To Fee or Not to Fee? San Diego's Processing Charge an Illegal Tax

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Introduction

The Fourth District Court of Appeal has ruled that a charge levied by the City of San Diego to administer a rental unit business tax program is a tax and not a fee.[1] Further, the court held that the levy is a new kind of general tax it captioned a "hybrid tax." The court's conclusion surprised even the plaintiffs, who argued that the charge was a special tax, and comes as bad news for local jurisdictions seeking to avoid voter approval requirements for the imposition of charges to cover program administration costs. By holding that the charge is a general tax, the court's decision offers a silver lining for the City of San Diego, since in an election, the imposition in question would require only a majority vote and not a two thirds vote as required for a special tax. The City has indicated it will appeal the decision to the California Supreme Court. Meanwhile, the Howard Jarvis Taxpayers Association has indicated it intends to use the decision to challenge other similar processing charges.

The Facts

Pursuant to its municipal code, the City imposes a tax on businesses, including owners of rental units, for the purpose of raising municipal revenues. In 2004, the City Council implemented a "business tax and rental unit tax processing fee," to offset the cost of administering the business tax program. The Council's resolution directed the City Manager to review the charge annually to ensure that "all reasonable costs incurred in providing services are being recovered." The City did not seek or obtain voter approval for the charge.

In 2005, plaintiff Weisblat, a rental unit owner, submitted a claim against the City seeking a refund, asserting that the charges were an illegal tax imposed without voter approval in violation of articles XIII A, C and D of the California Constitution and California Government Code section 50076. The City rejected the claim,

asserting the charge was a fee imposed for services provided to the taxpayer and for regulatory activities related to businesses that operated in the City. Plaintiff's lawsuit followed.

The plaintiff argued the charge was a special tax, not a fee, because:

- The revenue from the charge exceeded the reasonable cost of providing the service or regulatory activity for which the levy was imposed.
- The proceeds of the charge were being used for purposes in addition to collection of the business tax and accordingly, the charge exceeded the cost of the services provided.
- Activities related to collection of a tax were not a "service" since they provided no benefit to the payer.
- Activities related to collection of the business tax were not a "regulatory activity" that would justify concluding that the charge was a fee rather than a tax.

The trial court rejected these arguments and granted summary judgment in favor of the City, holding that the levy was not a special or general tax and was not a fee or charge "as an incident of property ownership" that was subject to property owner or other voter approval. Plaintiff's appeal ensued.

The Law

In determining whether the charge is a general or special tax, or a fee or assessment, the court relied on Proposition 13, which added article XIII A to the California Constitution in 1978, on Proposition 218, which added articles XIII C and D to the Constitution and on the cases interpreting them.

Proposition 13, among other things, imposed a two thirds vote requirement on "special taxes" enacted by local governments. After passage of Proposition 13, the Legislature enacted enabling legislation excluding from the term "special tax" any fee "which does not exceed the reasonable cost of providing the service or regulatory activity for which the fee is charged and which is not levied for general revenue purposes."

In 1996, the voters added articles XIII C and D to the California Constitution by approving Proposition 218, providing further definitional guidance. Article XIII C defines a general tax as "any tax imposed for general governmental purposes"[2] and a special tax as "any tax imposed for specific purposes" even if the proceeds are deposited in the general fund.[3] Article XIII D addresses "assessments, fees and charges."[4] Fees and charges, essentially interchangeable terms, are defined as "any levy other than an ad valorem tax, a special tax, or an assessment, imposed by an agency upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service."[5]

To the extent a fee or charge is imposed as an *incident of property ownership* or is for a *property related service*, it is subject to voter approval and related requirements in article XIII D. Other fees, such as regulatory fees that are not property related, are not subject to those requirements.

