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February 4, 2011

LETTER RULING NO. 2011-02
[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]

RE: APPLICATION OF TAX INCENTIVES TO ROYALTIES, LICENSE FEES, AND OTHER INCOME RECEIVED BY [REDACTED TEXT] (PETITIONER) IN CONNECTION WITH PERFORMING ARTS PRODUCTS

Dear [REDACTED TEXT]:

This responds to the letter of [REDACTED TEXT], submitted on your behalf by [REDACTED TEXT], in which you asked if certain of your income qualifies for the income tax exclusion for certain royalties or other income derived from copyrights.

QUESTION PRESENTED

Whether royalty payments, license fees, and other income (sometimes referred to herein as "compensation") earned by you (sometimes referred to herein as "Artist"), in connection with your authorship of parts of various performing arts products, qualify for the income tax exclusion under Hawaii Revised Statutes (HRS) § 235-7.3, for tax years beginning after December 31, 2009.

SHORT ANSWER

Because Petitioner satisfies all requirements necessary to obtain the tax incentive provided by HRS § 235-7.3, all of Petitioner's royalties, license fees, and other income derived from the copyrights identified in this letter are excluded from Petitioner's gross income, adjusted gross income, and taxable income for tax years beginning after December 31, 2009.

STATEMENT OF FACTS BY PETITIONER

A. Overview Of Petitioner's Performing Arts Activities.

Petitioner, a resident of [REDACTED TEXT], is an actor and derives royalties, license fees, and other income from this creative activity.

1. Petitioner's Audiovideo, Commercial Television, and Film Production Activities.

Petitioner[1] is, and has been since [REDACTED TEXT], under contract with [REDACTED TEXT], (hereinafter "the Production Company") to render creative services as an actor [REDACTED TEXT] on [REDACTED TEXT] (hereinafter the "Series"), which is filmed on location in the State of Hawaii and broadcast domestically by [REDACTED TEXT].

In addition to the domestic broadcast of the Series, which generates broadcast license fees, the Series is also licensed for broadcast outside the United States in numerous foreign territories, likewise generating broadcast license fees. Furthermore, copies of each season of the Series will be sold to the public for private noncommercial viewing in DVD/Blu-Ray format and may also be available through "video-on-demand"-type services for viewing on various networked devices designed for that purpose. The Series is, or may be, licensed to third parties for rerun or syndication usage. Pursuant to the Agreement between Petitioner and the Production Company, discussed below in this letter, and in accordance with applicable union and guild agreements, Petitioner is paid compensation (sometimes referred to in said agreements as royalties and/or residual, reuse, or license fees) in connection with such commercial exploitation.

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[1] Petitioner renders [REDACTED TEXT] services to the Production Company through [REDACTED TEXT] Loan-Out Company [REDACTED TEXT]. This "Loan-Out Company" is wholly owned by Petitioner. Pursuant to this arrangement, Petitioner is the employee of the Loan-Out Company and the Loan-Out Company has a contract with the Production Company to provide Petitioner's services. To ensure that an agreement between a production company and a Loan-Out Company (referred to in the entertainment industry as a "lending agreement") binds the individual artist involved as well as the artist's Loan-Out Company, it is industry practice to have the artist sign what is usually termed an "inducement letter" with the production company. The inducement letter, in essence, states that the artist has a binding agreement with the Loan-Out Company and agrees to be bound by, and perform all provisions of, the lending agreement between the Loan-Out Company and the production company. Typically, the artist will be employed by the Loan-Out Company and will render services in a specific capacity as directed by the Loan-Out Company. The agreement between the artist and the Loan-Out Company will also typically contain a "grant of rights" provision to ensure that the Loan-Out Company obtains the full benefit of all of the artist's services. Since the artist owns the Loan-Out Company, the grant of rights merely transfers ownership of the product of the artist's services from the artist individually to his or her own Loan-Out Company, so that the Loan-Out Company can in turn make a grant of rights to a production company. When such clauses are included in lending agreements with production companies, the purpose of the provision is to ensure that the production company obtains all the fruits of the artist's labors for which it is paying. Consequently, the grant of rights by the artist to Loan-Out Company encompasses all rights which the production company may require *i.e.* all copyright rights which rights become property of the production via a work-for-hire/copyright assignment agreement. So long as Petitioner utilizes the Loan-Out Company, Petitioner represents that the foregoing arrangements will apply.

