



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

DRAFT

Date Amended:	<b>06/23/09</b>	Bill No:	<a href="#"><u>AB 847</u></a>
Tax:	<b>Adult Entertainment Venue Tax</b>	Author:	<b>Salas</b>
Related Bills:	<b>AB 1082 (Torrico)</b>		

**BILL SUMMARY**

This bill would impose a 20 percent tax on the gross receipts, as specified, of an adult entertainment venue, as defined, in this state. The revenues derived from the tax would be transferred to a newly created Adult Entertainment Impact Fund.

**Summary of Amendments**

As introduced, this bill was authored by Assembly Member Calderon and would have repealed the sales tax exemption for tangible personal property shipped outside the state.

**ANALYSIS**

**CURRENT LAW**

**State Law.** Under existing law, the sales or use tax applies to the sale or use of tangible personal property in this state, unless otherwise exempted or excluded by statute. 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 8.25 percent<sup>1</sup>. Of the 8.25 percent base rate, 7.25 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’s 7.25 percent are as follows:

- 5 percent is allocated to the state’s General Fund, which is dedicated for state general purposes (Sections 6051, 6051.3, 6201, 6201.3 of the Revenue and Taxation Code (RTC));
- 1 percent is allocated to the state’s General Fund, which is dedicated for state general purposes (Sections 6051.7 and 6201.7 of the RTC, operative April 1, 2009);
- 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).

<sup>1</sup>Effective April 1, 2009, AB X3 3 (Chapter 18 of the Third Extraordinary Session, signed by Governor Schwarzenegger on February 20, 2009) temporarily increases the state sales and use tax rate by 1 percent. The combined state and local (Bradley-Burns local tax) tax rate, effective April 1, 2009, is increased from 7.25 percent to 8.25 percent. The 1 percent tax rate increase will expire on July 1, 2011.

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**Federal Law.** Under Title 18 United States Code (USC) Section 2257, producers of books, magazines, periodicals, films, videotapes, or other matter which contain visual depictions of actual, not simulated, sexually explicit conduct are required both to maintain records of each performer portrayed in a visual depiction of sexually explicit conduct and required to affix a statement to the product describing where the records are located. Title 18 USC Section 2257 is found under the provisions related to crimes and criminal procedure of sexual exploitation and other abuse of children.

Section 2257 provides that “actual sexually explicit conduct” is defined in Title 18 USC Section 2256. Section 2256 defines “actual sexually explicit conduct” to mean:

- sexual intercourse, including genital-genital, oral-genital, anal-genital, oral-anal, whether between persons of the same or opposite sex;
- bestiality;
- masturbation;
- sadistic or masochistic abuse; or
- lascivious exhibition of the genitals or pubic area of any person.

Section 2257 requires the U. S. Attorney General to establish regulations for the enforcement of this section, and has promulgated a series of regulations found in 28 Code of Federal Regulations (CFR) Part 75. Regulation 75.8, *Location of the statement*, provides that all books, magazines, and periodicals are required to contain a statement either on the first page that appears after the front cover or on the page on which copyright information appears. With respect to any film or videotape which contains end credits for the production, direction, or distribution, the statement is to be presented at the end of the end titles or final credits and is to be displayed for a sufficient duration to be read by the average viewer. For any other film or videotape, the statement is to be presented within one minute from the start of the film or videotape, and before the opening scene, and is to be displayed for a sufficient duration to be read by the average viewer.

#### PROPOSED LAW

This bill would add Part 14.5 (commencing with Section 33001) to Division 2 of the RTC to impose a 20 percent tax (in addition to the sales tax) on the gross receipts from the retail sale of tangible personal property, as specified, of an adult entertainment venue, as defined. This bill would be known as the “Adult Entertainment Venue Tax,” and would create a new fund, the Adult Entertainment Impact Fund, and provide that the revenues derived from the tax would be transferred to this fund.

**Definition of “adult entertainment venue.”** This bill would define an “adult entertainment venue” to mean any of the following:

- 1) A retail establishment whose gross receipts from the sale or rental of adult material exceed 50 percent of all gross receipts of the retail establishment.
- 2) The premises of any facility located in California that provides a public or private viewing of adult material.
- 3) The public premises of any facility located in California offering live sexually explicit conduct that is prohibited to audiences under 18 years of age or 21 years of age, depending on the sale of alcoholic beverages on the premises.

