

**Add Revenue and Taxation Code Section 6018.11 to the Sales and Use Tax Law to provide that establishments that perform garment alterations are consumers, rather than retailers, of tangible personal property used or furnished by these establishments in the alteration of new and used clothing.**

**Source: Business Tax and Fee Department**

**Existing Law.** Existing law<sup>1</sup> imposes a sales tax on retailers for the privilege of selling tangible personal property, unless an exemption or exclusion applies. Under existing law, certain types of labor charges are subject to tax. Tax applies to charges for producing, fabricating, or processing tangible personal property for customers who furnish directly or indirectly the materials used in these activities.<sup>2</sup>

Sales and Use Tax Regulation 1524, *Manufacturers of Personal Property*, interprets and makes specific the Sales and Use Tax Law applicable to charges for alterations of new and used clothing.

**Alteration of new items, including clothing.** Alteration of new items includes any work performed on new items, such as garments, bedding, draperies, or other personal and household items, which involves adding or removing material from the item, rearranging, restyling or otherwise altering the item. Alterations such as these create or produce a new item or constitute a step in the creation or production of a new item for the customer. Charges for the alteration of new items are subject to tax, except as provided in RTC Section 6018.6 which provides that clothes cleaners and dyeing establishments (hereinafter “dry cleaners”) are consumers of property used or furnished in altering new or used clothing, provided that their alteration activities represent no more than 20% of their total gross receipts during the preceding calendar year.

Historically, the BOE has considered clothing a customer brings in to be new if it does not have hems or cuffs, store tags are still attached, or the item is clearly unworn or unused to the observer. The courts have validated this interpretation. In *Duffy v. State Board of Equalization* (1984) 152 Cal.App.3d 1156, the court held that charges for alterations to new clothing, furnished by the customer, constituted a step in the producing or fabricating of a product and were therefore taxable as sales. The court further stated that Regulation 1524, the BOE’s rulings, and judicial construction of Section 6006 (b) put the plaintiff on reasonable notice that he would be liable for sales tax on amounts collected for alterations to new clothing for customers who had purchased the clothing elsewhere and had not worn the clothing except for fitting.

**Alteration of used items, including clothing.** Alteration of used items includes mending, shortening, or lengthening, taking in or letting out, or otherwise altering used items such as garments, bedding, draperies, or other personal and household items when these alterations merely refit or repair the item for its originally intended use. Charges for the alteration of used items are not subject to tax. Generally, businesses altering used items are consumers, and not retailers, of the materials and supplies furnished in connection with the alterations. Tax applies to the sale of supplies and materials to these businesses.

**Alterations of clothing by dry cleaners.** RTC Section 6018.6 contains special provisions relating to dry cleaners charges for alterations. Unlike other garment-alteration establishments, the law states dry cleaners that provide garment alterations to new or used garments supply nontaxable services and accordingly, are the consumers of materials and supplies furnished or used in these services as long as the alteration activities represent no more than 20% of their total gross receipts during the preceding calendar year.

Section 6018.6 defines dry cleaners as those who (1) operate a location or locations as a pickup and delivery point for garment cleaning; or (2) provide spotting and pressing services on the premises, but not garment cleaning; or (3) operate a garment cleaning or dyeing plant on the premises. For the sales tax exclusion to apply, dry cleaners that meet one of these three criteria must also satisfy both of the following conditions:

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<sup>1</sup> Section 6051 of the Revenue and Taxation Code (RTC).

<sup>2</sup> Sections 6006, 6011, and 6012 of the RTC.

- 75% or more of the dry cleaner's total gross receipts must derive from their clothes cleaning or dyeing services, and
- No more than 20% of the dry cleaner's total gross receipts during the preceding calendar year may be derived from the alteration of new and used clothing.

Conversely, other garment-alteration establishments (i.e., tailors and dry cleaners who do not meet the threshold requirement in Section 6018.6) who perform garment alterations are considered retailers, and tax applies to their charges for alterations.

**The Issue.** This proposal stems from the BOE's interested parties process proposing to amend Regulation 1524, *Manufacturers of Personal Property*, to clarify the application of tax to alterations of new and used garments. During the process, representatives from the tailoring industry commented that distinguishing between new and used garments is too difficult for tailors. According to the representatives, customers remove the sales tags from the garments before bringing them in to be altered. Some customers will wait several months before having it altered.

In addition, representatives surveyed several tailors throughout California. The survey disclosed that some tailors charge tax on *all* alterations (new and used clothing), while others charged no tax because they were unaware of how tax applies to alterations and considered their alterations to be a nontaxable service rather than a sale.