Each episode of the Series is, pursuant to United States copyright law, considered to be a "motion picture." Section 101 of the Copyright Act defines "motion pictures" as "audiovisual works consisting of a series of related images which, when shown in succession, impart an impression of motion, together with accompanying sounds, if any." 17 USC § 101. Motion pictures are, in turn, a subspecies of "audiovisual works," which are defined as "works that consist of a series of related images which are intrinsically intended to be shown by the use of machines or devices such as projectors, viewers, or electronic equipment, together with accompanying sounds, if any, regardless of the nature of the material objects, such as films or tapes, in which the works are embodied." *Id.*

Pursuant to long established industry practice, Petitioner renders [REDACTED TEXT] services on behalf of the Production Company pursuant to a written copyright "work-for-hire" agreement (the "Agreement"). This Agreement provides, among other things, that all copyright rights that Petitioner would otherwise own and enjoy, by virtue of [REDACTED TEXT] contribution to the Series of original and creative expression, shall be deemed to be "made-for-hire" on behalf of the Production Company such that, ultimately, the Production Company will own all copyright rights in and to the Series. The foregoing industry practice of requiring a work-made-for-hire arrangement is a legal and pragmatic necessity in order for the Production Company to be able to commercially exploit the Series.

In this regard, the Agreement provides, in pertinent part, the following:

[REDACTED TEXT]

2. Additional Audiovideo, Commercial Television, and Film Production Activities.

Pursuant to the Agreement, the Production Company has the right to reproduce Petitioner's voice from soundtracks or tracks (from programs from the Series) onto commercial phonograph records and all other forms of recordings[2] now known or hereafter devised, and to sell and distribute and/or license the same to third parties for which The Production Company shall pay Petitioner certain specified compensation pursuant to applicable union and guild agreements. In this regard, the Agreement provides, in pertinent part, the following:

[REDACTED TEXT]

More than fifty percent of the activities of the Production Company are conducted in performing arts products.

Finally, in addition to compensation received in connection with the Series, Petitioner anticipates receiving other royalties, license fees, and other income derived from the sale and/or licensing of other performing arts products developed and arising out of a Qualified High Technology Business as defined in §235-7.3 (c) HRS.

[2] Given the current state of technological development, all such recordings are or will be digital in nature and are therefore "audio files" within the meaning of §235-7.3 HRS.

APPLICABLE LAW

Section 235-7.3, HRS, provides the following exclusion from Chapter 235, HRS, Hawaii's income tax law:

> (a) In addition to the exclusions in § 235-7 HRS, there shall be excluded from gross income, adjusted gross income, and taxable income, amounts received by an individual or a qualified high technology business as royalties and other income derived from any patents, copyrights, and trade secrets:
>
> (1) Owned by the individual or qualified high technology business; and
>
> (2) Developed and arising out of a qualified high technology business.
>
> (b) With respect to performing arts products, this exclusion shall extend to:
>
> (1) The authors of performing arts products, or any parts thereof without regard to the application of the work-for-hire doctrine under United States copyright law;
>
> (2) The authors of performing arts products, or any parts thereof, under the work-for-hire doctrine under United States copyright law; and
>
> (3) The assignors, licensors, and licensees of any copyright rights in performing arts products, or any parts thereof.
>
> (c) For the purposes of this section:
>
> "Performing arts products" means:
>
> (1) Audio files, video files, audiovideo files, computer animation, and other entertainment products perceived by or through the operation of a computer; and
>
> (2) Commercial television and film products for sale or license, and reuse or residual fee payments from these products.
>
> "Qualified high technology business" means a business that conducts more than fifty per cent of its activities in qualified research.

"Copyright protection subsists...in original works of authorship fixed in any tangible medium of expression, now known or later developed, from which it can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device." 17 USC § 102(a); *see also* TIR No. 2008-02, Prop. Admin. Rule § 18-235-7.3-03. Copyrights include motion pictures, other audiovisual works, and sound recordings. *See id*.

