# STATE BOARD OF EQUALIZATION
# STAFF LEGISLATIVE BILL ANALYSIS

| | | | |
|---|---|---|---|
| Date Introduced: | **01/26/10** | Bill No: | **AB 1687** |
| Tax: | **Sales and Use** | Author: | **Jeffries** |
| Related Bills: | **AB 676 (Jeffries)** | | |

## BILL SUMMARY

This bill provides, until January 1, 2016, that a qualified destination management company (DMC), as defined, is a consumer, rather than a retailer, of tangible personal property it provides to its client in a qualified contract, as defined, for destination management services.

## ANALYSIS

### CURRENT LAW

Current law imposes a sales or use tax on the gross receipts from the sale of, or the storage, use, or other consumption of, tangible personal property, unless specifically excluded or exempted by statute. Under current law, gross receipts include all amounts received with respect to the sale of tangible personal property, with no deduction for the cost of the materials used, labor or service costs, or any other expenses of the retailer, unless a specific statutory exclusion applies. Moreover, gross receipts include any services that are a part of the sale. When sales tax does not apply, use tax is imposed and is measured by the sales price of property purchased from a retailer for storage, use, or other consumption in California. The use tax is imposed on the person actually storing, using, or otherwise consuming the property.

The Board's Sales and Use Tax Regulation 1603, *Taxable Sales of Food Products*, interprets and makes specific the sales and use tax law as it applies to businesses that sell meals, food, and drinks, such as bars, delis, restaurants, and catering operations. Regulation 1603 defines a caterer to mean a person engaged in the business of serving meals, food, or drinks on the premises of the customer, or on premises supplied by the customer, including premises leased by the customer from a person other than the caterer.

Regulation 1603 also specifies how tax applies to charges made by caterers with respect to their sales of meals, food, and drinks. Tax applies to the entire charge made by caterers for serving meals, food, and drinks, inclusive of charges for food, the use of dishes, silverware, glasses, chairs, table, etc., used in connection with serving meals, and for the labor of serving the meals, whether performed by the caterer, the caterer's employees or subcontractors. Tax applies to charges made by caterers for preparing and serving meals and drinks even though the food is not provided by the caterers.

Regulation 1603 (h)(3)(C), *Caterers Planning, Designing and Coordinating Events*, provides that tax applies to charges made by a caterer for event planning, design, coordination, and/or supervision if those charges are made in connection with the furnishing of meals, food, or drinks for the event. Tax does not apply to separately stated charges for services <u>unrelated</u> to the furnishing and serving of meals, food, or drinks, such as optional entertainment or any staff who do not directly participate in the preparation, furnishing, or serving of meals, food, or drinks, such as coat-check clerks, parking attendants, and security guards.

***This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.***

Under the Sales and Use Tax Law, **event planners, including DMCs, are treated in a similar manner to caterers** when providing meals, food, and beverages as part of a given event. In this case, the event planners such as DMCs are making a retail sale of the meals, food, and beverages they provide and the sales tax is due on the gross receipts from such sales. Tax applies to the entire charge, including the charge for labor in planning or coordinating that part of the event, because the charges for such labor are regarded as charges for services that are part of the sale of tangible personal property.

The Board has published several Sales and Use Tax Annotations (hereafter Annotation)[1] related to event planning that helps to explain how tax applies to certain charges. Annotation 550.0827 (11/28/95) describes the application of tax to an "event planning" business that is hired by clients to coordinate large functions. (See complete print of Annotation 550.0827 on last page of the analysis.)

**Service Enterprises.** In general, persons engaged in the business of rendering services are generally not considered retailers, but instead, are considered consumers of any tangible personal property incidentally transferred in the performance of their services. As consumers, tax applies to the service providers' purchase of any property used in the performance of their services.

The Board's Sales and Use Tax Regulation 1501, *Services Enterprises Generally*, provides that 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. If the true object of the contract is the service per se, the transaction is not subject to tax, even though some tangible personal property is incidentally transferred.

