



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

Date:	03/07/12	Bill No:	<u>Assembly Bill 2540</u>
Tax Program:	Sales and Use	Author:	Gatto
Sponsor:	Author	Code Sections:	RTC Ch. 3.8 (commencing with Section 6301)
Related Bills:	AB 1963 (Huber)	Effective Date:	01/01/13

BILL SUMMARY

This bill imposes a 7.5% state sales and use tax on the sale and purchase of specified services.

(The bill also makes other changes to the Personal Income Tax Law administered by the Franchise Tax Board.)

Summary of Amendments

Since the previous analysis, this bill was amended to delete charges for high net worth planning, carpet cleaning, pool maintenance, shoe shining and repair, personal private lessons (except personal fitness training), and self-service storage facilities from the imposition of the proposed tax, and to clarify the terms, party planning, elective cosmetic surgery, and passenger charter party carriers. In addition, the amendments provide an annual appropriation of \$105 million to the Department of Veteran Affairs for purposes specified in the bill.

ANALYSIS

CURRENT LAW

Under various provisions of the Revenue and Taxation Code, and Article XIII of the State Constitution, the statewide sales and use tax rate of 7.25% is imposed on taxable sales and purchases of tangible personal property. This 7.25% is made up of the following components (additional transactions and use taxes, also known as “district taxes,” ranging from 1/8% to 2.5% are levied in various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	Purpose/Authority
5.00%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5, operative 7/1/04)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)

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Rate	Jurisdiction	Purpose/Authority
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.25%	Total Statewide Rate	

Under existing law, generally, charges for services where no tangible personal property is transferred are not subject to sales or use tax in California. If there is an incidental transfer of tangible personal property along with a service, the charges generally are not subject to tax, if the true object of the contract is the service. For example, when an accountant prepares tax returns for a client, and delivers a copy of the completed tax returns to the client, the service charges made by the accountant are not subject to sales tax, since the transfer of the tangible item – the tax return – is incidental to the true object of the contract - the accountant’s services.

PROPOSED LAW

This bill would, among other things, amend Section 1656.1 of the Civil Code, and add Chapter 3.8 (commencing with Section 6301) to the Sales and Use Tax Law to impose a 7.5% sales or use tax beginning January 1, 2013 on the sale or purchase of the following services:

- (1) Yacht and boat repair.
- (2) Private aircraft pilot or private jet services.
- (3) Astrology, tarot, and palm reading.
- (4) Personal shopping.
- (5) Party planning, as specified.
- (6) Spa services provided to pets.
- (7) Elective cosmetic surgery, as specified.
- (8) Membership fees to private country clubs.
- (9) Marina services.
- (10) Limousine rental.
- (11) Nonmedical massage.
- (12) Pet grooming where the buyer is charged \$50 or more.
- (13) Nonmedical personal fitness training.
- (14) Access to the facilities of a ski resort through the imposition of a charge.
- (15) Access to storage facilities, not including storage facilities used for the storage of food or self-service storage facilities, through the imposition of a charge of \$1,000 a month or more.
- (16) Furniture repair.

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- (17) Watch repair.
- (18) Support activities for metal mining.
- (19) Passenger charter-party carriers, as defined.
- (20) Access to live theater productions through the purchase of a ticket or membership fees or dues.
- (21) Access to the facilities of a billiard parlor through the imposition of a charge.
- (22) Access to private, telephonic chat lines through the imposition of a charge to callers.

BACKGROUND

A survey <http://www.taxadmin.org/fta/pub/services/btn/0708.html> put out by the Federation of Tax Administrators (last updated July 2008) demonstrates that most states impose a tax on a wide range of services, including intangible items such as utility services, admissions, repair services, and lodging services. Beyond these general categories, however, the survey indicates that the states exhibit great diversity in the extent to which they tax the full range of the 168 services covered in the survey. Hawaii, New Mexico, and South Dakota have general sales tax systems with broadly defined bases that tax the bulk of the services. Delaware, which imposes no general sales tax, assesses a gross receipts tax on most businesses. Several other states impose a tax on a large number of selected services. These include Arkansas, Connecticut, Iowa, Kansas, Mississippi, New York, Tennessee, Texas, and Wisconsin. Conversely, there are some states, such as California, Illinois, Nevada, New Hampshire, and Virginia that include comparatively few services in their sales tax base. Professional services, such as lawyers, accountants, dentists, engineers, and physicians have been left largely untaxed.