Copyright initially vests in the author or authors of the work. The authors of a joint work are co-owners of copyright in the work. *See* 17 USC § 201(a); *see also* TIR No. 2008-02, Prop. Admin. Rule § 18-235-7.3-03. A "'joint work' is a work prepared by two or more authors with the intention that their contributions be merged into inseparable or interdependent parts of a unitary whole." 17 U.S.C. § 101; *see also* TIR No. 2008-02, Prop. Admin. Rule § 18-235-7.3-03. The Supreme Court has defined the word "author" twice, but only in dicta.[3] However, many of the cases that have

[3] *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 737 (1989) ("As a general rule, the author is the party who actually creates the work, that is, the person who translates an idea into a fixed, tangible expression entitled to copyright protection." (citing 17 U.S.C. § 102 (1994)); *Burrow-Giles Lithographic Co. v. Saroy*, 111 U.S. 53, 58 (1884) ("An author…is 'he to whom anything owes its origin; originator; maker….'")).

defined "author" for purposes of copyright analysis have focused their inquiry on whether the putative author produced something that is copyrightable.[4] "For purposes of performing arts products, sufficient copyrightable expression may arise from the artistic expression of…actors, directors, screen writers, cinematographers, or other similar performing arts roles that provide identifiable expressive components within a performing arts product that may give rise to copyright protection." TIR No. 2008-02, Prop. Admin. Rule § 18-235-7.3-03(b).[5]

For a work to qualify for copyright protection, the work must be original to the author. *See Feist Publications, Inc. v. Rural Telephone Service Co. Inc.* 499 U.S. 340, 345 (1991). Originality means that the "work was independently created by the author... and that it possesses at least some minimal degree of creativity." *Id.*

The author of a work is the party "who actually creates the work, that is, the person who translates an idea into a fixed, tangible expression entitled to copyright protection." *Community for*

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[4] *See, e.g., Erickson v. Trinity Theatre, Inc.*, 13 F.3d 1061, 1071 (7th Cir. 1994) (noting that a person who fixes ideas in tangible expression qualifies as author); *Childress v. Taylor*, 945 F.2d 500, 507 (2d Cir. 1991) (remarking that expression must be fixed before creator is considered author); *Ashton-Tate Corp. v. Ross*, 916 F.2d 516, 521 (9th Cir. 1990) (noting general rule that person must translate ideas into copyrightable expression to be considered author).

[5] In *Laws v. Sony Music Entertainment, Inc.*, 448 F.3d 1134 (9th Cir. 2006), the court found the decision in *Fleet v. CBS*, holding the actor's performances to be copyrightable expression to be persuasive:

> We find more to the point, and quite persuasive, the California Court of Appeal's decision in *Fleet v. CBS, Inc.*, 50 Cal. App. 4th 1911, 58 Cal. Rptr. 2d 645 (1996). There, defendant CBS owned the exclusive rights to distribute a motion picture in which plaintiffs performed. A third party who financed the operation of the movie refused to pay plaintiffs their previously agreed-to salaries. Plaintiffs brought suit against CBS alleging, *inter alia*, that by airing the motion picture using their names, pictures, and likenesses without their consent, CBS had violated their statutory right of publicity. The Court of Appeal held that the Copyright Act preempted the action. As the court observed, "it was not merely [plaintiffs'] dramatic performances which are…"copyrightable." *Id.* at 651. "[O]nce [plaintiffs'] performances were put on film, they became 'dramatic' work[s]' 'fixed in [a] tangible medium of expression….' At that point, the performances came within the scope or subject matter of copyright law protection," and the claims were preempted. *Id.* at 650; *see also Downing*, 265 F.3d at 1005 n. 4 ("In *Fleet*, the plaintiffs were actors in a copyrighted film. The claims of the plaintiffs were based on their dramatic performance in a film CBS sought to distribute. …This is clearly distinguishable from this case where the Appellants' claim is based on the use of their names and likeness, which are not copyrightable.")

448 F.3d 1142-1143.

> Similarly, in *TMGV Corp. v. Pegasus Broadcasting of San Juan*, 490 F.Supp. 2d 228 (D. Puerto Rico 2007), the court rejected TMTV's argument that actors appearing in a television program cannot hold the copyright to the characters, because they did not write the scripts in which they appear because:
>
> > "it is evident from the record that the actors portrayed the characters in an audio-visual media, which permits a reasonable inference that the actors' contributions to the characters rendered them authors."

490 F.Supp. at 236.

Creative Non-Violence v. Reid, 490 U.S. 730, 737 (1989). A work is "'fixed' in a tangible medium of expression" when the work is embodied in a copy by or under the authority of the author in a sufficiently permanent or stable form to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration. *See* 17 USC § 101.

In the case of a work "made-for-hire," the employer or other person for whom the work was prepared is considered the author for purposes of ownership of copyright, and, unless the parties have expressly agreed otherwise in a written instrument signed by them, owns all of the rights comprised in the copyright. *See* 17 U.S.C. § 101.