Under the Sales and Use Tax Law, the following service providers have been deemed by statute to be consumers, rather than retailers, of certain items that they use or furnish in the performance of their professional services:

- Optometrists, physicians and surgeons, and registered dispensing opticians with respect to ophthalmic materials for the treatment of conditions of the human eye. (Section 6018)
- Veterinarians with respect to certain drugs and medicines. (Section 6018.1)
- Chiropractors with respect to vitamins, minerals, dietary supplements and orthotic devices. (Section 6018.4)
- Podiatrists with respect to prosthetic materials and inlays in the diagnosis, treatment, or correction of conditions of the human foot. (Section 6018.5)
- Any person who receives 20 percent or less of his or her gross receipts from the alteration of garments during the preceding calendar year is a consumer of, and not a retailer with respect to property used or furnished by that person in altering new or used clothing, provided both of the following apply: 1) the person operates a location as a pickup and delivery point of garment cleaning, or provides spotting and pressing services on the premises, or operates a garment cleaning or dyeing

[1] Annotations are summaries of the conclusions reached in selected opinions of attorneys of the Board's Legal Department and are intended to provide guidance regarding the interpretation of Board statutes and regulations as applied by staff to specific factual situations.

plant on the premises; and 2) 75 percent or more of that person's gross receipts represent charges for garment cleaning or dyeing services. (Section 6018.6)

- Licensed hearing aid dispensers with respect to hearing aids. (Section 6018.7)
- Producers of x-ray films or photographs with respect to materials and supplies used for the purpose of diagnosing medical or dental conditions of humans. (Section 6020)

## PROPOSED LAW

This bill would add Section 6018.9 to the Revenue and Taxation Code to provide that a qualified DMC, as defined, is a consumer of, and would not be considered a retailer of, tangible personal property it provides to its client pursuant to a qualified contract, as defined, for destination management services.

This bill would define a "qualified destination management company" to be an incorporated business entity that meets all of the following:

- Is substantially engaged in the business of providing destination management services. "Substantially" means 80 percent or more of the gross sales are derived from the business of providing destination management services.
- Is not doing business as a caterer.
- Maintains a permanent nonresidential office in California in which the destination management services are provided.
- Has three or more full-time employees.
- Expends at least 1 percent of its gross revenue, annually, to market California and local destinations for tourism.
- Does not own any equipment used to provide destination management services, including, but not limited to, dance floors, decorative props, lighting, podiums, sound or video systems, stages, or equipment for catered meals. This condition does not apply to office equipment used in the conduct of the entity's business.
- Does not provide services for weddings.

This bill would define a "qualified contract" to mean a contract between a qualified DMC and its client for destination management services that meets all of the following conditions:

1) The client is a corporation, partnership, limited liability company, trade association, or other business entity principally located outside of the county in which the destination management services are provided. The client is not an individual, social club, or fraternal organization.
2) The client pays the qualified DMC for all the destination management services provided to the client.
3) The qualified DMC pays all the vendors that sell or lease tangible personal property to the qualified DMC for the contract services, including vendors' charges for sales tax reimbursement or collection for use tax.
4) The destination management services occur on two or more consecutive days.

"Destination management services" would mean a combination of four or more of the following services:

- Transportation.
- Entertainment.
- Meals.
- Recreational Activities.
- Tours.
- Registration.
- Staffing.

As a tax levy, the provisions of the bill would become effective immediately upon enactment, but would become operative on the first day of the first calendar quarter commencing more than 90 days after the bill is enacted.

The bill's provisions would remain in effect until January 1, 2016, and as of that date are repealed.

## BACKGROUND

Last year's AB 676 (Jeffries), contained provisions nearly identical to this bill. As amended on May 21, 2009, it was held on the suspense file in the Assembly Appropriations Committee. SB 1628 (Ducheny and Wiggins) and SB 700 (Ducheny), which were virtually identical to this bill, were introduced during the 2007-08 Legislative Session. SB 1628 was held on the suspense file in the Senate Appropriations Committee, while SB 700 was held in the Senate Revenue and Taxation Committee.

