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MEMORANDUM OF LAW

DATE: September 23, 2009

TO: Mary Lewis, Chief Financial Officer
Gail Granewich, City Treasurer

FROM: City Attorney

SUBJECT: Enacting a Business Tax Processing Fee

INTRODUCTION

On August 18, 2009, the Fourth District Court of Appeal in *Weisblat v. City of San Diego*, 176 Cal. App. 4th 1022 (2009), voided a portion of San Diego Resolution R-299382 (June 28, 2004) [R-299382], which imposes a processing fee on landlords who pay the Rental Unit Business Tax [RUBT]. The appellate court found that the City enacted the RUBT processing fee for the primary purpose of generating revenue and that the landlords did not receive any regulation or services in exchange for the payment of this fee. The appellate court concluded that the RUBT processing fee is an invalid general tax and void because it was not approved by a majority of the voters as required by the California Constitution.

In response to the ruling, the City suspended collection of the RUBT and business tax processing fees because the fees were adopted at the same time, through the same resolution, and for the same stated purpose.

QUESTION PRESENTED

What must the Office of the City Treasurer do in order to enact a legitimate and defensible processing fee associated with the business tax?

SHORT ANSWER

To be legitimate and defensible, the business tax processing fee should cover specific regulatory matters and the fee itself must be reasonable as determined by a "fee survey."

BACKGROUND

The City of San Diego [City] imposes a business tax for the purpose of raising revenue. *See* San Diego Municipal Code §§ 31.0101, 31.0301-8; and Cal. Const. art. XI, § 5. All businesses operating in the City, except for individuals engaged in the business of renting real property, pay business tax. *See* San Diego Municipal Code § 31.0305. The annual fee for a business tax certificate is \$34 for businesses with 12 employees or fewer and \$125 plus \$5 per employee for a business with 13 employees or more. *See* San Diego Municipal Code § 31.0131.

In 2004, the City adopted a business tax and RUBT processing fee of \$25 for an initial application and \$15 annually thereafter to “offset the \$17.3 million State budget reduction.” Mgr. Rpt. No. 04-138 (June 21, 2004). The City’s justification for the fee did not include a regulatory purpose even though revenue generated from the business tax processing fee, as opposed to the RUBT processing fee, supports the City’s regulatory processes.

In 2006, two landlords challenged the RUBT processing fee, claiming that the fee was unconstitutional and illegitimate. *See Weisblat v. City of San Diego*, 176 Cal. App. 4th 1022. The landlords did not challenge the business tax, the RUBT, or the business tax processing fee.

The Fourth District Court of Appeal agreed with the landlords and voided the portion of R-299382 that imposes the RUBT processing fee. The appellate court found that raising revenue was the primary purpose of the processing fee charged to all individuals who pay the RUBT and that landlords were not getting any regulation or services for their payments. The court held that the fee was an invalid general tax and void because it was not approved by a majority of the voters under article 13C, section 2(b) of the California Constitution.

In response to the ruling, the City suspended collection of the RUBT and business tax processing fees.

ANALYSIS

I. To Be a Fee and Not a Tax, the Business Tax Processing Fee Must Support a Regulatory Function.

In 1996, California voters approved Proposition 218, which added articles XIII C and XIII D to the California Constitution. These constitutional provisions require a local governmental entity to obtain voter approval before imposing or increasing any general tax, special tax, assessment, or charge. A “special tax” does not include “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.” Cal. Gov’t Code § 50076.

The case that best describes the difference between a permissible fee and an illegal tax is *Sinclair Paint Company v. State Board of Equalization*, 15 Cal. 4th 866 (1997). In *Sinclair*, the Sinclair Paint Company [Sinclair] challenged the State Board of Equalization's imposition of an assessment against it under the Childhood Lead Poisoning Prevention Act of 1991 [Act]. The trial court found that the assessment was an invalid tax because it had not been approved by a two-thirds majority as required by the Constitution. The Court of Appeal affirmed. Nevertheless, the Supreme Court reversed on the ground that the fees imposed were bona fide regulatory fees. The fees would shift the cost of providing evaluation, screening, and medically necessary follow-up services to potential child victims of lead poisoning from the public to those responsible for the poisoning. The Court considered this a reasonable police power decision.

Quoting with approval from an earlier decision, the *Sinclair* Court adopted a "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*, 15 Cal. 4th at 880. (citing *United Business Commission v. City of San Diego*, 91 Cal. App. 3d 156, 165 (1979)).