Although the topic of imposing a sales tax on services in California has been discussed in various legislative oversight hearings, by various commissions, and in other public forums and documents, only two bills have been introduced and considered by the Legislature that would have imposed a sales tax on various selected services. These include AB 9 (Coto, 2005-06) and AB 194 (K. Murray, 1995-96). Both measures died in the Assembly Revenue and Taxation Committee.

COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by the author. According to the author's office, a tax on services such as those listed in this bill is progressive. These services are purchased primarily by individuals in higher income brackets whose discretionary income would be less impacted by a tax on the selected services. The author notes that people who can afford personal and professional services, such as those described in this measure, can better afford to bear a larger share of the tax burden.
- 2. Clear definitions of each service should be made.** In order to effectively administer the proposed tax, and to enable affected businesses to know whether their charges are subject to the tax and to properly comply, clear definitions of each service, the charges of which are proposed to be subject to the sales and use tax are essential (i.e., Would a charge for a text message to vote for your favorite

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singing contestant in a reality show be considered a “private telephonic chat line?” Would “party planning” include wedding or event planners?).

At a minimum, the bill should reference the applicable industry codes using the North American Industry Classification System. Where a specific code is not available, a clear description of the types of services intended to be subjected to and/or excluded from the proposed tax should be incorporated. Staff will work with the author’s office as the bill progresses to add clarity to the types of services that the author intends to be included or excluded from this measure.

- 3. The bill is not specific as to whether tangible personal property purchased for use in the course of providing a service would be subject to sales or use tax.** With respect to sales of goods, tax applies to the sales of any property to persons who purchase the goods for the purpose of using them in the provision of a service. Tax does not apply to sales of any property to persons who purchase the goods for the purpose of reselling them – whether the goods are incorporated into the manufactured article to be sold, such as any raw material becoming an ingredient or component part of a manufactured article, or whether the goods themselves are simply resold. It is unclear whether property purchased for use in the provision of a service will still be taxable if the service itself is subject to tax, or if the use of a good in the provision of a taxable service would be considered to be a form of reselling, in which case the purchase of the property would not be subject to tax. For example, would the purchase of champagne by a limousine driver who provides the champagne to clients as part of the service be considered an item resold in the course of providing the service, so that the limousine driver may properly purchase the champagne without payment of sales tax? Would a shoe polisher be entitled to purchase shoe polish without payment of tax, as the shoe polish is an integral part of the service provided? The application of tax on such purchases should be made clear in the bill, particularly with regard to service industries for which special rules already exist.
- 4. The imposition of use tax on out-of-state purchases could pose some administrative issues.** The bill would impose a complementary use tax for out-of-state purchases of the specified services, when purchased for storage, use, or other consumption in this state. Some issues could arise with respect to whether a specific service was purchased for use in this state. Some states that impose a use tax on out-of-state purchases of services base this on whether the purchaser derives a benefit from the service in the state. Also, it is unclear how a service could be purchased for “storage” in California. These are areas that may pose administrative problems in enforcement and compliance in the use tax. For example, if a California resident had his or her palm read in Nevada while on a weekend getaway, would the charge for the palm reading be regarded as a service purchased for use in California? If a California resident’s yacht needed repair while cruising outside the territorial waters of Mexico, and the yacht was moored in a California marina a week later, would those charges be subject to use tax?
- 5. More complexities are associated with sellers of both services and tangible personal property.** For example, a pet groomer may provide pet grooming services as well as sell pet grooming products, such as brushes, pet shampoo, etc. When a customer purchases both the service and products, the groomer would be required to perform two calculations to reimburse him or herself for the proper amount of tax -

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7.5% for the service, and 7.25% to 9.25% (depending on the location) on the sale of the product. This would add another level of complexity for the affected service providers and a possible increase in cash register programming costs that must be borne by the affected service providers. Also, these complexities tend to be more prone to errors in reporting the proper amount of tax, which results in additional BOE administrative workload.

