August 30, 1995

REPORT TO THE HONORABLE
MAYOR AND CITY COUNCIL

AMENDMENT TO RENTAL UNIT BUSINESS TAX

INTRODUCTION

We are bringing this report to you to express our concern about the proposed amendment to San Diego Municipal Code (SDMC) section 31.0305. That section imposes a business tax on the rental of residential property. The amendment would allow owners of eight or more rental properties to consolidate all of their properties and obtain a single, consolidated business tax assessment. Owners of seven or fewer properties would remain subject to separate tax assessments for each of their properties.

We believe that the proposed amendment would be fundamentally unfair to owners of seven or fewer properties. As an example, an owner of seven condominiums would pay a total of $385 in tax but an owner of ten would only pay $100 in tax (rather than $550). This tax scheme would violate basic tax and equal protection principles. For these reasons, we can only approve the proposed ordinance as to form but not as to legality.

We have, however, drafted two alternatives that are approved as to form and legality, and offer them for your consideration. The alternatives provide either a consolidation for all properties or consolidation over a given number, for example seven. Under this latter tax scheme, both the owner of seven and the owner of ten condominiums would pay $385 for the first seven properties, but the owner of the ten would only pay an additional $65 for the last three consolidated properties (as opposed to $165).

BACKGROUND

In general, the rental unit business tax, codified at SDMC section 31.0305, provides that an owner of rental property receive a tax assessment for each "property" that has a separate County Tax Assessor parcel number. A sliding scale for the tax is used, based upon the number of units rented.F

For up to ten units, $50 per property and $5 per unit is assessed. For eleven to one hundred units, $57 per property and $9 per unit is assessed. For more than one hundred units, $150 per property and $8 per unit is assessed. Hotels and motels receive different treatment and are not addressed in this Report.

By way of example, a single family dwelling would be assessed a total of $55; $50.00 for the property and $5 for the single unit on that property. A thirty-unit apartment building, located on a single parcel, would be assessed a total of $327; $57 for the property and $270 for the thirty units on the property.

The rental unit business tax has undergone several revisions since its inception in 1942. Most recently, in April of 1992, the City Council considered an amendment to the rental tax ordinance to ensure that rental properties were properly taxed. City Manager's Report No. 92-126, dated April 15, 1992, and enclosed for your review as Attachment A, addressed how condominiums, which are separate "properties" under California law, should be taxed. At that time, the City Treasurer's Office allowed separate condominium properties, located on the same site or complex, and where 100% of the properties were owned by one person and operated essentially as an apartment complex, to obtain a consolidated tax assessment. This was detrimental and unfair to owners whose rental properties were not located on the same site or who did not own 100% of a condominium complex. The amendment was designed to eliminate that practice, but would allow for a consolidated assessment for certain rental property that was located on two contiguous parcels. The amendment was continued for a report from the City Manager on the effect that consolidation of fees would have on the budget. At the May 26, 1992, Council meeting, the item was referred to the Committee of the Whole for consideration and deliberations during the budget process.

Finally, in August of 1992, the ordinance was adopted, following the practice of the County of San Diego in basing tax assessments on individual parcels of land. Amended SDMC section 31.0305(b) provided in pertinent part: "the business tax for the rental of residential real estate shall be assessed per property and the liability for such tax shall be determined by the owner-lessor's ownership or leasehold interest in said property." Multiple family dwellings, hotels and the like situated on two or more contiguous parcels were accorded a "single consolidated business tax assessment for that property."

In 1994, a representative of the Apartment Owners' Association contacted City staff about perceived inequities in the rental tax. That individual spoke at the July 25, 1994, City Council meeting at which time he requested that Council consider treating owners of condominium units as they had been treated prior to the 1992 amendment; that is, to allow owners of condominium rental properties to combine all of their rental properties on one tax bill rather than assess an individual tax on each condominium.F

In preparing this Report, we have carefully reviewed the taped proceedings of the City Council so that we may accurately represent what occurred during those proceedings.

