California Cities To Tax Streaming Video?

By Michael J. Cataldo

Many cities in California are considering the expansion of their Utility User Tax (UUT) to streaming video services. Such an expansion may be inconsistent with the cities' existing ordinances, be invalid under Proposition 218 and the Internet Tax Freedom Act, and raise constitutional nexus and fair apportionment issues.

Background

Over 150 California cities impose a UUT on consumers of traditional utilities such as gas, electric, telephone, water or cable services.[1] Until recently, most UUT ordinances date from a model ordinance developed by the League of California Cities in the 1980s which did not reflect technological advancements, such as cell phones, Voice over Internet Protocol (VoIP) and the internet.[2]

Originally, most UUT provisions exempted telephone charges that were not subject to the federal excise tax (FET). This was not controversial before the advent of cell phones. However, the FET exclusion became very significant when the Internal Revenue Service conceded after years of litigation that most cell phone calls were in fact not subject to the FET because cell phone charges were not based on both time and distance.[3] Existing UUT ordinances on cable services were also becoming outdated because of the convergence of voice, data, video and other services offered through broadband by both traditional cable and telephone companies.[4] As a result, many cities sought and secured voter approval through ballot measures to eliminate reference to the FET, and to "modernize" their UUT ordinances to capture charges

[1] As of July 2015, 162 California municipalities impose a UUT, 154 of which impose their UUT on telephone services, and 90 on cable. See http://www.californiacityfinance.com/UUTfacts15.pdf.

[2] See https://ballotpedia.org/California_Utility_User_Taxes and http://www.cacities.org/getattachment/a44425c7-7efe-4e76-8560-a88372bb61a6/LR-Maynor-1-29-Prop-218-and-UUT-Ord-Pa.

[3] IRS Notice 2006-50. Since most cell phone companies charged either a flat monthly fee or a fee based on time, but not distance, those charges escaped FET. The California Supreme Court has authorized class action lawsuits against Los Angeles and Long Beach to recover UUT paid on charges not subject to FET. *Ardon v. City of Los Angeles*, 52 Cal.4th 241 (2011) and *McWilliams v. City of Long Beach*, 56 Cal.4th 613 (2013). Los Angeles has offered to settle the case, but denies that the UUT was improperly collected. See https://www.lataxrefund.com/Home.aspx

[4] City of Santa Barbara Council Agenda Report on proposed UUT ballot measure, June 24, 2008, p. 4.

for telecommunications and video services, "regardless of the technology used" to deliver those services, including cell phones, VoIP and broadband.[5]

Video Services

Roughly 40 cities have updated their UUT ordinances to subject "video services" to UUT and require video service suppliers to collect UUT from customers on charges for "video services." The following definitions have been adopted by most of these cities through voter-approved measures:[6]

> "Video services" means any and all services related to the providing or delivering of "video programming" (including origination programming and programming using Internet Protocol, *e.g.,* IP-TV and IP-Video) using one or more channels by a "video service supplier", regardless of the technology used to deliver or provide such services . . ..
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> "Video programming" means those programming services commonly provided to subscribers by a "video service supplier" including but not limited to basic services, premium services, audio services, video games, pay-per-view services, video on demand, origination programming, or any other similar services, regardless of the content of such video programming, or the technology used to deliver such services . . ..
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> "Video service supplier" means any person, company, or service which provides or sells one or more channels of video programming . . . [and] includes, but is not limited to, multichannel video programming distributors [as defined in *47 U.S.C.A. Section 522(13)*]; open video systems (OVS) suppliers; and suppliers of cable television; master antenna television; satellite master antenna television; multichannel multipoint distribution services (MMDS); video services using internet protocol (*e.g.*, IP-TV and IP-Video, which provide, among other things, broadcasting and video on demand), direct broadcast satellite to the extent federal law permits taxation of its video services, now or in the future; and other suppliers of video programming or communications (including two-way communications), whatever their technology.

The Streaming Video Ruling

MuniServices, a for-profit firm which provides revenue enhancement services to municipalities has recently provided a draft ruling (Ruling) for a coalition of the cities imposing UUT on "video services," interpreting that term to include streaming video (referred to in the Ruling as "over-the-top television" or "OTT").[7] The

[5] Not all cities that updated their UUT ordinances chose to tax video services. For example, San Francisco voters approved Proposition O in 2008 to amend the city's UUT ordinance, but those amendments explicitly exclude from UUT "video programming services, and digital downloads, such as downloads of books, music, video, ringtones, games and similar digital products." (See San Francisco Municipal Code section 701(j).) In contrast, roughly 40 other cities adopted UUT on video services through voter-approved measures. In some cases, a city's existing ordinance already subjected traditional cable services to the UUT, and the city adopted amendments to also subject to tax "video services" delivered by broadband. (See, e.g., Glendale Municipal Code section 4.36.060; Santa Monica Municipal Code section 6.72.050.)