6. **The BOE would prefer more lead time to implement the new tax.** Since the BOE would be required to identify, notify, and register a vast number of new taxpayers (an estimated 100,000), and amend existing affected regulations, and possibly draft new regulations to address ambiguities, it is recommended that the BOE, at a minimum, be given a lead time of six months.
7. **Qualified purchasers that provide services subject to the proposed tax would be removed from the “qualified purchaser” program.** Section 6225 of the Sales and Use Tax Law requires service-based businesses who receive \$100,000 or more in gross receipts to register with the BOE and report their use tax by April 15 on any taxable purchases made during the previous calendar year. For those businesses that provide any of the services described in this bill for which sales tax would be imposed, registration under the “qualified purchaser” program would no longer be required. Instead, these businesses would report any use tax liability incurred on out-of-state purchases on the same return that would be required to be filed report the sales tax on the charges for services proposed in this bill.
8. **The language will need to be refined as the bill progresses.** This bill provides some basic language to impose a tax on services. However, in order to clarify specific areas of the law, some contradictory references will need to be amended. BOE staff is willing to work with the author to refine the language as the bill progresses.
9. **Related legislation.** AB 1963 (Huber) bill has also been introduced to impose a sales and use tax on sales and purchases of specified services. That measure would, among other things, lower the overall sales and use tax rate on sales of tangible personal property by 2.25% and impose a 4% sales and use tax on a broad range of services.

COST ESTIMATE

Significant costs would be incurred to identify and register thousands of new business entities and processing a vastly increased volume of tax returns (some of these costs would be reduced if the bill is amended to *require* electronic registration and electronic return and payments). Proportional expenses for collections and audits would increase, and taxpayer education and seminar programs would also have to be developed. New regulations to interpret and explain the application of tax would be necessary also, as would amendments to existing affected regulations. Also, challenges to find space for additional staff of 250 positions would exist. These costs are preliminarily estimated to be:

Calendar Year 2013: \$38 million
Calendar Year 2014: \$32 million and ongoing

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

This bill imposes a 7.5% sales or use tax beginning January 1, 2013 on the sale or purchase of the services detailed beginning on page 2 of the analysis. Although this bill provides a list of services, it does not provide any specified NAICS codes or specific definitions of these services. For example, we have made an assumption that *private aircraft pilot or private jet services* refers to NAICS code 481211 (nonscheduled chartered passenger air transportation) and NAICS code 48799 (scenic and sightseeing transportation). Another example is *high net worth estate planning*. For this service, we included NAICS codes 523920 (portfolio management) and NAICS code 523930 (investment advice).

Although most of our receipts or revenues for these services have been ascertained from the 2010 *Annual Services Report* and 2007 *Economic Census*, we have also ascertained data from industry. For example, for *elective cosmetic surgery*, we used data from the *American Society for Aesthetic Plastic Surgery*.

This bill would become operative on or after January 1, 2013. Based on census and industry data, we estimate that the above specified services would have receipts or revenues of about \$41 billion in 2013.

REVENUE SUMMARY

The static revenue impact from imposing a 7.5 percent state sales and use tax on the sale and purchase of the specified services amounts to an estimated \$3.1 billion in sales and use tax revenues in 2013. However, this revenue estimate assumes that there is no taxpayer response to the imposition of the sales tax on these specified services.

Qualifying Remarks. We believe that taxpayer behavior will be a critical factor. This is particularly true in the case of portfolio management (which can be done in a neighboring state), which accounts for about 70 percent of the estimated revenues. Taxpayers impacted by this measure who have portfolio managers could choose someone in a neighboring state to manage their portfolios and thus avoid the newly-imposed tax. Consequently, the full amount of our static revenue estimate may not be realized.

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