ANALYSIS

A. Petitioner is the Author of Parts of Performing Arts Products (§ 235-7.3(b)(1) & (2), HRS) and is an Assignor of Copyright Rights in Performing Arts Products (§ 235-7.3(b)(3), HRS).

Based upon the foregoing representations, Petitioner is, in the absence of the application of the "work-for-hire" doctrine, the author of a part of, or joint author of, various audiovisual files, motion pictures, and television programming. Furthermore, Petitioner is alternatively an assignor of all of [REDACTED TEXT] copyright rights therein.

Depending upon the format of the particular performing arts products involved, the Series is a "commercial television and film product" and an "audiovisual file" within the meaning of HRS §§ 235-7.3(c)(1) and (2). Also, any sound recordings produced therefrom in CD, MP3, or other digital file formats are "audio files" pursuant to §§ 235-7.3(c)(1) and (2), HRS.

But for Petitioner's execution of the Agreement, which expressly provides that Petitioner's performances shall be deemed to be subject to the "work-for-hire" doctrine on behalf of the Production Company, Petitioner would be deemed an author or joint author of a part of a performing arts product.

Section 102 of the Copyright Act, by its express terms, protects "original works of authorship fixed in any tangible medium of expression...from which they can be perceived, reproduced, or otherwise communicated either directly or with the aid of a machine or device." 17 USC § 102(a). A work of authorship is specifically defined to include "dramatic works." *See* 17 USC § 102(a)(3). A work is fixed in a tangible medium of expression "when its embodiment in a copy or phonorecord, by or under the authority of the author, is sufficiently permanent or stable to permit it to be perceived, reproduced, or otherwise communicated for a period of more than transitory duration." 17 USC § 101.

Accordingly, without regard to the application of the work-for-hire doctrine under United States copyright law, Petitioner is an author of performing arts products, or a part thereof, because [REDACTED TEXT] contribution of copyrightable expression is "fixed." *See Laws v. Sony Music Entertainment, Inc.*, 448 F.3d 1134 (9th Cir. 2006); *Fleet v. CBS Inc.*, 50 Cal. App. 4th 1911, (1996). ("There can be no question that, once appellants' performances were put on film, they became "dramatic work[s]" "fixed in [a] tangible medium of expression" that could be "perceived, reproduced, or

otherwise communicated" through "the aid of a machine or device."). At that point, the performances came within the scope or subject matter of copyright law protection. *Id.* at 1919-1920.

Also, to the extent that the Production Company, creates stand-alone sound recordings featuring, among other things, Petitioner's voice, Petitioner will be deemed to be an author of a part of audio files pursuant to HRS § 235-7.3(c)(1).

B. Petitioner is Entitled to Exclude from Gross Income, Adjusted Gross Income and Taxable Income, all Amounts Received as Royalties, License Fees, and other Income Derived from [REDACTED TEXT] Authorship of a Performing Arts Product (Or Any Parts Thereof).

Act 221, Session Laws of Hawaii 2001, amended § 235-7.3, HRS, by adding subsection (b). This subsection provides that the income tax exclusion benefits set forth in § 235-7.3, HRS, (excluding from Hawaii income tax, royalties and other income derived from copyrights) shall extend to:

(1) The authors of performing arts products, or any parts thereof, without regard to the application of the work-for-hire doctrine under United States copyright law;

(2) The authors of performing arts products, or any parts thereof, under the work-for-hire doctrine under United States copyright law; and

(3) The assignors, licensors, and licensees of any copyright rights in performing arts products, or any parts thereof.

HRS § 235-7.3(b) (as amended).

Act 221 eliminated, with respect to performing arts products only, the requirement that the subject copyright rights must be "owned" by an individual. Therefore, under the Act 221 amendment set forth in § 235-7.3(b), HRS, the income tax exclusion benefits of § 235-7.3, HRS, extend to: a) the authors of performing arts products even if said authors do not "own" the copyright rights in said products; and b) the assignors of copyright rights in performing arts products.