At that hearing, former Councilmember Roberts discussed the concern of fair treatment of businesses and stated that several units located at

the same site were "clearly one business." He requested that numerous units located on one site, and owned by a single owner, be treated as one business. The City Manager's office agreed, but emphasized that only units located on the same site could be treated in that manner. The City Treasurer's staff added that, although it would require a manual process on the part of staff, such a system could be handled administratively since it would only involve approximately twenty property owners.

Councilmember Roberts also discussed the City's goal of reducing business taxes and made a motion wherein sites on which eight or more units under single ownership would be licensed as one business.F

The number eight was apparently chosen because, according to the Association representative, California law requires that any property with more than eight rental units must have a property manager on site.

Mr. Roberts did admit that some inequities may be claimed by owners of fewer than eight units, but emphasized that the ultimate goal was to combine all parcels of two or more owned by the same person. The motion passed and City staff was directed to investigate the "budget and fairness" consequences of combining two or more parcels located at the same site and owned by the same person.

The City Attorney was asked to research the equal protection aspects of allowing the combination of only properties located at the same "site." In a memorandum of law, the City Attorney advised that multiple, single-owner condominiums located on one site could not be treated differently than multiple, single-owner condominiums located on different sites, or differently than similarly situated single family dwellings.

In the meantime, citizens who had assumed that the July, 1994 resolution had implemented the change to the Municipal Code were receiving their tax bills in the mail. Complaints began to be received that those bills did not reflect the consolidated tax assessment for owners of eight or more properties which they thought was already in place. In response, the City Manager is recommending that the proposed consolidation of properties, and the resulting lower tax, be retroactive to July of 1994 and that those eligible for the adjustment be reimbursed for taxes paid over the amount that would have been required by the proposed amendment.

The Rental Tax issue came before the City Council again on February 27 of this year. It was continued to March 20, at which time Councilmember McCarty made a motion that the Municipal Code be amended to allow for owners of eight or more properties to receive a consolidated tax assessment for all their properties. As set forth in City Manager's Report No. 95-42, enclosed as Attachment B, the Manager was opposed to the amendment. The motion passed, however, and staff was

directed to return with an implementing ordinance and a report on the budget impact of such changes. Staff was further directed to report on the issue of fairness that may be raised by the amended language; specifically, the rights and concerns of owners of seven or fewer properties.

The City Manager has, as directed, asked our office to prepare the ordinance necessary to amend the Municipal Code, and has docketed the amendment for your consideration. This report represents this office's concerns about the legal fairness of the proposed amendment.

ANALYSIS

I.

THE CITY MAY PROPERLY CLASSIFY BUSINESSES

Businesses may legally be classified for purposes of taxation. "Businesses . . . may properly be subdivided and classified separately for license tax purposes." City of Berkeley v. Oakland Raiders, 143 Cal. App. 3d 636, 639 (1983), quoting Tax Commissioners v. Jackson, 283 U.S. 527, 537 (1930). The California Supreme Court has set forth the basic principles for tax classification of businesses:

> "The power of the states to make classifications of persons or property for taxation is very broad. . . . A statute is presumed to be constitutional until the contrary appears. . . . While the classification should be reasonable, natural and just, in the absence of a showing to the contrary, it will be assumed there are good grounds for the classification, and the act will be upheld. . . . ." No constitutional rights are violated if the burden of the license tax falls equally upon all members of a class, though other classes have lighter burdens or are wholly exempt, provided that the classification is reasonable, based on substantial differ-ences between the pursuits separately grouped, and is not arbitrary.

Fox Bakersfield Theatre Corp. v. City of Bakersfield, 36 Cal. 2d 136, 141-142 (1950) (citations omitted).

See also Sail'er Inn, Inc. v. Kirby, 5 Cal. 3d 1, 16-17 (1971); Westbrook v. Mihaly, 2 Cal. 3d 765, 784-785 (1970). The law also upholds a tax on each location of a particular business: "Where the business is operated at different locations a license may be required for each location." Web Service Co. v. Spencer, 252 Cal. App. 2d 827, 835 (1967).

