreements is discussed below.

“With respect to TP’s licensing agent activities, TP’s art department receives a style guide from each owner. The style guide contains pictures of the Properties which can be used by licensees to promote the sale of products incorporating the Properties. One of TP’s duties as a licensing agent is to provide the style guide to each licensee. Upon request of a licensee, TP’s art department may also modify characters or other artwork presented in the style guide, such as by redrawing a character in a different position. TP would then provide this artwork to a licensee. TP may also provide artwork to a licensee on an unsolicited basis from time to time.

“2. Summary of Licensing Agent Agreements
Concerning--Artwork

TP’s licensing agent agreements as they relate to artwork are described in detail below.

“(a) Licensing Agent Agreement One

Under Licensing Agent Agreement One, TP promises, among other things, to ‘provide artwork incorporating the Properties for use by such licensees.’ The agreement also states ‘that nothing contained in this Agreement gives [TP] any interest or property rights in the Properties; and that all uses of the Properties by third party licensees shall inure to the benefit of Owner. [TP] shall not, during this period of this Agreement or thereafter, directly or indirectly, assert any interest or property rights in any of the Properties.’ TP currently receives as a licensing agent fee 40% of the gross royalties collected by the owner pursuant to Licensing Agent Agreement One.

“In connection with licenses granted with respect to the Properties covered by this Licensing Agent Agreement One none of the licensees have any rights to obtain any artwork from TP. Because Licensing Agent Agreement One is very new, TP has not yet provided artwork to any licensees. It is contemplated, however, that TP will provide artwork to some of the licensees.

“(b) Licensing Agent Agreement Two

Under Licensing Agent Agreement Two, TP is required, among other things, to ‘provide artwork incorporating the Properties for use by such licensees.’ Licensing Agent Agreement Two also states ‘that all uses of the Properties by third party licensees shall enure to the benefit of Owner. [TP] shall not, during the period of this Agreement or thereafter, directly or indirectly assert any interest or property rights in any of the Properties.’ Under Licensing Agent Agreement Two, TP receives as its licensing agent fee 40% of the gross royalties payable by licensees.

“Under the licensing agreements granted by owner in connection with the Properties covered by Licensing Agent Agreement Two, none of the licensees have any rights to receive any artwork from TP. In addition, TP provides virtually no artwork to any of the licensees in connection with Licensing Agent Agreement Two. However, royalty payments paid by licensees to owner do not change whether or not TP provides artwork to those licensees. Similarly, TP’s licensing agent fees it receives from owner do not change whether or not TP has

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provided artwork to licensees.

“(c) Licensing Agent Agreement Three

Under Licensing Agent Agreement Three, TP agrees that it ‘shall provide artwork incorporating the Properties for use by such Licensees subject to the prior written approval of [Owner]’ and it ‘shall provide artwork, designs, prototypes, and similar materials based on the [musical] Group, for use in connection with the Products, subject to the prior written approval of [Owner].’ The agreement also states that the owner ‘specifically reserves to itself all other uses of and rights in connection with the Group and the Property.’ Under Licensing Agent Agreement Three, TP receives as a licensing agent fee 50% of the royalties collected by owner.

“None of the licensees of the Properties in connection with Licensing Agent Agreement Three have any rights to obtain any artwork or art support from TP. TP provides artwork to some licensees, but does not provide artwork to the majority of licensees. Royalty payments paid by licensees to owner do not change whether or not TP provides artwork to those licensees. Similarly, TP’s licensing agent fees do not change simply because TP has provided artwork to licensees. Of course, to the extent TP’s artwork results in licensees selling more licensed products, then TP’s licensing agent fees increase.

“(d) Licensing Agent Agreement Four

Under Licensing Agent Agreement Four, TP’s duties include to ‘be responsible for the development of artwork based upon the character being incorporated into or used in connection with the articles and the advertising materials.’ The agreement also states that ‘nothing contained in this Agreement gives [TP] any interest or property rights in the Properties; and that all uses by third party licensees of the Properties shall inure to the benefit of [Owner]. [TP] shall not, during the period of this Agreement or thereafter, directly or indirectly, assert any interest or property rights in any of the Properties.’ Under Licensing Agent Agreement Four, TP receives as a licensing agent fee 50% of all royalties collected by owner.