[6] See, e.g., Benicia Municipal Code section 3.26.030; Indio Municipal Code section 34.150(v); Glendale Municipal Code section 4.38.010; Pico Rivera Municipal Code section 3.50.020(v); San Bernardino Municipal Code section 3.46.020(W).

[7] Of all the California cities imposing a UUT, more than half are represented by MuniServices, which for many years has advised cities on how to enact and/or amend UUT ordinances (including the voter-approved amendments described above), while also performing UUT audits and collection services for the cities, usually on a contingency-fee basis. See http://www.uutinfo.org/table/Summary_Listing.htm for a list of cities represented by MuniServices.

cities of Benicia, Indio, and Pasadena actually adopted the Ruling in August and September of 2016.[8] Indio and Pasadena have since withdrawn or suspended application of the Ruling.[9] Benicia has yet to announce whether it will follow the lead of Indio and Pasadena and withdraw or suspend the Ruling. The Ruling provides that "video services" are subject to tax:

> regardless of the technology used to deliver such services, including but not limited to such technologies as cable, IP-TV, wireless, and others [including over the top TV (OTT) which is simply the delivery of video programming via a broadband or internet connection whether it is wired, wireless, microwave or any other technology used to access the internet.]

The Ruling states that the tax on “video services” “shall be collected and remitted to the City by all “video service suppliers” providing such “video services” to customers in the City, including service suppliers using cable, wireless, IP-TV, and other internet-based distributors (including OTT).” The Ruling identifies specific streaming video service suppliers, including Netflix, Hulu, Apple TV, Amazon Video and several others, and states that it shall be implemented by no later than January 1, 2017 for service suppliers that do not have a state or local cable franchise, and as of the effective date of the ordinance for those that do.

This attempted expansion of the UUT to tax streaming video may be invalid for several reasons, including the following:

(1) Doing so by administrative ruling may be inconsistent with a city’s existing ordinances;

(2) Expanding the UUT by administrative ruling without voter approval may violate Proposition 218;

(3) Subjecting streaming video to UUT may violate the nondiscrimination provisions of the Internet Tax Freedom Act (ITFA);

(4) Requiring a video streaming service supplier to collect the UUT may violate the Due Process Clause because of the absence of sufficient contacts with the particular city; and

(5) Imposition of the UUT on streaming video may violate the Commerce Clause because of the absence of the requisite substantial nexus between the service supplier and the city, and because the tax is not fairly apportioned.

[8] Benicia, Indio, and Pasadena adopted the Ruling on August 23, 2016, August 29, 2016, and September 22, 2016, respectively.

[9] In an October 13, 2016 email to the author, Rob Rockwell, City of Indio Finance Director stated that the City has suspended the Ruling pending further discussions with representatives of the OTT industry. The Pasadena City Manager stated in a letter to the City Council dated September 29, 2016, that “[t]he City is not presently adopting nor applying an administrative ruling that would tax OTT services,” and that “whether an administrative ruling is ultimately adopted in Pasadena will come only after a full and complete review of the matter, including a review of the City's underlying ordinance and ballot measure; monitoring other cities' activities in seeking to apply a video tax on OTT services, including litigation, if any; updates from MuniServices, the City's UUT consultant; updates from other experts in the field, and advice of counsel. When, and if, the City were to adopt the position that OTT services are subject to the video tax under the existing UUT ordinance, it will advise the City Council, the public and OTT providers of the decision well in advance of any assessment.”

The Ruling May Be Inconsistent with a City's Ordinances

It is well-settled that a rule or regulation that alters or enlarges the terms of a legislative enactment is invalid.[10] If a city attempts to expand its UUT to streaming video by adoption of the Ruling (or similar administrative guidance), doing so may impermissibly alter or enlarge the language of a city's ordinance by adding that "video services" provided by a "video services supplier" include OTT services (i.e. streaming video). The ordinances define "video services" as "'video programming' using one or more channels by a 'video service supplier,'" and a "video service supplier" as a person providing "one or more channels of video programming." Since streaming video suppliers do not provide "channels of video programming" under the plain language of most UUT ordinances, they should not be required to collect the UUT on charges for streaming video services.