Based on these principles, there should be no doubt that

the overall scheme of the rental unit business tax is valid. However, the proposed amendment raises several serious legal questions. First is the issue of equal protection -- arbitrarily treating owners of seven or fewer properties differently than owners of eight or more.

Second is the reasonableness of the proposed classification of businesses in light of the purpose of the overall taxing scheme -- creating an arbitrary classification that will result in a reduction of revenue for the City, when the purpose of the Rental Tax is clearly to raise revenue.

Finally is the issue of retroactivity -- may the tax reduction be applied retroactively to Fiscal Year 1994-95?

II.

THE PROPOSED AMENDMENT WOULD VIOLATE PRINCIPLES OF EQUAL PROTECTION

The equal protection clauses of both the United States and California Constitutions are violated if an ordinance creates a purely arbitrary classification for the purposes of taxation, without any rational basis for the distinction. In other words, a statute violates equal protection if it selects one particular class of persons for a species of taxation and no rational basis supports such classification. Department of Mental Hygiene v. Kirchner, 60 Cal. 2d 716, 722 (1964), judgment vacated, 380 U.S. 194, aff'd on remand, 62 Cal. 2d 586 (1965). Further, a discrimination that bears no reasonable relation to a proper legislative objective is invalid. "A legislative classification that is purely arbitrary and capricious and based upon no reasonable or substantial difference between classes is clearly unconstitutional." John Tennant Memorial Homes, Inc. v. City of Pacific Grove, 27 Cal. App. 3d 372, 379 (1972), quoting O'Kane v. Catuira, 212 Cal. App. 2d 131, 137 (1963).

Under the proposed amendment, the owners of seven or fewer rental properties will be paying a separate per-property rental tax on each of their properties while the owners of eight or more will be paying only a single per-property tax. By way of example, an owner of ten condominiums would pay a total of $100 in tax; $50 for the consolidated properties and $50 for the ten units. An owner of seven condominiums, by contrast, would pay $385; $350 for the seven properties and $35 for the seven units.

The only justification offered for the distinction between owners of seven or fewer properties, and owners of eight or more, is that the law requires owners of eight or more units to have an on-site property manager. In addition, the City Treasurer's office indicated it would be administratively easy to deal with owners of eight or more properties, as opposed to seven or fewer. In our opinion, neither of these justifications suffices under an equal protection analysis and we believe the proposed amendment would be found unreasonable and arbitrary.

III.
IF UNREASONABLE AND ARBITRARY, THE PROPOSED AMENDMENT VIOLATES BASIC TAX PRINCIPLES

As indicated above, a tax system must be reasonable and not arbitrary. In addition, the U.S. Supreme Court has held that a tax will be constitutional if it bears a fiscal relation to opportunities or benefits provided. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940). In other words, the greater the possible benefit to the citizen (i.e., more opportunities to collect rent) the higher the tax may be. On the other hand, an owner who collects less rental income may not be penalized by not receiving a tax benefit provided to one who collects more. "If a classification of persons or occupations made for the purpose of imposing taxes is founded on natural, intrinsic or fundamental distinctions which are reasonable in their relation to the object of the legislation and otherwise, they will be deemed to be valid and binding." Fox, 36 Cal. 2d at 141-142 (emphasis added). Finally, "the rule is established in California that a license tax imposing the same amount upon all engaged in the same business, regardless of business done or profits received therefrom, is not an unreasonable discrimination against any particular person engaged in the business because its net profit is less than that of others engaged in the same business. . . ." Web Service Co., 252 Cal. App. 2d at 834, quoting American Locker Co. v. City of Long Beach, 75 Cal. App. 2d 280, 286 (1946).

Here, the object of the City's rental tax scheme is to raise revenue for the City. The amendment would result in less revenue. Certainly, modifications of the overall scheme to be more "business friendly," even if the modifications result in less revenue, would generally be valid. However, we believe the proposed amendment to be unreasonable and arbitrary because it does not treat similarly situated persons alike and there is no rational basis for the indicated classification. The combination of arbitrariness in the light of lost revenue, in our opinion, violates the basic taxing principles set forth above. We believe the proposed amendment would be found invalid for that reason.