## COMMENTS

1. **Sponsor and purpose.** The sponsor of the bill is the Association of Destination Management Executives (ADME) who represents DMCs. According to the sponsor, the true object of a DMC's contract with its client is services, and any tangible personal property that is transferred to the client is incidental in the providing of those services. As such, DMCs want to be regarded as consumers, rather than retailers of any transferred tangible personal property under the Sales and Use Tax Law.

2. **What is the effect of this measure?** This bill would make a qualified DMC a consumer, rather than a retailer, of tangible personal property (most notably meals, food and beverages) it provides to its client in a qualified contract for destination management services. Therefore, a qualified DMC would not be liable for sales tax on its retail sales of food and beverages and other items related to the sale of food and beverages (e.g., centerpieces, flowers, candles, silk or papier mache flowers, ice sculptures), including any mark ups associated on these items. Moreover, DMCs would not be liable for sales tax on their charges for planning, design, and coordination that are related to the sale of tangible personal property.

   Rather, a DMC would be regarded as a consumer of the tangible personal property which they use in performing their destination management services under a qualified contract and tax would apply to the sale of the property to the qualified DMC.

   However, if a qualified DMC's contract with its client to provide destination management services does not meet the requirements of "qualified contract," under the provisions of this bill, the DMC for that contract would be regarded as a retailer

and would be liable for sales tax on its sales of tangible personal property, including any markups or fees charged by the DMCs for planning and coordination if those charges are related to the sale of the property.

3. **As part of the Board's education and outreach efforts, notices were mailed to 80 potential DMCs.** The Board mailed four separate notices (in August 2007, March 2008, and February and May 2009) informing DMCs of their tax reporting requirements under the Sales and Use Tax Law. The 80 companies were recognized by the ADME as DMCs and other identified large event planners that also offer services referred to as destination management services. The notices discussed some of the services and products offered by DMCs and the taxable nature of the sale of certain products. It also reminded DMCs of their requirement to hold a California seller's permit and report and remit tax due on their sales of items such as meals, food and beverages, t-shirts, and other souvenir items and gifts as part of their contracts for destination management services.

4. **Should other event planners also be treated as consumers of food, beverages, and other tangible personal property furnished by them in the performance of their event services?** Other event planners' business activities are very similar to the activities of DMCs. They also design, coordinate, plan, produce, and manage special events for individuals and groups. These event planners go by many different titles, including conference and meeting planner, convention coordinator, festival organizer, wedding planner, special event or occasion organizer, and trade show planner. The type of services and items they provide varies depending on the event they are planning, and include the following: 1) advertising and marketing, 2) furnishing of food and beverages, 3) planning and providing of entertainment, decorations, security and parking, 4) coordinating travel, transportation, and hotel accommodations, and 5) hiring, supervising, and training of support staff.

   Under current law, other event planners like DMCs are treated similarly to a caterer when providing meals, food and beverages. The event planner is making retail sales of these items and any charges for services related to the furnishing and serving of the food and beverages are subject to tax. Since other event planners' business transactions are very similar to DMCs, should the bill be amended to give them the same tax treatment?

   Along the same lines, Board staff notes that the bill would essentially give preferential tax treatment to qualified DMCs. Qualified DMCs would not be liable for sales tax on their retail sales of food and beverages, including any mark ups associated on such sales. DMCs would also not be liable for sales tax on their charges for planning, designing, and coordination that are made in connection with the sale of food and beverages. Consequently, other event planners may believe they are being unjustly treated and may question why legislation was enacted that gave special tax reporting privileges for qualified DMCs over all event planners.

5. **For DMCs, sales and use tax reporting would be simplified; however, bill sets a precedent.** Other businesses have fees and charges for professional services that are related to the sale of tangible personal property and subject to tax. These businesses have to segregate their charges for professional services directly related to the sale of merchandise from charges for services that have no relation to the sale of merchandise.

One such example is interior designers and decorators, who typically perform design, repair, reupholstering, color coordination, and planning. They also sell merchandise such as furniture, window coverings, carpeting, home accessories, and samples. Their professional services typically include consulting, design, layout, selection of color schemes, coordinating furniture and fabrics, and supervising installation. For interior designers and decorators, tax applies to any charges for their professional services that are directly related to the sale of merchandise. Conversely, tax does not apply to charges for professional services that are not directly related to the sale of merchandise.