While the cities' ordinances do not define "channels of video programming," it may be instructive to consider a recent ruling from the Kentucky Board of Tax Appeals (BTA), which found Netflix streaming video services were not a "multichannel video programming service."[11] A "multichannel video programming service" is defined under Kentucky law as "programming provided by or generally considered comparable to programming provided by a television broadcast station." The BTA found that Netflix streaming video services were not comparable to programming of a television broadcast station because, unlike television broadcasts, Netflix's streaming video services do not offer live programming or have a schedule for when shows are aired.

The cities might argue that the Ruling is an administrative interpretation that is consistent with the broadly drafted ordinance provisions (i.e., video services are subject to tax "regardless of the technology used to deliver or provide such services"). If the ordinance is ambiguous, a court may give deference to a city's interpretation,[12] or it may look to evidence of the voter's intent to approve amendments to subject "video services" to tax.[13] A good example of evidence that the voters may not have intended to subject streaming video to tax in the City of Alameda can be found in the city's response to its own "Frequently Asked Questions" about the Utility Modernization Act Measure K1, which was approved by a majority of voters on November 8, 2016. The FAQ states:[14]

> **Will the Utility Modernization Act tax Netflix and other streaming services?**
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> No. The City is updating language in order to restore revenues that are being lost as people shift from land lines to cell phones. If in the future there is another shift to an emerging technology, the updated language would allow the City to determine if a change should be considered. At this time the City has no intentions to change the tax except to ensure that it is being applied correctly and fairly by all cell phone providers.

Intent of the voters may also be derived from the circumstances when the ordinance amendments were presented to the voters. At the time many of the ordinances were amended to subject "video services" to tax, the cities were concerned that their existing UUT ordinances on cable services were outdated because of the convergence of voice, data, video and other services offered through broadband by traditional cable

[10] *Whitcomb Hotel, Inc. v. Cal. Emp. Comm'n*, 24 Cal.2d 753, 757 (1944).

[11] *Netflix, Inc. v. Kentucky Finance and Administration Department of Revenue*, K13-R-31; K13-R-32, Kentucky Board of Tax Appeals, Order No. K-24900 (Sept. 23, 2015).

[12] *Yamaha Corp. v. State Bd. of Equalization*, 19 Cal.4th 1, 3-4 (1998).

[13] *Silicon Valley Taxpayers Assn., Inc. v. Santa Clara County Open Space Authority*, 44 Cal.4th 431, 445 (2008).

[14] See https://alamedaca.gov/sites/default/files/document-files/files-inserted/revised_uma_faq_103116.pdf

and telephone companies.[15] Since streaming video was either nonexistent or not widely used at that time suggests the voters did not intend to tax it.

Expansion of the UUT to Streaming Video by Administrative Ruling May Violate Proposition 218

Proposition 218 requires any local tax increase to be approved by a majority of the voters.[16] Thereunder, a tax is "increased" if a city either "(1) increases any applicable rate used to calculate the tax; or (2) revises the methodology by which the tax is calculated if that revision results in an increased amount being levied on any person or parcel."[17] A tax is not "increased" if a city "implements or collects a previously approved tax...so long as the rate is not increased beyond the level previously approved by the agency, and the methodology previously approved by the agency is not revised so as to result in an increase in the amount being levied on any person or parcel.[18]

MuniServices has suggested that violations of Proposition 218 might be avoided by merely placing a provision in the UUT ordinance that authorizes the city's tax administrator to periodically issue "administrative rulings" to address questions of tax applicability of new utility services and charges.[19] It is questionable whether the cities could avoid application of Proposition 218 by doing so, particularly in light of the ruling in *AB Cellular LA, LLC* v. *City of Los Angeles*.[20]

In *AB Cellular,* Los Angeles sought to unilaterally apply the Federal Mobile Telecommunications Sourcing Act (MTSA)[21] to source cell phone charges to the city subject to its UUT. Before enactment of the MTSA, the city's ordinance did not contain an explicit sourcing provision, so it administered the tax in accordance with the U.S. Supreme Court's holding in *Goldberg v Sweet*,[22] which held that a local taxing jurisdiction may only subject a call to tax under the Commerce Clause of the U.S. Constitution if the call either originated or terminated within the taxing jurisdiction, and the customer's billing address was in the jurisdiction.[23]

Once Congress passed the MTSA, the jurisdictional limitation imposed by *Goldberg* was removed for mobile telephone calls, and allowed cities to tax mobile calls if the service address of the customer was in the city. Los Angeles did so by informal guidance and argued that since a federal law (the MTSA) removed a barrier to subjecting mobile telephone calls to tax, that it was entitled to adopt the MTSA sourcing provisions without voter approval. The court disagreed, finding that imposition of the MTSA sourcing provisions was a "change of methodology" resulting in increased tax and therefore required voter approval under Proposition 218. The court stated that "[c]ontrary to the City's position, a local government's methodology cannot evolve — even if it is due to external factors such as the MTSA — and avoid

[15] City of Santa Barbara Council Agenda Report on proposed UUT ballot measure, June 24, 2008, p. 4.

