



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

|                  |                          |          |                |
|------------------|--------------------------|----------|----------------|
| Date Introduced: | <b>02/09/06</b>          | Bill No: | <b>AB 1999</b> |
| Tax:             | <b>Sales and Use Tax</b> | Author:  | <b>Torrico</b> |
| Related Bills:   |                          |          |                |

### BILL SUMMARY

This bill would impose an additional 1 percent tax on sales or purchases of “harmful matter,” as defined. The revenues derived from the tax would be transferred to a newly created Survivors of Domestic Violence and Sexual Abuse Fund.

### ANALYSIS

#### Current Law

Under current law, the sales and use tax is imposed on all 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 retail sales and purchases of tangible personal property in this state. Currently, the Sales and Use Tax Law contains no special tax provision with respect to the sale or use of tangible personal property of a sexually explicit nature. Tax applies to these sales or purchases in the same manner as it applies to sales of tangible personal property in general.

The base state and local sales and use tax rate is 7.25 percent. Of the 7.25 percent base rate, 6.25 percent is the state sales and use tax portion and 1 percent is the local sales and use tax portion. The components of the state sales and use tax rate of 6.25 percent are as follows:

- 4.75 percent is allocated to the state’s General Fund, which is dedicated for state general purposes (Sections 6051 and 6201 of the Revenue and Taxation Code (RTC));
- 0.25 percent is allocated to the state's General Fund which is also dedicated for state general purposes (Sections 6051.3 and 6201.3 of the RTC);
- 0.25 percent is allocated to the Fiscal Recovery Fund which is dedicated to the repayment of the Economic Recovery Bonds (Sections 6051.5 and 6201.5 of the RTC).
- 0.5 percent is allocated to the Local Revenue Fund which is dedicated to local governments for program realignment (Sections 6051.2 and 6201.2 of the RTC);
- 0.5 percent is allocated to the Local Public Safety Fund which is dedicated to local governments to fund public safety services (Section 35 of Article XIII of the California Constitution).

*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.*

### Proposed Law

This bill would add Sections 6051.8 and 6201.7 to the RTC to impose an additional state sales and use tax at a rate of 1 percent on the sale or purchase of all tangible personal property that is harmful matter, as defined by Section 313 of the Penal Code.

Section 313 of the Penal Code defines “harmful matter” as matter, which to the average person, applying contemporary statewide standards, appeals to the prurient interest and is matter that depicts or describes in a patently offensive way sexual conduct. Such matter must also lack serious literary, artistic, political, or scientific value for minors.

“Matter” is defined as any book, magazine, newspaper, video, or other printed or written material such as any picture, drawing, or photograph. “Matter” also includes any statue or other figure, motion picture, or any mechanical, chemical, or electrical reproduction, or any other articles, equipment, machines, or materials.

Section 313 of the Penal Code also provides that when it appears from the nature of the matter or the circumstances related to its dissemination, distribution, or exhibition that such matter is designed for clearly defined deviant sexual groups, the appeal of the matter will be considered in reference to the intended recipient group.

This bill would also create a new fund, the Survivors of Domestic Violence and Sexual Abuse Fund, and provide that the revenues derived from the 1 percent tax would be transferred to this fund.

As a tax levy, the bill would become effective immediately upon enactment.

### Background

**AB 1301 (Washington, 1999)** would have required the California Health and Human Services Agency to conduct a study to determine whether there is any connection between pornography and sexual abuse, and to reports its findings to the Legislature by August 31, 2000. This bill would have also required the Board to make recommendations to the Legislature, by August 31, 2000, regarding an appropriate method to impose a tax on pornography. This bill was never heard in a committee.

**SB 1013 (Calderon, et al., 1997)** would have added a 5 percent tax, administered by the Board, to the sale of sexually explicit pornographic materials or entertainment, as defined, and would have directed the Department of Justice (DOJ) to disburse the tax revenues for use in services provided by rape crisis centers and battered women’s shelters. This bill failed passage in the Senate Revenue and Taxation Committee.

### COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to fund programs for victims of sexual assault and domestic violence. According to the author’s office, these programs are currently under funded.
2. **Definition of “harmful matter” would be very difficult to administer.** It appears that the purpose of Section 313 of the Penal Code is to prohibit any sale, dissemination, distribution, or exhibition to minors of an item that appeals to the prurient interest and depicts or describes in a patently offensive way sexual conduct. Since the definition is extremely subjective in nature, it creates difficulty in determining when such item qualifies as a “harmful matter.”

*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.*

Moreover, we note that the definition of “obscene matter” under Penal Code section 311 is almost identical to the definition of “harmful matter” under Penal Code section 313 and is based on the standards provided by the U.S. Supreme Court in *Miller v. California* (1973) 413 U.S. 15, who struggled for some time in establishing a test for obscenity, causing it to review each case ad hoc. Under *Miller v. California* (1973) 413 U.S. 15, as applied in a later case *Jenkins v. Georgia* (1974) 418 U.S. 153, 161, the U.S. Supreme Court justices had to personally review the allegedly obscene material, even to the point of actually watching an allegedly obscene movie.

This bill would require the Board of Equalization, a tax administration agency, to evaluate magazines and videos for their content. Perhaps the DOJ is the agency best charged with determining what constitutes “harmful matter.”

3. **Certain subscriptions of magazines may not be subject to the 1 percent tax.** Since the tax at issue is in addition to other sales and use taxes, a transaction that is exempt from the sales and use tax would be exempt from the additional 1 percent tax proposed in this bill. That is, current law provides for a sales and use tax exemption for the sale or use of a “periodical,” including magazines and newspapers that contain news or information of general interest to the public, or to some particular organization or group of persons, which appear at least four, but not more than 60 times each year, are sold by subscription, and which are delivered by U.S. mail or common carrier. Certain magazines that could be considered “harmful matter” might also qualify as exempt sales of periodicals. If so, sales of these magazines, which currently are exempt from tax, would also be exempt from the additional 1 percent tax proposed in this bill.
4. **This bill could complicate retailers’ records and reporting.** Retailers of “harmful matter” are required to report and remit sales tax on their sales of “harmful matter” in California. Retailers of “harmful matter” most likely sell other tangible personal property subject to sales tax. Adding an additional 1 percent tax on the sale of “harmful matter” would require retailers to identify and keep track of “harmful matter” separately from other sales of tangible personal property so that their employees could determine which sales are subject to the additional 1 percent tax. In addition, retailers’ cash registers might need to be reprogrammed.

Also, the sales and use tax return would be more complicated as it would provide a separate line for reporting sales subject to the 1 percent tax.

5. **Purchases of “harmful matter” subject to use tax.** Purchasers can acquire items regarded as “harmful matter” over the Internet, by mail, or telephone and they can be purchased privately and anonymously. The proposed tax increase provides further incentive to acquire these items from unregistered retailers outside this state, in an effort to avoid the tax. This bill would, however, subject such purchases to the use tax.

The Board’s collection of use tax relies heavily on the voluntary compliance of purchasers of tangible personal property. However, due to the general misconception that purchases from outside this state are “tax free” and the insufficient audit resources to pursue all purchasers, the voluntary compliance rate has been very low. In fact, the voluntary reporting of use tax on purchases from out-of-state retailers is regularly the largest area of non-compliance the Board’s audit

*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.*

staff encounters. The tax increase proposed in this bill would exacerbate noncompliance by purchasers in reporting their use tax obligations on their out-of-state Internet or mail order purchases of “harmful matter.” Consequently, the anticipated revenues associated with the proposed tax increase may not be realized.

In addition, for persons who report and remit use tax on their purchases from out-of-state businesses, they, like California retailers, could find it difficult to determine whether their purchases are “harmful matter,” and thus subject to the additional 1 percent tax.

6. **Operative date of bill.** As a tax levy, this bill would become effective immediately upon enactment and operative upon its effective date. The Board needs at least six months to implement this tax. The language should specify that the tax would go into effect on the first day of the first calendar quarter commencing at least six months following the bill’s effective date.