This bill would specify that an “adult entertainment venue” would not include:

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- A business whose primary purpose is to conduct live performances which may include the display of complete nudity, so long as the live performance is a legitimate play, opera, ballet, or concert shown at a concert house, playhouse or theater, museum, or education institution or facility whose premises may sell alcoholic beverages but derives less than 20 percent of its total gross receipts from the sale of alcoholic beverages.

**Definition of “adult material.”** This bill would define “adult material” to include all of the following:

- Harmful matter, as defined in Section 313 of the Penal Code. Section 313 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 also lacks serious literary, artistic, political, or scientific valued for minors.  
 “Matter,” under Penal Code Section 313, 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.
- Live sexually explicit conduct provided at a business establishment.
- Any item that includes sexually explicit conduct or is subject to the requirements of Section 2257 of Title 18 of the United States Code.

This bill defines “sexually explicit conduct” to mean any of the following actual, but not simulated, conduct:

- 1) sexual intercourse, including genital-genital, oral-genital, anal-genital, oral-anal, whether between persons of the same or opposite sex;
- 2) masturbation;
- 3) sadistic or masochistic abuse; or
- 4) lascivious exhibition of the genitals or pubic area of any person.

“Gross receipts” would include receipts from whatever source, received by the adult entertainment venue, except those receipts would not include sales taxes imposed on the transaction.

Any determinations, collections of tax, overpayments and refunds, and administration required under the provisions of this bill would be governed pursuant to Part 1 of the Sales and Use Tax Law.

The Board would be required to enforce the provisions of this bill and may prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of this bill.

The revenues derived from the tax, less refunds and the Board’s administrative costs, would be deposited into the Adult Entertainment Impact Fund, which this bill creates.

As a tax levy, the bill would become effective immediately upon enactment. However, the provisions would be operative on or after October 1, 2009.

**BACKGROUND**

Recent measures have proposed similar taxes.

**AB 2914 (Calderon, 2008)** is similar to this bill, but would have imposed a 25 percent tax, rather than a 20 percent tax, on the gross receipts of an adult entertainment venue, and would have imposed an 8.3 percent tax on digitally transmitted adult material, and the qualified gross receipts of a qualified business, as defined, where the business has more than 50 percent of its gross receipts derived from the production, distribution, or sales of adult entertainment movies. This bill was held on the suspense file in the Assembly Appropriations Committee.

**AB 1551 (Calderon, 2007)** is similar to this bill but would have also imposed an 8 percent tax on the total gross charges, as defined, incurred by a purchaser of a pay-per-view adult entertainment movie, as defined. This bill was never heard in a committee.

**AB 1999 (Torrico, 2006)** would have imposed an additional 1 percent tax, administered by the Board, on sales and purchases of "harmful matter," as defined. This bill was never heard in a committee.

**COMMENTS**

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to provide funding to ameliorate the negative secondary effects of adult entertainment venues.
2. **The June 23, 2009 amendments** (1) delete the provisions related to the repeal of the sales tax exemption on tangible personal property shipped outside the state, (2) change the author, and (3) insert the current language imposing a tax on an adult entertainment venue, as defined.
3. **What is an adult entertainment venue?** This bill defines three categories of adult entertainment venues which would be subject to the tax:

A retail establishment whose gross receipts from the sale or rental of adult material exceed 50 percent of all gross receipts of the retail establishment. A retail establishment meeting this description would be an adult store. Under the provisions of this bill, all of the adult store's gross receipts would be subject to the additional tax. That is, tax would apply to sales of all items, including, but not limited to sales of videotapes, DVDs, books, magazines, pictures, lingerie, oils, lotions, statues, and sexual devices or toys.

A facility located in California that provides a public or private viewing of adult material. A business establishment meeting this description would be an adult arcade or adult motion picture theater. Under the provisions of this bill, an adult arcade or theater's gross receipts from the retail sale of all tangible personal property would be subject to the additional tax. This includes receipts from the sale of food items, drinks, and other tangible personal property sold by the adult arcade or theater. Charges for tickets only would not be subject to the additional tax. However, if charges for tickets include any tangible personal property, such as drinks, that portion of the charge related to the sale of tangible personal property would be subject to the additional tax.