For these businesses, it's not always easy to determine the point at which their professional services are related to a sale and subject to tax or unrelated to a sale and nontaxable. While enactment of this measure will simplify the DMCs' tax reporting and record keeping, it could set a precedent for other businesses whose business activities also involve nontaxable professional services and taxable services related to a sale.

6. **In some instances, a qualified DMC may need to obtain a seller's permit.** The bill provides that a qualifying DMC would be considered a consumer and not a retailer of items provided to its customers under a *qualified contract* for destination management services. However, if a contract is not *qualifying* (e.g., one day only), a DMC would be required to obtain a seller's permit and file tax returns. For instance, a DMC enters into a contract to provide the following services within a one-day period: (1) coordinate and plan a meeting, (2) provide event registration, and (3) arrange for a dinner at a nearby restaurant. In this instance, the DMC would be considered a retailer of its charges related to the restaurant meals and drinks, and would need to obtain a seller's permit, and report and pay sales tax on its retail sales.

## COST ESTIMATE

Some costs would be incurred in notifying affected taxpayers, revising the Board's regulation and publications, preparing guidelines for both taxpayers and Board staff, and answering inquiries from taxpayers. A cost estimate is pending.

## REVENUE ESTIMATE

### BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

DMCs are a type of a travel service company that provide local knowledge, expertise and resources for designing, organizing and implementing events, activities, tours, transportation, and program logistics. This industry appears to be categorized under North American Industrial Classification (NAICS) code 561920, "Convention and trade show organizers."

According to the most recent U.S. Economic Census, in 2002 there were 741 companies in this industry in California, with gross receipts of about $1.5 billion. Estimates indicate that the California travel industry as a whole has increased receipts by about 33 percent from 2002 to 2008[2].

A recession began in December 2007 and continued well into 2009. Many economic analysts believe that an economic recovery began sometime in mid-2009. Since travel

[2] *California Travel Impacts by County,* Dean Runyan Associates, California Travel and Tourism Commission, April 2009.

spending tends to be sensitive to economic conditions, we believe that it would be prudent to estimate 2009 travel spending and forecast 2010 travel spending in order to accurately estimate revenue losses for this legislation. A late 2009 presentation estimated 2009 California travel spending to have declined 8 percent and forecasted a 3.5 percent increase in 2010.[3] Combining the decline for 2009 and the forecast gain for 2010 results in a 4.5 percent decrease in California travel spending for the two years since 2008.

From Board records, we have determined that about 20 percent of DMC receipts are typically derived from taxable sales, most of which are prepared meals. Also from Board records, it appears that a 10 percent taxable management fee (markup) on sales is typical. Under this bill, DMCs would not be taxed on this management fee.

It is impossible for us to determine how many DMCs meet all the requirements specified in this bill. One requirement for which the U.S. Census Bureau have data on are sales by firms with three or more employees. About 96 percent of national sales in NAICS industry 561920 are made by companies with three or more employees. For purposes of revenue estimation, we will assume that all DMCs in California meet this and the other requirements of the bill.

Based on research by Board staff, we estimated that there were about 100 DMCs in California in 2007. With the recession, it is likely that this number has declined from 2007 to the present and there may be further declines. In the 2001 recession, data from the U.S. Small Business Administration indicate that the numbers of U.S. employer firms in the "Administrative and Support and Waste Management and Remediation Services" industry with 5 to 20 employees declined by about 10 percent from 2001 to 2002.[4] While this is a broader industry group and these are U.S. data, we believe this decline is likely to be representative of California convention and trade show organizers during the current recession. Therefore, we adjusted our estimate from 100 DMCs meeting the requirements of SB 700 (Ducheny) in 2007 to 90 DMCs in 2009. We assume average sales per company for this industry for these 90 DMCS.