The *Sinclair* Court characterized the challenged assessment as a regulatory fee instead of a tax because Sinclair and other lead-based product manufacturers remained subject to government regulation; the manufacturers would not be entitled to operate free of regulation once the fee was paid; and the fees collected under the Act would be used exclusively for mitigating the adverse effects of lead poisoning on children and not for general revenue purposes.

Also instructive is *Collier v. City and County of San Francisco*, 151 Cal. App. 4th 1326 (2007). In this case, San Francisco assessed a regulatory fee against persons engaged in building construction in San Francisco. The City assessed the fee to recover the cost of processing and reviewing applications and building plans; performing necessary field inspections; ensuring compliance with all relevant code provisions; preparing and reproducing all necessary documents; and issuing building permits. The tasks were performed jointly by the building, fire, and planning departments although the building department ultimately approved the building permit. The court held that the fee related to permissible regulatory services that benefit or are necessitated by the activities of the affected class of building permit fee users.

In addition to *Sinclair* and *Collier*, the courts have also approved regulatory fees in the following cases:

- (1) A city ordinance that imposed an inspection fee on owners of all buildings subject to inspection was permissible because the fee financed the cost of inspection and enforcement by the Housing Department. *Apartment Association of Los Angeles County, Inc. v. City of Los Angeles*, 24 Cal. 4th 830 (2001);

- (2) The city rent control ordinance that imposed an annual rental unit fee on landowners was permissible because the fee defrayed the cost of providing and administering the hearing process prescribed in the ordinance and did not exceed the sum reasonably necessary to cover the cost of the regulatory purpose sought. *See Pennell v. City of San Jose*, 42 Cal. 3d 365 (1986); and
- (3) A city ordinance that included the imposition of sign inventory fees was a valid exercise of the city's police power. The ordinance presented "a set of reasonable, non-arbitrary, and non-discriminatory standards and controls, which are designed to optimize communication between the citizen and his environment, to facilitate the protection not only of the public, but the aesthetic character of the City, and to ensure the availability to the business community of adequate quality on-premises signs." *United Business Commission v. City of San Diego*, 91 Cal. App. 3d 156, 162-163 (1979).

Once the City establishes a legitimate regulatory purpose, it must clearly explain the regulatory intent of the fee in its historical documents. In *United Business Commission v. City of San Diego*, for instance, the Court praised the City of San Diego's evidentiary record as follows:

There is ample evidence to support the trial court's conclusion of the regulatory nature of the enactment and fee. The evidentiary record relating to the historical background leading to the adoption of Ordinance No. 11718 and the inventory fee clearly support this conclusion. Further, a city manager report to the mayor and city council dated after the adoption of Ordinance No. 11718 reflects the regulatory intent behind the fee. The report reads: "In November 1975 Council adopted amendments to the on-premises sign regulations which included provisions for a one-time, existing sign inventory fee. This fee was designed to recover, as nearly as possible, the City's direct cost of inventorying and bringing into conformance on-premises signs existing as of April 5, 1973." In addition, the report summarized the results of the sign inventory fee, noting the cost to the City was \$262,441 and the total fees invoiced was \$220,846, leaving a deficit of \$41,595. The record includes evidence that the expenses involved reasonably related to the regulatory goal involved--the inventory process constituted much more than a mere counting, but a thorough procedure of inspection, inventory, administration and enforcement.

United Business Commission v. City of San Diego, 91 Cal. App. 3d at 165-167.

To enact a legitimate regulatory fee, the City Treasurer will need to show for the record that the primary reason for enacting the fee is regulatory. This is best done by showing a direct

link between the City Treasurer's collection of the fee and the City Treasurer's use of this fee. The use should include a thorough procedure of inspection, inventory, administration, and enforcement if applicable. The City Treasurer may consider, for instance, serving as a "one-stop shop" for members of the public who are either starting a new business or renewing an existing license by issuing permits on behalf of the Development Services, the Police, and the Fire departments. This would likely involve staff taking additional information from applicants, doing some type of background check, and fingerprinting. The procedure and its regulatory effect must be thoroughly evidenced in a report to the City Council and in the resolution enacting the fee.