7. **Technical amendment.** The following technical correction is recommended:

6201.7 (a) In addition to the taxes imposed by any other provision of this part, an excise tax is hereby imposed on the storage, use, or other consumption in this state of tangible personal property that is harmful matter, as defined by Section 313 of the Penal Code, purchased from any retailer for storage, use, or other consumption in this state at the rate of 1 percent of the sales price of the property.

#### **COST ESTIMATE**

The Board would incur substantial costs to administer this bill. These costs would be attributable to, among other things, identifying and notifying taxpayers, developing regulations, revising manuals and publications, modifying the tax return including the design of a new schedule or worksheet or creating a new tax return, computer programming, training staff, answering numerous inquiries from the public. A detailed cost estimate is pending.

#### **REVENUE ESTIMATE**

This bill imposes a tax on the sale of tangible personal property such as video sales and rentals, magazines and novelties, defined as “harmful matter.”

*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.*

**Video Sales and Rental**

The Video Software Dealer's Association (VSDA), a not-for-profit trade association for the home video industry, estimated that in 2005, total U.S. adult video sales and rental revenue in retail stores was \$4.28 billion. The Free Speech Coalition, a trade association for the adult industry, in a 2005 White Paper on the adult entertainment industry, indicated that of the 801 million rentals of adult tapes and DVD's in the U.S. in 2002, 130 million of those rentals took place in California. California's share, based on this data, amounts to about 16% (130 million rentals / 801 million rentals = 16%).

Based on data compiled by the Free Speech Coalition, we estimate that adult video sales and rental revenues for retail stores in California amounted to \$685 million (16% × \$4.28 billion = \$685 million).

Tax revenue is estimated to be \$6.9 million (\$685 million × 1% = \$6.9 million).

**Magazines**

According to VSDA, U.S. adult entertainment magazine revenue in 2005 was estimated to be \$1 billion. Based on California's population, magazine revenues for California are estimated to be \$120 million (12% × \$1 billion = \$120 million).

Regulation 1590, section (b) (3) states that effective November 1, 1992, tax does not apply to the sale or use of a periodical which appears at least four, but not more than sixty times each year, which are sold by subscription, which is delivered by mail or common carrier, and which contain news or information of general interest to the public, or to some particular organization or group of persons. Based on a previous analysis of the magazine industry, we estimate 60% of adult entertainment magazines sales are via subscriptions.

Tax revenue is estimated to be \$0.5 million (((\$120 million × 40%) × 1% = \$0.5 million).

**Novelties**

According to VSDA, U.S. adult novelties revenue in 2005 was estimated to be \$1.5 billion.

Based on California's population, novelties revenue for California are estimated to be \$180 million (12% × \$1.5 billion = \$180 million).

Tax revenue is estimated to be \$1.8 million (\$180 million × 1% = \$1.8 million).

*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.*

| <b>California Adult Entertainment Industry Summary</b> |                    |                 |               |
|--|--------------------|-----------------|---------------|
| (in millions of dollars)                               |                    |                 |               |
|  | <b>Industry</b>    | <b>Proposed</b> | <b>Excise</b> |
|  | <b>Revenues \$</b> | <b>Tax %</b>    | <b>Tax \$</b> |
| Video Sales & Rental                                   | 685                | 1               | 6.9           |
| Magazines  | 48                 | 1               | 0.5           |
| Novelties  | 180                | 1               | 1.8           |
| <b>Total</b>   | <b>985</b>         |                 | <b>9.2</b>    |

**Revenue Summary**

This bill would generate an estimated \$9.2 million in revenues annually.

**Qualifying Remarks**

This revenue estimate is based on information pertaining to the adult entertainment industry. This estimate is overstated to the extent that some of the items included in the estimate could be determined not to be “harmful matter” as defined in Section 313 of the Penal Code.

|                       |                   |              |          |
|-----------------------|-------------------|--------------|----------|
| Analysis prepared by: | Debra Waltz       | 916-324-1890 | 03/21/06 |
| Revenue estimate by:  | Bill Benson       | 916-445-0840 |          |
| Contact:              | Margaret S. Shedd | 916-322-2376 |          |

Is

1999-1reviseddw.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.*