[16] Proposition 218 added Article XIII.C to the California Constitution.

[17] Government Code section 53750(h)(1).

[18] Government Code section 53750(h)(2)(B).

[19] MuniServices Policy Update, November 15, 2016, which may be accessed at http://www.muniservices.com/wp-content/uploads/111516_MuniServices_Policy_Update_Administrative_Ruling_Background_OTT_-Media_Edition_and_Contact-.pdf. See also http://www.cacities.org/getattachment/a44425c7-7efe-4e76-8560-a88372bb61a6/LR-Maynor-1-29-Prop-218-and-UUT-Ord-Pa. MuniServices acknowledges in its Policy Update that "the action of the local tax administrator of applying and interpreting the existing local law to a particular service, must be done in a manner that is consistent with the requirements of Proposition 218."

[20] *AB Cellular LA, LLC v. City of Los Angeles*, 150 Cal.App.4th 747 (2007).

[21] Public Law No. 106-252 (July 28, 2000).

[22] *Goldberg v. Sweet*, 488 U.S. 252 (1989).

[23] *Id.* at 263.

submitting it to voter approval. . . . [I]t does not matter for purposes of Proposition 218 that taxation law lags behind but eventually adapts to technology. The people want a say in how tax law adapts, if at all."[24]

If a city attempts to expand its UUT to streaming video by administrative ruling, this may be considered a "tax increase" subject to voter approval under Proposition 218 – even if the objective of the Ruling is to adopt the ordinance to current technology.[25]

Subjecting Streaming Video Services to UUT May Violate the Internet Tax Freedom Act

The Howard Jarvis Taxpayers Association as well as industry trade groups such as the Internet Association have stated that imposing the UUT on streaming video may violate the ITFA, which prohibits "discriminatory taxes on electronic commerce."[26] Under the ITFA, a "discriminatory tax" is one that "is not generally imposed . . . on transactions involving similar property, goods, services, or information accomplished through other means."[27] "Electronic commerce" is defined as "any transaction conducted over the Internet or through Internet access comprising the sale, lease, license, offer, or delivery of property, goods, services, or information . . ."[28]

Recently, the Illinois Supreme Court held that Illinois' "click through nexus" law discriminated against electronic commerce in violation of the ITFA.[29] In so doing, the court stated that "performance marketing over the Internet provides the basis for imposing a use tax collection obligation on an out-of-state retailer when a threshold of $10,000 in sales through the clickable link is reached. However, national, or international, performance marketing by an out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois, and which reaches the same dollar threshold, will not trigger an Illinois use tax collection obligation."[30]

Since video purchased in tangible form (i.e., DVD), is not subject to the UUT, subjecting video services delivered over the internet to tax may violate the anti-discrimination provision of the ITFA because DVDs are "similar property, goods, services, or information" which allow consumers to view videos through means other than via the internet.

Requiring Video Streaming Service Suppliers to Collect UUT May Violate the Due Process Clause

A business may be subject to taxation under the Due Process Clause if it purposefully avails itself of the benefits of an economic market in the taxing state.[31] The Due Process Clause "requires some definite link" between a jurisdiction and the person, property or transaction it seeks to tax, and that the income attributed to that jurisdiction must be rationally related to values connected with the taxing jurisdiction.[32]

[24] *AB Cellular*, *supra*, at 756, fn. 8.

[25] In resolutions to place Measures K1 and K on the Alameda and Watsonville November 8, 2016 ballots, the City Councils recognized that Proposition 218 requires such changes be approved by a majority of voters. See https://alamedaca.gov/sites/default/files/document-files/files-inserted/resolution_15183.pdf, and http://www.votescount.com/Portals/16/nov16/Utility%20Users%20Tax%20Measure%20Resolution%20113-16.pdf.

[26] ITFA section 1101(a)(2).

[27] ITFA section 1105(2)(A)(i).

[28] ITFA section 1105(3).

[29] *Performance Marketing Ass'n v. Hamer*, 998 N.E.2d 54 (2013).

[30] *Id.* at 59.

[31] *Burger King Corp. v. Rudzewicz*, 471 U. S. 462, 476 (1985).