“None of the licensees of the Properties in connection with Licensing Agent Agreement Four have any rights to obtain any artwork or art support from TP. TP provides artwork to a majority of the licensees, but does not provide artwork to some licensees. Royalty payments paid by licensees to owner do not change whether or not TP provides artwork to those licensees. Similarly, TP’s licensing agent fees do not change simply because TP has provided artwork to licensees. Of course, to the extent TP’s artwork results in licensees selling more licensed products, then TP’s licensing agent fees increase.

“(e) Licensing Agent Agreement Five

Under Licensing Agent Agreement Five, one of TP’s obligations is to ‘provide appropriate consulting, supervisory, advisory, artwork and other services to affiliates.’ The agreement also states that ‘nothing contained in this agreement gives [TP] any interest or property rights in the Trademarks or the Copyrights, except the right to use the same as specifically set forth herein; and that all uses by [TP] and its Affiliates of the Trademarks and the Copyrights included within the Trademarks shall inure to the benefit of the [Owner].’ The agreement also states ‘[TP] agrees that it will not, during the period of this agreement or thereafter, directly or indirectly, assert any interest in or property rights in any of the Trademarks or Copyrights which are now or hereafter owned or controlled by the [Owner].’ Under Licensing Agent Agreement Five, TP generally receives as a licensing agent fee 33% of the royalties collected by owner.

“Licensing Agent Agreement Five also contains within it a license to TP of the Properties such that TP may use the Properties in connection with the manufacture, sale and distribution of various articles in various territories. Licensing Agent Agreement Five also states that TP ‘shall provide or cause to be provided not less than \$500,000 per year of art and creative development utilizing the Characters in support of its efforts to exploit the sale of the Articles under this Agreement.’ Although a significant portion of TP’s expenditures on art and creative development support its efforts to exploit the Properties in connection with the manufacture, sale and distribution of certain articles in certain territories, some of its art expenditures and creative development activities support licensees under Licensing Agent Agreement Five.

“None of the licensees of the Properties in connection with Licensing Agent Agreement Five have any rights to obtain any artwork or art support from TP. TP provides artwork to a majority of the licensees and does not provide artwork to some licensees. Royalty payments paid by licensees to owner do not change whether or not TP provides artwork to those licensees. Similarly, TP’s licensing agent fees do not change simply because TP has provided artwork to licensees. Of course, to the extent TP’s artwork results in licensees selling more licensed products, then TP’s licensing agent fees increase.

“(f) Licensing Agent Agreement Six

Licensing Agent Agreement Six is somewhat different from the other five agreements, since it is principally a trademark license. Under the Licensing Agent Agreement Six TP promises, among other things, to ‘provide artwork incorporating the licensed material for use by such licensees only in connection

with the manufacture and distribution of the articles.’ However, under this Agreement, TP retains ownership in any artwork it develops for use in the licensing, production, sale and distribution of articles and advertising materials, as long as the artwork does not include the licensed Properties within it.

“To date, it is TP’s belief that all of the artwork provided to licensees by TP in connection with Licensing Agent Agreement Six is owned by TP. Because the licensees use both the licensed Properties and some of the artwork owned by TP, TP has entered into an artwork license agreement with owner pursuant to which TP grants the owner the right to have owner’s licensees use TP’s artwork. Under this artwork license agreement, TP also agrees to certain restrictions on its own use of the artwork. TP is not separately compensated under this license agreement with owner, rather TP’s licensing agent income is simply increased to the extent TP’s artwork causes licensees to sell more products. Under Licensing Agent Agreement Six, TP receives 50% of the royalties collected by owner as a licensing agent fee.

“Under the licensing agreements granted by owner in connection with the Properties covered by Licensing Agent Agreement Six, none of the licensees have any rights to receive any artwork from TP. However, TP does provide some of its own artwork to all of the licensees in connection with the licensing agent agreement. Royalty payments paid by licensees to owner do not change whether or not TP provides artwork to those licensees. Similarly, TP’s licensing agent fees do not change simply because TP has provided its own artwork to licensees. Of course, to the extent TP’s artwork results in licensees selling more licensed products, then TP’s licensing agent fees increase.