The public premise of any facility located in California offering live sexually explicit conduct that is prohibited to audiences under 18 years of age or 21 years of age, depending on whether alcoholic beverages are sold on the premises. A business

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establishment meeting this description would be an adult cabaret, nightclub, strip bar, or theater offering live entertainment. The adult establishment's gross receipts from the sale of tangible personal property would be subject to the additional tax. This would include receipts from the sale of food, beverages or other items sold by the adult establishment. Separate charges solely for admission or for a ticket to enter the adult entertainment venue would not be subject to tax. However, if customers are allowed to recoup the admission or cover charge in food and beverages, such charges would be subject to tax (whether or not the customer recoups those charges). In addition, if the charges include any charges for food and beverages, those amounts related to the sale of food and beverages would be subject to the additional tax.

An adult entertainment venue would not be: live performances with displays of complete nudity where the performance is considered a legitimate play, opera, ballet, or concert (e.g., Hair) would not be considered an adult entertainment venue.

4. **Purchases of "adult entertainment materials" from out of state sellers.** Purchasers can acquire items regarded as "adult entertainment materials" 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 would create a competitive disadvantage for California adult entertainment businesses.
5. **Determining what items qualify as "harmful matter" would be very difficult to administer and perhaps beyond the scope of the Board.** Examining an item to see if it shows sexually explicit conduct or has a federal disclosure statement would pose less difficulty for Board staff, but would still have problems.

"**Harmful matter**" is defined as matter, taken as a whole, which to the average person, applying contemporary statewide standards, appeals to the prurient interest and depicts or describes in a patently offensive way sexual conduct. Because the definition is extremely subjective in nature, it creates difficulty in determining when such item qualifies as a "harmful matter."

Moreover, Board staff notes that often a court test is needed to determine if matter is harmful. 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.

**Adult material also includes material showing sexually explicit conduct.** Even though the definition of sexually explicit conduct is more defined than "harmful matter," determining what items qualify (books, magazines, statues, sex toys, videos) could be very difficult and perhaps beyond the scope of the Board. Perhaps the Department of Justice could provide a list of such qualifying items.

With respect to items subject to the requirements of Section 2257, this provision more clearly defines items which would be subject to the tax. This provision would also eliminate the Board's need to evaluate an item for its content; if the magazine or

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video contains the federally-required disclosure statement, it qualifies as adult material. However, if the author intends for adult material to include certain statues and sex toys, these items are not subject to the Section 2257 requirements. In addition, Board staff can examine a magazine or video to see if the item bears the disclosure statement, but what if a magazine or video does not contain a statement? Perhaps the bill should provide that any item carrying a federally-required disclosure statement pursuant to the requirements of Section 2257 is subject to the tax.

6. **Impact on adult entertainment stores.** It is important that these stores periodically test their sales of merchandise to determine if their gross receipts are primarily attributable to the sale of adult materials and subject to the tax. When a store changes its product mix, it should perform a test to determine whether the store is an adult entertainment venue and subject to the tax.
7. **How would the Board be funded for administrative start-up costs?** Section 33006 provides that the Board would transmit all payments attributable to the adult entertainment venue tax, less refunds and the Board's costs of administration, to the deposit of the Adult Entertainment Impact Fund, which this bill creates. Thus, the bill's provisions would provide for reimbursement of the Board's *ongoing* administrative costs. However, how would the Board be funded for administrative start-up costs? This bill proposes a new tax to be imposed effective October 1, 2009. The Board would incur administrative costs beginning with the 2009-10 fiscal year in order to develop computer programs and create a new tax return and publications and hire appropriate staff. To cover these administrative startup costs, the Board would need a direct adequate appropriation that would not have already been identified in the Board's 2009-10 budget.

Staff will work with the author's office to address this issue as the bill progresses through the legislative process.

8. **Bill should have a delayed operative date.** The bill provides for an operative date of October 1, 2009. However, the Board would need at least a six-month lead time from the effective date of the bill to perform the various tasks such as programming, identifying and notifying affected adult entertainment venues, modifying or creating a new tax return, and more. 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.
9. **First amendment issues.** Applying the proposed tax to certain "adult entertainment venues" might trigger first amendment protection. As the U.S. Supreme Court explained in *Arkansas Writers' Project, Inc. v. Ragland* (1987) 481 U.S. 221, a state may not levy a sales tax on certain types of magazines based on the content of those magazines. Arkansas had imposed a tax on general interest magazines, but had exempted newspapers and religious, professional, trade, and sports journals. The court found that since the tax would be "content-based," a heightened scrutiny under the First Amendment would be triggered.