IV.
PROPOSED ALTERNATIVES

We have drafted alternative proposals for your consideration, which may accomplish the Council's desires and which we are able to approve as to both form and legality. The first proposal is an amendment that provides for consolidated tax treatment for all properties over a certain number -- in this case we have chosen eight or more to be consistent with the current proposal. In other words, all owners of rental properties would receive separate assessments for the first seven that they own but could apply for a consolidated assessment only for the number in excess of seven.

The second proposal is an amendment that simply provides for a consolidated tax assessment for all properties under common ownership. In other words, an owner of multiple properties may apply for a consolidated tax assessment for all properties. We believe either of these proposed amendments to be valid because they treat all similarly situated owners the same and would be rationally related to a valid purpose -- a business friendly atmosphere and stimulation of the local economy.

Both of these proposals are provided in ordinance form, approved as to form and legality, and enclosed as Attachments C and D, for your consideration.

V.

IF UNREASONABLE AND ARBITRARY, THE TAX SCHEME MAY NOT BE APPLIED RETROACTIVELY

The City Manager's proposal to apply the suggested amendment retroactively, and refund taxes to owners of eight or more properties, may not be legally defensible. A return of taxes that have been lawfully imposed and collected may be considered a gift of public funds and a violation of City Charter section 93. Schettler v. County of Santa Clara, 74 Cal. App. 3d 990, 1003 (1977). However, such expenditures may avoid being classified as gifts of public funds if they are expended for a public purpose. Retroactive tax relief has been consistently upheld so long as there is a valid public purpose served by the retroactive application. See, e.g., County of Sonoma v. State Board of Equalization, 195 Cal. App. 3d 982, 995 (1987); Schettler, 74 Cal. App. 3d at 1003.

The above cited cases held that the determination of what constitutes a public purpose is primarily a matter for the legislature, and its determination normally will not be disturbed by the courts so long as that determination has a reasonable basis. County of Sonoma, 195 Cal. App. 3d at 993; Schettler, 74 Cal. App. 3d at 1004. "The concept of public purpose has been liberally construed by the courts, and the Legislature's determination will be upheld unless it is totally arbitrary." Atlantic Richfield Co. v. County of Los Angeles, 129 Cal. App. 3d 287, 298 (1982).

If the City Council thus has a reasonable basis for believing that the proposed refund will serve a public purpose, the refund may be lawful. In this case, the Council may articulate its belief that the refund will serve the public purpose of making San Diego a more "business friendly" city by encouraging business and economic development in San Diego. We believe that such a purpose would certainly be considered a valid one. However, as noted above, the proposed amendment itself, applicable to owners of eight or more properties, would probably be found to be arbitrary and unreasonable. Thus, that particular amendment could not be applied retroactively. If, however, the Council were to adopt one of the proposed alternative

amendments, which we believe are lawful, such an amendment could be applied retroactively based upon the public purpose set forth above.

Finally, it is the general rule that legislative changes do not apply retroactively unless the legislature specifically expresses its intent that they do so. County of Sonoma, 195 Cal. App. 3d at 992. Thus, if the Council desires that the new taxing scheme apply retroactively, the adopting ordinance must specifically state that desire. We have drafted the alternative proposals accordingly.

In sum, unless the City Council expressly approves the retroactive application of one of the alternative amendments, a refund could not be accomplished. We do not believe that the present proposal could be applied retroactively.

CONCLUSION

We are unable to approve as to legality the current proposed amendment to the business rental tax. We believe the amendment violates equal protection and basic taxing principles. We have, however, drafted alternative amendments for your consideration which we believe accomplish the Council's desire to create a more business friendly atmosphere but do not run afoul of the law.

Respectfully submitted,
JOHN W. WITT
City Attorney

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Attachments
RC-95-26