STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**05/10/01**	Bill No:	**AB 1199**
Tax:	**Sales and Use**	Author:	**Cardenas, et al.**
Board Position:	**Support**	Related Bills:	**AB 1185 (Mountjoy)**

BILL SUMMARY

This bill would provide a sales tax exemption for the sale of any article of clothing or footwear for $200 or less, and any computer and related accessories, as specified, sold for $1,000 or less, during a three-day period in August 2001. The bill would also specify that unless the governing body of a city, county or district votes to not have the sales tax holiday apply to its respective local tax, the holiday would additionally apply to those taxes.

ANALYSIS

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property at retail in this state. The use tax is imposed upon the storage, use, or other consumption of tangible personal property purchased in this state. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless specifically exempted.

Under current law, sales of clothing and footwear, as well as computers and related accessories, are generally subject to the sales or use tax to the same extent as any other sale of tangible personal property not otherwise exempted or excluded by statute. However, Section 6375.5 of the Sales and Use Tax Law provides an exemption for sales of new children's clothing when sold to a nonprofit organization for its distribution without charge to elementary school children.

The rate of tax currently applicable to retail sales of clothing, footwear, and computers and related equipment is made up of various components:

- 4 3/4% percent state tax allocated to the state's General Fund (Section 6051, 6051.3, 6201 and 6201.3).
- 1/2 percent state tax allocated to the Local Revenue Fund which is dedicated to local government for program realignment (Section 6051.2 and Section 6201.2)
- 1/2 percent state tax allocated to the Local Public Safety Fund which is dedicated to local governments to fund public safety services (Sec. 35 of Article XIII of the California Constitution).
- 1 1/4 percent Bradley-Burns Uniform Local Sales and Use Tax which is allocated to cities and counties (Part 1.5, commencing with Section 7200).

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.

- 1/8 to 1 1/4 percent Transactions and Use Tax which is allocated to special taxing jurisdictions in various counties and cities within the state (Part 1.6, commencing with Section 7252).

Proposed Law:

This bill would add Sections 6397 and 6398 to the Sales and Use Tax Law to provide a sales tax exemption for the sale of any article of clothing and footwear the gross receipts of which are $200 or less, and any computer and related accessories, as specified, sold for $1,000 or less, beginning at 12:01 a.m. on Friday, August 24, 2001, and ending at 12:00 midnight on the following Sunday, August 26, 2001. This bill would also provide the following:

- The proposed exemption would apply to layaway agreements entered into during the specified period for which the purchaser has made a deposit of at least 10 percent of sales price.
- The proposed exemption would apply to orders placed during the specified period and paid for in full regardless of the fact that delivery of the article is made subsequent to the specified exempt period.
- The proposed exemption would *not apply* to sales of any special clothing or footwear that is primarily designed for athletic activity or protective use and that is not normally worn except when in use for the athletic activity or protective use for which it is designed, nor does it apply to sales of jewelry, handbags, book bags, backpacks, luggage, umbrellas, wallets, watches, and similar items carried on or about the human body.
- The proposed exemption would *not apply* to rentals of clothing and footwear.

This bill would specify that the exemption *shall apply* to the Bradley-Burns Uniform Local Sales and Use Tax, and the Transactions or Use Tax, unless the governing body of the city, county or district votes to not have the exemption apply. Any governing body that votes to not have the exemption apply would be required to notify the Board no later than July 15, 2001.

Further, the bill would specify that the exemption *shall apply* to the taxes levied pursuant to Sections 6051.2 and 6201.2 of the Revenue and Taxation Code, and the tax levied pursuant to Section 35 of Article XIII of the California Constitution.

The bill would become effective immediately.

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Background

This proposed law is modeled after a similar law in New York State. Sales of clothing and footwear are exempt from tax in New Jersey, and many residents of New York went to New Jersey to purchase their clothes. To help discourage this, New York state implemented a law in 1997 allowing for a one-week exemption from the tax for the sales of clothing valued under $100. The State of New York was pleased with the results, so it added two additional one-week exemption periods in 1998 and also raised the limit from $100 to $500. New York again had the one-week exemption periods during 1999, and a permanent exemption for sales of clothing under $500 will became effective in 2000. Other states that have enacted a sales tax holiday for clothing and/or computers include Florida, Texas, Connecticut, South Carolina, Pennsylvania, Iowa and Maryland.