The *Sinclair Paint* decision defined a special tax as a tax levied for a special purpose as opposed to tax levies placed in the general fund to be used for general governmental purposes[6] and established general guidelines for determining whether an imposition was a tax or a fee.[7] In order for a charge to qualify as a regulatory fee, the court suggested the government needed to demonstrate that the charges levied on a payer bear a "fair or reasonable relationship to the payer's burdens on or benefits from the regulatory activity."[8]

The *Sinclair Paint* court also adopted a "primary purpose" test, stating that if the primary purpose of the imposition is revenue generation and regulation is merely incidental, the imposition is a tax. However, if regulation is the primary purpose, the mere fact that revenue is also obtained does not make the imposition a tax.[9]

The Decision

In finding against the City, the court focused on the purpose of the imposition as a revenue generator, referencing the City's resolution adopting the charge and noting the City unambiguously cited business tax collection cost recovery as the purpose of the charge. The court rejected the City's argument that the charge was a regulatory fee attendant to City staff carrying out its regulatory activities, concluding that nothing in connection with the tax regulation and collection activity served any purpose that either benefitted the taxpayer or provided any permit or governmental privilege in return for payment of the charge.

Conceding that the distinction between a regulatory fee and a tax was sometimes "blurry," the court concluded that under the primary purpose test stated in *Sinclair Paint,* the charge was primarily for revenue generation and that any arguable regulatory purpose was merely incidental.

Since the court concluded the charge was a tax and not a fee, addressing the issue of whether the charge was a property-related fee subject to the requirements of article XIII D was unnecessary.

While the court's analysis up to this point is supportable under applicable law, the conclusion that the tax was a general and not a special tax surprised even the plaintiff, who argued the imposition, clearly for a special and limited purpose, was therefore clearly a special and not a general tax.

In finding the tax was general and not special, the court articulated a new tax category, the "hybrid tax."[10] In defining this new concept, the court concluded that although the charge in question was not available for expenditure for "any and all governmental purposes," it indirectly made funds available for general governmental purposes since it raised funds to pay costs related to collecting the business tax, thus making funds previously used for that purpose available for other general governmental purposes.

Comment and Conclusion

In its broadest application, the decision potentially undermines the concept of both the regulatory fee and the special tax. In respect to the "blurry" distinction between special taxes and regulatory fees, the decision is a cautionary message to local governments: be careful to establish the regulatory benefits of new charges as their primary purpose, as opposed to any incidental revenue that the charges might generate.

The "hybrid tax" construct potentially eliminates the distinction between special and general taxes, since any special tax potentially relieves the general fund of some fiscal obligation and thus "indirectly" makes money that was otherwise to be used for the special purpose available for general fund purposes.

The "hybrid tax" construct is not entirely bad news for local governments, however. To the extent that a local government can conclude a tax is general and not special, the government's burden to achieve a two thirds vote approval is relieved. Of course, from a local government's perspective, concluding the imposition is a regulatory fee is always the best solution.

The City has indicated that it will appeal the decision. Local governments will be interested to see if the Supreme Court takes the appeal, and if it does how it will deal with this novel approach.

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[1] *Weisblat v. City of San Diego* (August 18, 2009, D052787), _____ Cal. App. 4th _____) *(*hereinafter *Weisblat).*

[2] Article XIII C, section 2, subd. (a).

[3] Article XIII C, section 1, subd. (d).

[4] Article XIII D, section 1.

[5] Article XIII D, section 2, subd. (e).

[6] *Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866 (hereinafter *Sinclair Paint*).

[7] The Sinclair Paint decision identifies at least three classes of fees: (i) *fees* based on the value of benefits conferred on property; (ii) *development fees* exacted in return for a permit or other government privilege; and (iii) *regulatory fees* imposed under the police power. *Sinclair Paint*, *supra,* 15 Cal.4th at p.874.

[8] *Sinclair Paint*, *supra,* 15 Cal.4th at p.878.

[9] *Sinclair Paint*, *supra,* 15 Cal.4th at p.880.

[10] Like the hybrid car, an idea not yet universally embraced.