[32] *Quill Corp. v North Dakota*, 504 U.S. 298, 306 (1992).

A streaming video service supplier may not have "purposefully availed" itself of a city's economic market or established the "necessary link" with a city to satisfy due process simply by having a customer in the city. For example, a customer may register for streaming video services while residing in a city that has no UUT, but subsequently moves into a city with a UUT imposed on streaming video. The streaming video service supplier may not even be aware of the new city, much less "purposefully availed" itself of that city's market.

Imposition of the UUT on Streaming Video May Violate the Commerce Clause

A tax may only be imposed under the Commerce Clause if it is "applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[33] Imposition of UUT on streaming video may not satisfy either substantial nexus or fair apportionment.

The Supreme Court in *Quill*, held that an out-of-state vendor must have an *in-state physical presence* to be required to collect use tax under the substantial nexus prong of *Complete Auto*.[34] If video streaming is subject to UUT, cities may not be able to require streaming video service suppliers without a physical presence in the city to collect the UUT from their customers under *Quill*.

A tax is fairly apportioned if it is internally and externally consistent.[35] To be internally consistent, a tax must be structured so that if every jurisdiction were to impose an identical tax, no multiple taxation would result.[36] The external consistency test asks whether the jurisdiction has taxed only that portion of the revenues which reasonably reflects the extent of activities being conducted in the taxing jurisdiction.[37] Under *Goldberg*, for a jurisdiction to subject an interstate telephone call to a fairly apportioned telecommunications tax, the call must either originate or terminate within the taxing jurisdiction, and the customer's service address must also be in the taxing jurisdiction.[38]

Many UUT ordinances source video services to a customer's service address, which is the location of the customer's equipment from which the video services originate or terminate, or if that location is unknown (e.g., mobile devices), to the customer's billing address.[39]

The typical UUT sourcing ordinances fall short of the *Goldberg* standard by taxing receipts where the location of the equipment is unknown (e.g., mobile devices) based solely on the customer's billing address, without regard to where the service originates or terminates.[40] Where the location of the equipment is

[33] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[34] *Quill*, *supra*, at 317.

[35] *Container Corp. of America v. Franchise Tax Bd.*, 463 U. S. 159, 169 (1983).

[36] *Id*.

[37] *Id.*

[38] *Goldberg*, *supra*, at 263.

[39] See, e.g., Benicia Municipal Code section 3.26.050(A); Indio City Municipal Code section 34.154(A); Glendale Municipal Code section 4.38.020; Pico Rivera Municipal Code section 3.50.040; San Bernardino Municipal Code section 3.46.040.

[40] Some city ordinances may not contain an explicit sourcing rule for video services. For example, Pasadena simply imposes its tax on every person "using video services in the city from a video service supplier," but does not provide how charges for those services are apportioned. (See Pasadena Municipal Code section 4.56.070.) Failure to provide any apportionment mechanism for taxing video services violates the fair apportionment requirement, and Pasadena may not be able to reform its ordinance to provide an apportionment mechanism. (*See Ventas Finance I, LLC, v. Franchise Tax Board*, 165 Cal. App.4th 1207, 1214 (2008) (unapportioned tax on the gross income of limited liability companies could not be reformed to include an apportionment mechanism.)) If Pasadena wishes to amend its UUT ordinance to add an explicit sourcing rule, it may not be able to do so under Proposition 218 without securing a majority vote of the electorate. (*See AB Cellular LA, LLC*, *supra*, at

known, taxing such receipts where the video services originate or terminate may violate the internal consistency test, since more than 100 percent of the receipts could be subject to UUT if all cities imposing a UUT on video services applied the above sourcing rule. David Kline of the California Taxpayers Association asked "what if someone goes on vacation out of town and uses Netflix at their hotel? Are you still going to tax them?"[41] Kline's question is a good illustration of the types of problems under the Commerce Clause a city might have to confront if it were to apply these sourcing rules.

Conclusion

If California cities decide to tax streaming video, they may face significant obstacles under California and federal law. An administrative ruling extending UUT to streaming video services may be inconsistent with a city's current UUT ordinances and violate Proposition 218. Even if voter approval is secured to amend the UUT ordinances to explicitly subject streaming video services to UUT, those ordinances may nevertheless violate the ITFA and the Due Process and Commerce Clauses.

This material is not intended to constitute a complete analysis of all tax considerations Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.

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150 Cal.App.4th 747 (Los Angeles could not adopt the federal MTSA to apportion cell phone charges subject to its UUT without voter approval.))

[41] http://www.latimes.com/business/la-fi-agenda-netflix-tax-20161003-snap-story.html