Two "sales tax holiday" measures were considered during the 1999-00 Legislation Session. Assembly Bill 944 (Cardenas), in its last amended form, would have provided an exemption for clothing and footwear purchased for $100 or less during a 3 day period, and Assembly Bill 1320 (Ashburn) proposed a one-week exemption from the sales tax on purchases of any tangible personal property for less than $500. AB 944 was held in the Senate Revenue and Taxation Committee, and AB 1320 failed to pass from its house of origin by the deadline. The Board's position was "neutral" on both measures.

COMMENTS:

1. **Sponsor and purpose of the bill.** This is the Governor's proposal to create an exemption for sales of clothing and footwear and computers and related equipment during a specific period of the year to help ease the financial burden on lower to middle income families when purchasing necessities for their children going back to school.

2. **The May 10, 2001 amendments make nonsubstantive changes.** These amendments simply make technical corrections to the language for consistency purposes and add co-authors to the bill.

3. **Local option provisions could be problematic.** This bill would enable local jurisdictions the option of voting to not join in the sales tax holiday period with respect to their locally-imposed taxes. Unlike other states, California has three levels of locally-imposed taxes: county-imposed, city-imposed, and district-imposed. Under this bill, the governing bodies of California's 58 counties would have to vote to determine whether their ¼ percent county transportation tax should be excluded, as would the 570 governing bodies of California's cities and the 40 governing bodies of the state's transactions and use tax districts. It is unclear how many governing bodies would vote to opt out of the proposed tax holiday. It is conceivable that the holiday exemption could range from a complete exemption to an exemption of 6 percent with varying rates in between, depending on the location of sale and which governing bodies opt out of participating in the exemption. And, rates even within a single county could vary. For example, in Sacramento, Arden Way runs both within the city limits and the unincorporated area of Sacramento County. If the city officials

vote not to participate in the holiday exemption, but the county officials vote to include the county tax within the exemption, a customer purchasing clothing from a retailer in the city portion of Arden Way could have a different rate imposed on the same items from a retailer on the county side of Arden Way.

There are several problems associated with this. First, customers that have to pay any portion of the sales tax during the holiday period would be confused – most of California's population are unaware of the varying components in the sales tax rate. Second, retailers selling items both included and excluded within the proposed exemption would have to segregate sales between those subject to whatever local tax may apply on the exempt sales, and those sales that are fully taxable, which adds a new level of complexity with respect to bookkeeping. Third, retailers having retail locations in multiple jurisdictions would have a more complex record-keeping task with potentially numerous rates, which could result in a larger margin of error in collecting and reporting the correct amount of tax. And fourth, the Board's administrative costs could be proportionately higher if some locally imposed taxes apply and some do not - this adds a new area of complexity not currently associated with return processing, and additional programming costs would be incurred as well.

4. **Exemption applies to layaway sales and other orders placed during the exemption period.** Due to the exemption only applying during a specific time period, the bill contains language to address certain transactions that may overlap exempt and taxable periods. The bill provides that layaway agreements entered into during the exemption period, for which the purchaser has made a deposit of at least 10 percent of the sale price, would qualify for the exemption. The bill also provides that orders placed during the exemption period and paid for in full, but delivered subsequent to the exemption period, would also qualify for the tax exemption.

5. **Exemption may not apply to some merchandise exchanges and rain checks.** Under current law, when merchandise is returned for other merchandise, the law considers the transaction as two separate transactions: a recission of the original sale and a separate sale of the replacement merchandise. As an example, if a customer purchases a medium-sized shirt and exchanges the shirt for a small-sized shirt, the transaction is regarded under the law as a separate sale of the small-sized shirt and a recission of the original sale of the medium-sized shirt. The retailer is allowed to deduct from his or her taxable sales amount for purposes of reporting the correct amount of sales tax to the Board, the sales price of the medium-sized shirt, and is also required to include in his or her taxable sales amount, the sales price of the small-sized shirt. Using this example under the proposed holiday period, if the medium-sized shirt is purchased during the sales tax holiday period, and is exchanged for the small-sized shirt *after* the holiday period, the proposed exemption would not apply to the exchange of the small-sized shirt since that transaction is recognized under the law as having occurred after the exempt holiday period. This may result in reporting errors by retailers and added confusion and inquiries by customers.