Tailors argue that alterations for new and used garments should be treated the same. A simple alteration, such as hemming a pair of pants, does not create a new product. In addition, treating dry cleaners as consumers rather than retailers places tailors at a competitive disadvantage. Customers will choose dry cleaners where sales tax is not charged to hem a pair of pants over tailors that must charge and separately state sales tax for the alterations. This disparity in tax treatment confuses customers who do not understand why alterations in some instances are taxable and others are not.

**This Proposal.** Proposed RTC Section 6018.11 provides that a taxpayer who alters garments is the consumer of property used or furnished in altering new or used garments, provided that *all* of the following apply:

- 1) The alterations do not result in a new or different item.
- 2) The taxpayer was not the retailer of the garment when sold as a new item.
- 3) The taxpayer performing the alterations does not have a formal or informal agreement to perform alterations for a clothing retailer's customers.

Qualifying taxpayers' charges for alterations will not be subject to tax. Such taxpayers will be considered consumers of the supplies and other materials used in performing alterations of new and used garments, and tax applies instead to their purchase of supplies and other materials. Sales tax would not apply to their charges for alterations. However, these qualifying taxpayers will remain retailers when they sell miscellaneous items, such as lint brushes, collar stays, laundry bags, and stain protection products sold to customers in the regular course of business.

In addition, proposed Section 6018.11 specifies that a taxpayer who creates or fabricates new garments to a customer's specification or for retail sale is considered a retailer of those items and tax applies to their charges for labor and materials (i.e., creation of custom-made clothing sewn from scratch).

This proposed exemption would not apply to clothing retailers who perform alterations on items they sell. These taxpayers' charges for alterations would continue to be subject to tax.

**Revenue Impact.** According to IBISWorld's June 2016 Market Research Report, there were 25,900 businesses in the U.S. clothing alteration industry, with gross receipts of approximately \$1 billion. The report also states that over a five year period (2011 through 2016), the industry has experienced a 1.9%

annual growth. This industry provides garment repair, tailoring and clothing alteration services, which involves cutting, sewing, and reworking clothing items to customers' specifications (e.g., hemming and sleeve-shortening, waist adjustments, trousers and jeans hemming). The industry also provides care and maintenance to coats made from natural or faux leathers, suede, and fur. Industry participants may also provide limited garment cleaning services. This industry does NOT include dry cleaners or businesses engaged in clothing manufacturing.

Historically, California represents 12% of U.S. industry. Accordingly, California holds approximately 3,100 clothing alteration businesses (25,900 X 12%), with gross receipts of approximately \$120 million (\$1 billion X 12%).

This industry also performs maintenance to coats made from leathers, suede, and fur, plus limited garment cleaning services, and sells miscellaneous items such as lint brushes, specialty buttons, and stain protection products. Based on BOE staff research, staff believes that a reasonable assumption is that approximately 70% of gross receipts are attributable solely to alterations. Applying this percentage, staff calculates approximately \$84 million in gross receipts from alterations.

To adjust for alterations solely to new clothing, we examined a prior audit of a tailor. This audit determined that 60% of alteration charges were for new clothing. BOE staff estimates that alterations charges for new clothing may be in a range from 30% to 60%. Thus, the taxable sales that this proposal would exclude amount to approximately between \$25.2 million (\$84 million x 30%) to \$50.4 million (\$84 million X 60%), with an estimated annual revenue loss of between \$2 million (\$25.2 million x 8.21%) to \$4.1 million (\$50.4 million x 8.21% average sales tax rate).

*Section 6018.11 is added to the Revenue and Taxation Code to read:*

6018.11. (a) Any person who creates or fabricates new garments to a customer's specification or for retail sale is considered the retailer of those items and tax applies with respect to their sale.

(b) Any person who performs the alteration of garments shall be considered the consumer of, and not a retailer within the provisions of this part with respect to property used or furnished by that person in altering new or used clothing, provided that all of the following apply:

(1) The alteration does not result in a new or different item.

(2) The person or alteration establishment was not the retailer of the garment when sold as a new item.

(3) The person or alteration establishment performing the alterations does not have a formal or informal agreement to perform alterations for a clothing retailer's customers.

(c) Sales tax shall not apply to the charges for alterations specified in subdivision (b). However, that person is a retailer of any other tangible personal property sold to consumers in the regular course of business and sales tax shall apply to the gross receipts from those sales.

(d) For the purpose of this section:

(1) "Alteration" means mending, shortening, lengthening, taking in or letting out, adding or removing material, rearranging, or restyling, or otherwise altering of garments.

(2) "Formal agreement" means a contract to perform alterations of new items for customers of the retailer.

(3) "Informal agreement" means a verbal or written agreement between a person or alteration establishment whereby the person or alteration establishment offers a discount or preferential pricing to alter new items for customers of the retailer.

(4) "New garment" means a garment that was previously purchased somewhere else but not worn except for trying on or fitting.