Because, without regard to the application of the "work-for-hire" doctrine, Petitioner is or would be considered to be the author of performing arts products, or parts thereof, Petitioner is entitled to exclude from gross income, adjusted gross income, and taxable income, all amounts received as royalties, license fees, and other income derived from Petitioner's participation in the Series. Furthermore, Petitioner is entitled to the subject income tax exclusion benefits because the subject performing arts products are developed and arise out of a qualified high technology business. For purposes of § 235-7.3 HRS, a qualified high technology business is a business that conducts more than fifty percent of its activities in "qualified research." "Qualified research" means "performing arts products." Because the companies that produce, distribute, sell, and/or license the subject performing arts products conduct more than fifty percent of their activities in performing arts products, the

companies that actually own the subject copyrights are qualified high technology businesses for purposes of § 235-7.3 HRS.

Hawaii law provides that the terms "gross income," "adjusted gross income," and "taxable income" mean the same as those terms are defined and determined under the Internal Revenue Code, except as otherwise provided. Thus, the income taxable for Hawaii tax purposes is the same as for federal tax purposes, except for certain specific differences not relevant here. Section 61(a)(1), (3) and (6) of the Internal Revenue Code define gross income to include compensation for services, gains from the sale of property, and royalties. "Gross income" under the Internal Revenue Code is defined as "all income from whatever source derived, including (but not limited to)... compensation for services." 26 USC § 61. Therefore, money received as compensation for the authorship of copyrightable expression and the licensing or sale of copyrights are included in gross income for income tax purposes.

The exclusion benefits under HRS § 235-7.3 expressly apply to "royalties" and "other income." The Department interprets "royalties" to mean " compensation, however designated, paid to the owner of a…copyright…for the use of, or the right to use…the copyright…or any interest in the same. The payment is typically a percentage of profit or a specified sum per item sold; however that in itself is not determinative. The purpose for which the payment is made and not the manner of payment is the determining factor." TIR 2008-02, Prop. Admin. Rule § 18-235-7.3-06(b).

The Department interprets "other income" to mean "accumulations of wealth from sources other than royalties. Other income includes compensation for services; gross income derived from business activities; gains from the sale of property interests; dividends; pension income; distributive shares of partnership interests; and other non-royalty income items that would fall within the definition of 'income' for purposes of section 61(a) of the Internal Revenue Code; provided that the 'other income' is derived directly from…copyrights. TIR 2008-02, Prop. Admin. Rule § 18-235-7.3-06(c).

Importantly, royalties or other income can be derived in any form. "For example, income received in the form of a royalty or other income payment may be received and reported on Form W-2 or Form HW-2 (wage income) or on Form 1099 (non-wage income), or other source of receipt and reporting." TIR 2008-02, Prop. Admin. Rule § 18-235-7.3-06(d).

As noted above, the compensation Petitioner receives in connection with the subject performing arts products (*i.e.*, salary, royalties, or other income derived from the Petitioner's exploited interests in performing arts products as discussed in this letter) consists of "income" and said "income" is "derived from copyrights" under 17 USC § 106, and/or result from Petitioner's status as an "author of performing arts products, or parts thereof," as required under § 235-7.3 HRS. Therefore, all royalties, license fees, and other income received by Petitioner that is derived from [REDACTED TEXT] performances embodied in copyrightable performing arts products and related reuse and residual fees is and shall be excluded from Petitioner's gross income, adjusted gross income, and taxable income pursuant to § 235-7.3, HRS.

Income received from other sources is not addressed in this letter. However, income

received from personal appearances, ticket sales, autograph fees, or for activities that do not constitute copyrightable subject matter attributable to Petitioner will not be excluded under this ruling. *See* TIR 2008-02, Prop. Admin. Rule § 18-235-7.3-06(e).

CONCLUSION

Based solely on the information and representations discussed in this letter, all royalties, license fees, and other income received by Petitioner which is derived from [REDACTED TEXT] contribution of copyrightable expression to performing arts products and related reuse and residual fees is and shall be excluded from Petitioner's gross income, adjusted gross income, and taxable income pursuant to § 235-7.3, HRS. This ruling is limited to taxable years beginning after December 31, 2009.

This ruling is applicable only to the Petitioner and may not be used or cited as precedent by any other taxpayer.

The conclusions reached in this letter are based on our understanding of the facts that Petitioner has represented in this letter. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

You have reviewed and agreed that the redacted version of this ruling attached as Exhibit A will be available for public inspection and copying.

If you have any further questions regarding this matter, please call me at 808-587-1569. Additional information on Hawaii's taxes is available at the Department's website at www.state.hi.us/tax.

Very truly yours,

JOSEPH B. TICHY
Administrative Rules Specialist