   Another source of confusion could result from the use of rain checks. Current law also provides that a rain check issued by a retailer does not constitute a sale of

tangible personal property. Therefore, if a retailer is out of stock of a particular item and issues a rain check to the customer during the holiday period, and the customer subsequently uses the rain check to purchase the out of stock item after the proposed holiday period, the exemption would not apply.

6. **A 3-day exemption could increase retailers' costs.** Creating an exemption that only lasts for three days would place an additional burden on retailers to have their cash registers programmed to tax sales on certain dates and not tax sales on other dates, or apply a partial rate of tax on certain dates. This may require retailers to incur costly and frequent reprogramming of their registers to accommodate the change. Retailers would presumably be compensated for this by increased sales activity during the exempt period.

   Based on information in a 1990 report that the Board prepared to determine the impact on retailer's costs with respect to implementing a tax increase in 1989, on average, retailers with quarterly prepay accounts spent $94.35 to reprogram their cash registers and computers and retailers with monthly and quarterly accounts paid $19.47. Adjusting these figures for an increase in the California Consumer Price Index and the increase in the number of accounts since the 1990 study, it is estimated that retailers incur approximately $9.3 million in comparable reprogramming costs to implement a rate change.

7. **Exemption applies to sales tax only.** The proposed law would exempt sales of clothing and footwear from the computation of the sales tax, but not the use tax. Therefore, California consumers ordering clothing and footwear from out-of-state, Internet and mail order retailers, for example, would continue to remain liable for the use tax during the holiday period. There could be a constitutional concern with this under the Commerce Clause of the United States Constitution. It could be argued that allowing an exemption for in-state purchases while applying use tax to out-of-state purchases discriminates against interstate commerce.

8. **Related legislation.** Another sales tax holiday measure has also been introduced. That measure, AB 1185 (Mountjoy), would provide an ongoing partial sales tax exemption of 6 percent for the sale of any article of clothing or footwear sold for $200 or less during the 7-day period ending on the last Thursday in August. The Board also voted to support AB 1185.

COST ESTIMATE

Administrative costs would be incurred in preparing and mailing a special notice to affected retailers, creating and distributing new sales tax charts to affected retailers, and answering potentially numerous inquiries. Because of the potential for a partial tax exemption with varying local tax rates, administrative costs would also be incurred in computer programming, return revision, return analysis, and return processing. A detailed cost estimate is pending.

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REVENUE ESTIMATE

Clothing and Footwear

As reported by the Department of Commerce, national personal consumption expenditures for clothing and footwear amounted to $294.6 billion in 1999. We assume that California accounts for 12% of national sales, as California's population is 12% of the total United States population. Sales of clothing and footwear in California were estimated to be $35.4 billion in 1999.

Taxable sales of apparel and general merchandise stores, the main retailers of clothing and footwear in California, have been increasing annually at an average of 3.8% for the last few years. If we assume that sales of clothing and footwear will increase by 3.5% annually, then estimated California sales of clothing and footwear for 2002 will be $39.2 billion.

We would expect sales of clothing and footwear to be higher than average for the periods when these sales would be exempt from the sales tax. The state of Texas found that during a week's tax holiday on clothing and footwear, sales were double the normal weekly sales. Based on this information, we assume that the three-day period involved represents 6/365 of a year's worth of sales. Also, we have not been able to find any information regarding what percentage of clothing and footwear sales are for items priced at $200 or less. However, if 80% of clothing and footwear sales were for $200 or less, then sales subject to the provisions of this bill would be as follows:

Annual Sales	Period Percentage	Period Sales	Exempt Percentage	Exempt Sales
	(sales in millions)			
$39,200	6/365	$644	80%	$515