In addition, Board staff notes that certain broad-based attempts at both the federal and state level have failed, due in no small part to concerns that the proposed laws would not pass constitutional muster. The Internet Safety and Child Protection Act of 2005 (Sen. No. 1507, 109<sup>th</sup> Cong., 1<sup>st</sup> Sess.) would have: 1) set tighter age verification standards to block minors from entering Internet pornography sites; and 2) provide funding and support to law enforcement efforts to combat Internet and

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pornography-related crimes against children. The Adult Entertainment Tax Act of 2004 (Mo. Sen. Bill No. 0821, 92<sup>nd</sup> Gen. Assem., 2<sup>nd</sup> Reg. Sess.) would have taxed adult entertainment products and services including matter containing sexually explicit material, or live performances of sexually explicit conduct.

The most recent case Board staff found involved strip club fees. On June 5, 2009, a Texas appeals court determined that a \$5 admissions tax on adult entertainment venues that provide nude dancing and serve alcohol violates First Amendment free speech protections. *Texas Entertainment Ass'n, Inc. et al., v. Combs. Et al.*, No. 03-08-00213-CV (Court of Appeals, Third District, 6/5/09). The tax already had been held unconstitutional in a March 2008, decision by a Travis County district court. The following provides a background of this case.

The Texas Court of Appeals, Third District, has affirmed a trial court decision concluding a tax on sexually oriented businesses is unconstitutional because the tax is content-based and not narrowly tailored to promote a compelling state interest.

In 2007, the Texas Legislature enacted a statute that imposed a tax on sexually oriented businesses in the amount of \$5 for each customer entry. A sexually oriented business was defined by the statute as a nightclub, bar, or similar enterprise that provided live nude entertainment and authorized consumption of alcoholic beverages. Karpod Inc., a sexually oriented business, and Texas Entertainment Association, which represents sexually oriented business interests, filed a claim against the Comptroller of Public Accounts for declaratory and injunctive relief. The trial court concluded the statute violated the First Amendment to the U.S. Constitution, permanently enjoined the comptroller from collecting or assessing the tax, and awarded attorney fees. The comptroller appealed to the court of appeals.

The appeals court rejected the comptroller's argument that the tax was an alcohol regulation. The court determined that because the statute appears in the business and commerce code that governs sexually oriented businesses and is not regulated by the Texas Alcoholic Beverage Commission, the predominant purpose of the tax is a content-based burden on protected speech that is subject to strict scrutiny. The court noted that the comptroller failed to show that the tax is necessary to serve a compelling state interest and was narrowly tailored for that purpose. The court granted Karpod attorney fees. The court affirmed the trial court's decision.

On June 25, 2009, Texas state officials asked the Texas Supreme Court to review the appeals court decision.

- 10. Related legislation.** AB 1082 (Torrico) would impose an additional 12 percent tax on sales or purchases of "harmful matter," as defined. The revenues derived from the tax would be transferred to the newly created funds—Domestic Violence and Sexual Abuse Prevention Fund and Domestic Abuser Surveillance Fund.

## **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.

This bill provides that a portion of the revenues generated from the new tax would pay for the Board's costs of administration. A detailed cost estimate is pending.

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**REVENUE ESTIMATE****BACKGROUND, METHODOLOGY, AND ASSUMPTIONS**

Under this bill, an *adult entertainment venue* would not include any business whose primary purpose is to conduct live performances which may include the display of complete nudity, so long as the live performance is a legitimate play, opera, ballet, or concert shown at a concert house, playhouse or theater, museum, or education institution or facility whose premises may sell alcoholic beverages but derives less than 20 percent of its total gross receipts from the sale of alcoholic beverages.

The Free Speech Coalition, an industry trade association, discussed in its 2007-08 State of the Industry Report, that there is very little raw data available to estimate the size of the adult entertainment industry. It discusses about the lack of an information system for tracking adult entertainment sales and that the majority of adult companies are privately held with no convincing reason to disclose their own sales data. The Adult Video News (AVN) Media Network, an adult entertainment trade publication, published an *Annual Survey of the U.S Adult Entertainment Industry* in 2006. In reference to adult entertainment retail sales estimates, most recent research or literature reviewed reference the 2006 AVN survey.

