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ADMINISTRATIVE FEE FOR TAX COLLECTION IS AN UNCONSTITUTIONAL HIDDEN TAX

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In 1997, in an attempt to clarify the sometimes blurry distinction between a government “fee” and a government “tax,” the California Supreme Court explained that “taxes are imposed for revenue purposes, rather than in return for a specific benefit conferred or a privilege granted.” (*Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866, 874.) Recently, on August 18, 2009, California’s Fourth Appellate District Court further clarified the distinction in *Weisblat, et al., v. City of San Diego* (Super. Ct. No. GIC871893). The issue was whether the City of San Diego’s “Tax Collection Fee” charged to landowners to cover the expense of collecting and administering the City’s rental unit business tax was, in fact, a general tax. The court held that it was a general tax because the purpose of the Tax Collection Fee was not to provide a government service to landlords (such as building inspection), but rather to facilitate the City’s general tax collection efforts (processing rental tax applications, answering taxpayer questions, and generating and mailing out billing statements to collect the rental tax). As a general tax, the court voided the Tax Collection Fee because the City Council levied it in 2004 without approval of a majority of qualified voters in the City as required by the California Constitution. The City’s underlying rental unit business tax, which was established in 1942 and generates \$11 million annually, was not challenged and remains in effect.

In its holding, the court rejected three City arguments that the Tax Collection Fee was a fee that required no voter approval. First, the City claimed that the Tax Collection Fee afforded a specific benefit to landlords because it funded a courtesy billing notice that helped landlords avoid penalties for failure to timely register their rental businesses. The court disagreed finding that the central purpose of such notices was to facilitate collection of the rental unit business tax. Assisting landlords in avoiding penalties was only an incidental benefit. The court looked to the City’s resolution approving the Tax Collection Fee, which stated that its purpose was “to recover costs associated with processing applications and renewals for [rental unit business tax certificates].”

Second, the City claimed the Tax Collection Fee funded regulatory activities, noting the Supreme Court’s pronouncement that “all regulatory fees are necessarily aimed at raising ‘revenue’ to defray the cost of the regulatory program in question, but that fact does not automatically render those fees ‘taxes.’” (*Sinclair Paint, supra*, at pp. 876, 880). A City employee for the City’s tax department provided a declaration that the Tax Collection Fee funded 22 full-time employees who provided tax and regulatory services. However, the

Court of Appeals disagreed, noting the Supreme Court’s “primary purpose” test for determining whether a regulatory fee should be deemed a tax:

[I]f revenue is the primary purpose, and regulation is merely incidental, the imposition is a tax, but if regulation is the primary purpose, the mere fact that revenue is also obtained does not make the imposition a tax. (*Sinclair Paint, supra*, at p. 880.)

Here, the court found that the City provided no details about how its services regulated the conduct of any person. Furthermore, the City staff report recommended the City Council adopt the fee “as one of the solutions to offset the \$17.3 million State budget reduction.” As such, the Court of Appeals found that the primary purpose was to raise revenue, not to regulate.

Third, the City claimed that the Tax Collection Fee fell within the provision of Government Code § 50076 which provides that a fee may be treated as a special tax only when (1) the fee exceeds “the reasonable cost of providing the *service or regulatory activity* for which it is charged,” and (or) (2) the fee is levied for “general revenue purposes.” (Gov’t Code § 50076, italics added; [citation omitted].) The Court of Appeal disagreed holding that Government Code § 50076 only applied where the fee is imposed to provide either a service or a regulatory activity. In this case the record was clear that the primary purpose of the Tax Collection Fee was to raise revenue, not to provide a service or regulate activity.

Having determined that the Tax Collection Fee was a tax, the Court of Appeal then held that it was a general tax requiring approval of a majority of eligible voters under California’s Constitution,^[1] instead of a special tax (a tax levied for specific purposes) that would have required two-thirds voter approval.^[2] These constitutional requirements were created in 1996 via Proposition 218 in a statewide taxpayer revolt against rising local government fees. The court found that the Tax Collection Fee had special tax characteristics because it was tracked in accounts separate from other tax receipts in the General Fund, monitored annually to ensure it did not exceed the cost of the City’s Business Tax program, and served a specific purpose. However, because the rental unit business tax was a general tax used to raise revenue for the General Fund, which could be used for any and all governmental purposes, the court held that the Tax Collection Fee indirectly raised revenue for the General Fund, making it a general tax. The court remanded the matter back to the trial court to rule on Weisblat’s motion to order a refund of the fees collected.

At a time when local government budget shortfalls (exacerbated by State budget cutbacks) force hard choices between less government spending and raising revenue, this case clarifies the procedures local governments must follow when opting to raise revenue. Understanding and properly identifying taxes versus fees improves transparency, helps the taxpayer know where money is being spent, and assists government

officials in making informed choices about the level of public support needed for revenue increases. In this case, a tax was levied on landlords within the City to provide benefits to society at large without an electoral-level debate or voter consent. Likewise, the City Council voted without knowing whether voters agreed that this group should be targeted to provide general benefits for all.

During such voter debates, government officials have the opportunity to vet the fairness and efficiency of such measures. For example, the City estimated the cost of collecting and administering the rental unit business tax was \$3.5 million a year (\$25 per landlord, later reduced to \$15 per landlord). Therefore, at the time it was adopted, the City was spending \$3.5 million to collect only \$11 million for the City's General Fund -- an inefficiency rate of 31.8 cents per tax dollar. In contrast, the IRS in 2006 spent approximately \$10 billion to collect \$1.236 trillion in individual income tax -- an inefficiency rate of only 0.8 cents per tax dollar.^[3] If the Tax Collection Fee had been properly labeled a tax, voters could have questioned whether or not (1) it was appropriate to target landlords; and (2) it was an efficient means of raising General Fund revenue. However, the cost of seeking voter approval to raise only \$3.5 million, even if successful, would have exacerbated this already high inefficiency rate.

To the extent local governments believe they are not collecting fees that fully recover the cost of services they provide to a discrete group, *Weisblat v. City of San Diego* highlights the importance of identifying the primary purpose of imposing a fee, the specific benefit provided to the group, and some details on the group's exact conduct the fee proposes to regulate. California's courts are increasingly looking past the label given a fee or tax to determine the true nature of revenue-raising measures. Due to the fact that valid fees, special taxes or general taxes are each established through different procedures, understanding the nature of the revenue-raiser at the outset is critical. Whether a local agency or a regulated entity, consulting legal counsel can assist greatly in navigating the web of constitutional, state, and local rules and court opinions that govern the process of raising government revenue in California. The pressure to raise revenue to cover budget gaps without evoking a new tax revolt is growing in these economic times, which creates a strong incentive to label every revenue increase a fee regardless of its true nature. Traps abound for unwary local governments and taxpayers alike.

A copy of the case is available through our offices, or at the following site:

<http://www.courtinfo.ca.gov/opinions/documents/D052787.PDF>

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[1] Art. 13C, § 2, subd.(b)

[2] Art. 13C, § 2, subd.(d)

[3] Joseph Henschman and Travis Greaves, *Charging Taxpayers for Tax Collection Is a Tax: Weisblat v. City of San Diego*, Taxpayer Foundation Fiscal Fact No. 160 (February 2009).