Table 1 on the next page shows how the data discussed above were used to calculate DMC receipts subject to taxation under this bill. As shown in the table, we believe that about $4,565,000 in DMC receipts would no longer be subject to sales and use taxes.

## REVENUE SUMMARY

The annual revenue loss from defining DMCs as consumers, rather than retailers, of taxable items is about $415,000. Table 2 on the next page shows how these revenues are distributed among the various funds.

[3] "The Outlook for California Travel and Tourism," October 2009, Tourism Economics.
[4] U.S. Small Business Administration, http://www.sba.gov/advo/research/us98_01_06n_mi.pdf

| **Table 1** | |
|---|---|
| **Estimated Taxable Sales Impacts** | |
| | **Thousands of Dollars** |
| California "Convention and trade show organizers," NAICS 561920[1/] | |
| 2002 Receipts | $1,483,097 |
| Growth Factor From 2002 to 2008 [2/] | 1.33 |
| Estimated 2008 Receipts | $1,967,998 |
| Forecast Growth Factor From 2008 to 2010 [3/] | 0.955 |
| Estimated 2010 Receipts | $1,879,438 |
| Receipts of 90 of the 741 CA Companies Meet Criteria of bill | $228,272 |
| Percent of Receipts Taxable | 20.0% |
| Taxable Revenues | $45,654 |
| **Ten Percent Taxable Management Fee** | **$4,565** |

1/ Source: 2002 Economic Census, *Administrative and Support Services and Waste Management and Remediation Services,* Geographic Area Series, California, March 2005, U.S. Census Bureau.

2/ Source: *California Travel Impacts by County, 1992-2007,* Dean Runyan Associates, California Travel and Tourism Commission, April 2009.

*3/* Estimates using percentage changes in total travel expenditures, "The Outlook for California Travel and Tourism, October 2009," *Tourism Economics.*

| **Table 2**<br>**State and Local Sales and Use Tax Revenues** | **2010-11 Dollars** |
|---|---|
| State | $285,340 |
| General Fund (6.00%) | $273,926 |
| Fiscal Recovery Fund (0.25%) | $11,414 |
| Local (2.00%) | $91,309 |
| Transit (0.85%) | $38,806 |
| State and Local (9.10%) | $415,455 |

| | | | |
|---|---|---|---|
| Analysis prepared by: | Debra Waltz | 916-324-1890 | 02/22/10 |
| Revenue estimate by: | Joe Fitz | 916-445-0840 | |
| Contact: | Margaret S. Shedd | 916-322-2376 | |

ls 1687-1dw.doc

***This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.***

Sales and Use Tax Annotation 550.0827, ***Event Planning Service*:**

The taxpayer is an ‘‘event planning’’ business. It is hired by customers to coordinate large functions. When an event is booked, the taxpayer obtains various caterers and restaurants that cater the food. The caterer or restaurant sends the taxpayer an invoice and the taxpayer in turn sends an invoice to the customer. The taxpayer bills the customer the same amount the caterer or the restaurant invoices it. The taxpayer’s compensation is obtained from the caterer or restaurant who pays the taxpayer a certain percentage of the total cost of food and beverage. The customer makes the check payable to the taxpayer.

Under these facts, the taxpayer is the person contracting with the customer for a sale. Therefore, the taxpayer is buying and selling for its own account and is not acting as an agent for the caterer or restaurant. Accordingly, the retail sale in this situation is the sale by the taxpayer to the customer and the taxpayer owes sales tax measured by the entire charge for catering collected from the customer. The taxpayer should issue ‘‘resale certificates’’ to the caterer or restaurant.

Furthermore, the taxpayer’s event planning is a preliminary step in its contract to furnish the party supplies, meals, food and beverages for the event. In this situation, sales tax applies to the entire charge for furnishing the party supplies, meals, food, and beverages, including the charge for the taxpayer’s labor in planning the event because the charge for the labor would be regarded as a charge for services that are part of the sale of tangible personal property. Such amounts are part of the taxpayer’s taxable gross receipts from the sale of tangible personal property, even though such amounts are received from the caterer or restaurant. 11/28/95.