Computer Equipment

This bill would exempt computers, monitors, keyboards, printers and scanners selling for $1,000 or less. Retailers could unbundle computer systems and separately price computers, monitors, keyboards, software, etc. According to a study by DataQuest, 6,425,000 computers were sold in California in 1999. The average price for a computer system that includes a monitor and keyboard is estimated to be $1,800. We have not been able to find any information regarding what percentage of these computers would sell for $1,000 or less. However, if 20% of computer sales were for $1,000 or less, and the average price of these computers is estimated to be $900, then the sales subject to the provisions of this bill would be as follows:

Computers sold annually	6,425,000
Percent sold during three-day period	6/365*
Computers sold in three-day period	105,616
Percent sold for $1,000 or less	20%
Number sold for $1,000 or less	21,123
Average price	$900
Estimated sales for $1,000 or less	$19.0 million

(*we have assumed that sales will be double the normal three-day period)

Monitors

We expect that monitors would be priced separately, and that any monitor purchased for $1,000 or less would be eligible for this exemption. Monitors range in price from $150 to $2,500. Those costing more than $1,000 are specialized monitors/TVs. The average price for a monitor is $300. We assume that a monitor is sold with each computer and that 95% of the monitors sold would be for $1,000 or less.

Monitors sold annually	6,425,000
Percent sold during three-day period	6/365*
Monitors sold in three-day period	105,616
Percent sold for $1,000 or less	95%
Number sold for $1,000 or less	100,335
Average price	$300
Estimated sales for $1,000 or less	$30.1 million

Keyboards

We expect that keyboards would also be priced separately and that any keyboard purchased for $1,000 or less would be eligible for this exemption. The average price for a keyboard is $50. We assume that a keyboard would be sold with each computer and that 100% of the keyboards sold would be for $1,000 or less.

Keyboards sold annually	6,425,000
Percent sold during three-day period	6/365*
Keyboards sold in three-day period	105,616
Percent sold for $1,000 or less	100%
Number sold for $1,000 or less	105,616
Average price	$50
Estimated sales for $1,000 or less	$ 5.3 million

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Printers

We expect that printers would be priced separately and that any printer purchased for $1,000 or less would be eligible for this exemption. Printers range in price from $100 to $1,500. The average price for a printer is $350. We assume that a printer would be sold with 75% of the computers sold and that 80% of the printers sold would be for $1,000 or less.

Printers sold annually (6,425,000 x .75)	4,819,000
Percent sold during three-day period	6/365*
Printers sold in three-day period	79,216
Percent sold for $1,000 or less	80%
Number sold for $1,000 or less	63,373
Average price	$350
Estimated sales for $1,000 or less	$22.2 million

Scanners

We expect that scanners would be priced separately and that any scanner purchased for $1,000 or less would be eligible for this exemption. Scanners range in price from $50 to $1,000. The average price for a scanner is $250. We assume that a scanner is sold with 25% of the computers sold and that 100% of the scanners sold will be for $1,000 or less.

Scanners sold annually (6,425,000 x .25)	1,606,000
Percent sold during three-day period	6/365*
Scanners sold in three-day period	26,400
Percent sold for $1,000 or less	100%
Number sold for $1,000 or less	26,400
Average price	$250
Estimated sales for $1,000 or less	$ 6.6 million

Total Sales

The estimated sales that would be subject to the provisions of this bill would be as follows:

Item	Estimated Sales
Clothing and footwear	$515.0 million
Computers	19.0 million
Monitors	30.1 million
Keyboards	5.3 million
Printers	22.2 million
Scanners	6.6 million
Total	$598.2 million

Revenue Summary

The revenue impact from exempting clothing, footwear and computer equipment from the sales tax for a three-day period (August 24 – 26, 2001) would be as follows:

	Revenue Effect
State loss (4.75%)	$28.4 million
Local Revenue Fund loss (0.5%)	3.0 million
Public Safety Fund loss (0.5%)	3.0 million
Local loss (1.25%)*	7.5 million
Special District loss (0.67%)*	4.0 million
Total	$45.9 million

* Under this proposal, local jurisdictions are given the option to have the exemption not apply to their local or transactions and use taxes. This estimate gives the loss as if the exemption applies to all local taxes.

Qualifying Remarks

The figures from the Department of Commerce do not include accessories or rentals, but do include special clothing and footwear designed primarily for athletic activity or protective use. However, we do not believe that the inclusion of these items materially affects the revenue estimate.

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