The following breakdown depicts 2006 US adult entertainment industry estimated sales.

**US Adult Industry Revenue Segments in 2006**

<b>Segment</b>	<b>Sales \$</b>
Video Sales Rental	\$3,622,000,000
Magazines	950,000,000
Novelties	1,725,000,000
Exotic Dance Club	2,000,000,000
Cable/PPV (TV)	1,745,000,000
Mobile	39,000,000
Internet	2,841,000,000
<b>Total</b>	<b>\$12,922,000,000</b>

**California Adult Entertainment Industry.** With the effective date being on or after October 1, 2009, and the most recent raw data being 2006 estimated sales, our revenue estimate analysis takes into consideration the California State Department of Finance (DOF) taxable sales forecast. According to DOF, taxable sales were down by -2.1% in FY 2007-08, are forecast to be down -12.6% in FY 2008-09 and down by -3.0% in FY 2009-10. Taxable sales revenues are expected to increase in FY 2010-11 by 5.1% and in FY 2011-12 to increase by 8.1%.

The Free Speech Coalition, in a 2006 industry report, indicated that during 2005 adult and mainstream video stores in the U.S reported a total of 957 million rentals of adult tapes and DVDs, almost all of which were produced in California. Further, it noted that AVN reported in 2003 that nearly 130 million of those rentals took place in California.

To give us an idea about California's market share based on the above statistic, it is estimated that California's share would be 14% (130 million rentals / 957 million rentals

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= 14%). For the other segments of the adult entertainment industry we used 12% for California's share of the industry.

Magazines are either sold by subscription (delivered by mail or common carrier) or at retail establishments. Based on the definition of *adult entertainment venue*, it is assumed that the proposed tax would only apply to magazines sold at retail establishments and not subscription sales. Based on a previous analysis of the magazine industry, we estimate 60% of adult entertainment magazines sales are via subscriptions. Therefore 60% of the adult entertainment magazine sales not subject to this proposed tax.

The California adult entertainment industry revenues for fiscal years 2009-10, 2010-11 and 2011-12, that are subject to this bill are provided in the following table:

Industry Segment	FY 2009-10	FY 2010-11	FY 2011-12
Video Sales Rental	\$421,000,000	\$ 442,000,000	\$ 478,000,000
Magazines	38,000,000	39,600,000	43,000,000
Novelties	172,000,000	181,000,000	195,000,000
Exotic Dance Club	199,000,000	209,000,000	226,000,000
Total	\$830,000,000	\$871,600,000	\$942,000,000

**REVENUE SUMMARY**

This bill would generate an estimated \$110 million in revenues in FY 2009-10. The following is a breakdown:

Industry	Proposed Revenues FY 2009-10	Tax %	State Revenue		
			10/1/2009 Start FY 2009-10 (in millions)	FY 2010-11	FY 2011-12
Video DVD Sales Rental	\$ 421	20%	\$ 63	\$ 88	\$ 96
Magazines	38	20%	6	8	9
Novelties	172	20%	26	36	39
Exotic Dance Club	100	20%	15	21	23
Total	\$ 731		\$ 110	\$ 153	\$ 167

**Qualifying Remark.** The industry segment revenue used for this revenue estimate reflects sales by all establishments. This bill exempts establishments whose gross receipts in relation to adult material sales do not exceed 50%. We do not know how much of these revenues would reflect such establishments.

In addition, with regard to exotic dance clubs, the industry data related to these establishments does not provide a breakdown between retail sales of tangible personal property (e.g., food, beverages, novelties) and cover charges. Further, we are not able to find sufficient data to estimate the amount of tangible personal property sold at these establishments.

As stated under Comment 3, cover charges that customers may recoup in food and beverages would be subject to the additional 20 percent tax (whether or not the customer recoups those charges). However, separate charges solely for admission or for a ticket to enter the establishment would not be subject to the additional tax. For purposes of this revenue estimate, we will use an order of magnitude. If we assume half of the total amount of the estimated revenue for exotic dance clubs is attributable to retail sales of tangible personal property, then the revenue generated for fiscal year 2009-10 would be \$110 million.

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