“3. Existing Sales and Use Tax Practices

TP currently pays sales tax in connection with all materials which it purchases and uses in connection with its art activities. TP provides tangible art products from time to time to licensees in support of its licensing agent activities, and does not receive any direct consideration from the licensees or owners. TP does not collect and/or remit to the Board any sales or use tax in connection with its transfer of tangible personal property (artwork) to the licensees.

“To the extent licensees use art work developed by TP, the right to use that artwork is pursuant to the licensees’ licensing agreement with the owner of the Properties. This is true even with respect to the limited class of artwork owned by TP in connection with Licensing Agent Agreement Six, because TP has granted owner the right to allow licensees to use that artwork in connection with the exploitation of owner’s Properties. Owners currently do not separately

compensate TP for any artwork provided to licensees. A few of the licensees which receive artwork created by owner are located in California, while most licensees are located outside of California. Artwork is generally shipped to licensees by common carrier or, in a few instances, hand delivered.

“4. Proposed Licensing Agent Agreement Seven

TP is currently negotiating Licensing Agent Agreement Seven. It is contemplated that owner will pay TP a licensing agent fee of 35% of royalties collected by owner in connection with licensees found by TP when TP does not provide original artwork to licensees involving concepts not present in the style guide. However, in those cases where TP provides original artwork to licensees, owner will increase the licensing agent fee paid to TP in consideration for such art support to 40% of the royalties collected by owner.”

It is not clear to us from your facts whether TP is or is not required to provide artwork to the licensees. For example, in the facts regarding Licensing Agent Agreement One, you note in the first paragraph the TP promises to “provide artwork incorporating the Properties to licensees.” In the second paragraph, you note that, “None of the licensees have any rights to obtain any artwork from TP.” Nonetheless, we believe the contracts between TP and its customers consist of both a service and a sale of tangible personal property. We disagree that TP’s transfers of artwork to the licensees are nontaxable transfers of tangible personal property incidental to the licensing agent services. Further, we do not believe the case, MCI Airsignal, Inc. v. State Board of Equalization (1991) 1 Cal.App.4th 1527, calls for a different result. In that case, a company provided paging services and furnished devices to customers which the customers needed to receive the signals. The company retained ownership of the tangible personal property transferred and was responsible for the maintenance and repair of that property. The paging device had no functional use other than to receive the telecommunications signals. In this case, TP transfers designs to its customers which the customers use to create images to sell. TP would be able to perform its services for the owners without repairing and transferring artwork for the licensees to use.

Since TP provides a variety of services to the owner for a fee and does not separately state a charge for the artwork, we believe the portion of the charge attributable to the sale of the artwork is as provided in Sales and Use Tax Regulation 1540, Advertising Agencies, Commercials Artists and Designers, which provides in relevant part at subdivision (b)(1):

“ . . . If an agency supplies tangible personal property such as finished artwork to a client and the entire payment for such property is included in some other form of compensation such as a fee, commissions or a combination thereof, tax applies to the fair retail selling price of such property.

“Fair retail selling price’ is an amount sufficient to cover (i) the net labor costs of employees of the agency plus an allowance for overhead and profit of not less than 100 percent of such labor cost, and (ii) the cost of purchased items incorporated into the tangible personal property as to which the agency is a seller. If an agency has furnished a firm quoted price based on estimated labor costs plus overhead and profit of not less than 100 percent of the labor cost and bills in accordance with such a quoted price, the agency will be deemed to have charged a fair retail selling price.”

As to the proposed Licensing Agent Agreement Seven, the taxable gross receipts from the sale of the artwork is the five percent increased licensing agent fee, the owner will pay TP in consideration for the transfer of the artwork.

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

Ronald L. Dick
Senior Tax Counsel

RLD:sr

cc: San Francisco District Administrator - BH
Mr. Glenn A. Bystrom - MIC:43