II. The Processing Fee Must Be Reasonable in Light of the Expense of the Regulatory Effort.

Once the City establishes the regulatory purpose for the fee, the City will need to prove that the amount of the fee is reasonable. To be reasonable, the fee must be fair and equitable in nature and proportionately representative of the costs incurred by the regulatory agency. *See Associated Homebuilders of the Greater East Bay, Inc. v. City of Livermore*, 56 Cal. 2d 847 (1961). Thus, the City "should prove (1) the estimated costs of the service or regulatory activity, and (2) the basis for determining the manner in which the costs are apportioned, so that charges allocated to a payor bear a fair or reasonable relationship to the payor's burdens on or benefits from the regulatory activity." *Collier*, 151 Cal. App. 4th at 1346. (citing *San Diego Gas and Electric Company v. San Diego County Air Pollution Control District*, 203 Cal. App. 3d 1132, 1146 (1988)).

In *United Business Commission*, the Court approved the fee calculation submitted by the City in support of their sign inventory fee. The Court stated:

The fee schedule . . . establishes a graded fee structure for both building permit and one-time sign inventory fees. Plaintiffs challenge the latter fee grading as unreasonable since it takes no longer to count a 100-foot sign than a 10-foot sign. They fail to consider, however, the basic fact that the inventory process involved far more than the mere counting of signs The field study and cost analysis of the inventory process used to determine the graded fee schedule seems valid in nature, as it took into consideration the actual cost involved in the inventory and the varying amounts of time required in the field to inventory the different types of signs. For example, empirical data from the field established that electrical signs took a proportionate longer period of time to inspect than painted signs, due to the mechanical nature of the former. Ground, roof and projecting signs took a proportionate longer period of time to inventory than wall signs, due to access difficulties.

The greater the square footage of a sign, the longer it took to inspect. We find the graded fee schedule to be reasonable in character, successfully reflecting the proportionate inventory cost to the city of the inspection of each sign predicated upon its type.

United Business Commission, 91 Cal. App. 3d at 167-68, referencing Baldwin v. Redwood City, 540 F.2d 1360, 1371 (9th Cir. 1976).

The Court in *United Business Commission* recognized that a fee survey is not an exact science. It determined that the fee was appropriate because it “seems valid in nature,” “took into consideration actual cost,” and appeared “reasonable in character.” *Id.*

Similarly, the Court in *Collier* recognized the difficulty of precise fee determinations and emphasized the importance of allowing flexibility. Citing *Brydon v. East Bay Municipal Utility District, 24 Cal. App. 4th 178, 193 (1994)*, the *Collier* Court noted that “cost allocations for services provided are to be judged by a standard of reasonableness with some flexibility permitted to account for system-wide complexity.” *Collier, 151 Cal. App. 4th at 1340.* Here, the Court allowed San Francisco to include the cost of long-range planning activities, fringe benefits to the long-range planning staff, the cost of hiring outside contractors, and administrative overhead cost in its fee calculation, because San Francisco proved to the Court’s satisfaction that there is a link between regulatory enforcement and long-range planning.

Also note that a fee may include direct and incidental costs. “The general rule is that a regulatory license or permit fee levied cannot exceed the sum reasonably necessary to cover the costs of the regulatory purpose sought. Such costs, however, include all those incident to the issuance of the license or permit, investigation, inspection, administration, maintenance of a system of supervision and enforcement.” *United Business Commission, 91 Cal. App. 3d at 165.* (Citing *County of Plumas v. Wheeler, 149 Cal. 758 at pp. 763,766 (1906)*). In this case, the City included the inspection of hazards, travel time, office supplies, telephone expenses, overhead, and clerk’s time, and the court deemed those incidental expenses permissible.

The City Treasurer’s Office will need to do a fee survey in order to determine the amount of a fair and reasonable fee. This fee should apply only to those who pay a business license tax since the RUBT processing fee is illegal. The record justifying the fee should include evidence that the expenses involved reasonably relate to the regulatory goal involved.

Once a proper fee amount is established, the City Treasurer will need to develop a method that ensures that the fee is paid only by those who are regulated. The City Treasurer may, for instance, reconstitute the business tax application so that one section addresses information needed to process the tax certificate and a second and distinct section collects information that pertains only to those who should be or are regulated. Those not subject to regulation would not pay the processing fee.

Finally, the fee must be justified in a report to the City Council so that they can review this along with the rationale for enacting a business tax processing fee. The fee calculation should describe in detail the steps that staff took in formulating the fee so that an accurate historical document is created.

CONCLUSION

Should the City Treasurer submit a new proposal to the City Council, we suggest that the City Treasurer propose fees to cover specific regulatory matters based on a "fee survey" that determines the reasonableness of the fee for its stated purpose. Our Office is available to assist staff as needed.

Alternatively, the City Treasurer may (1) elect to forego the processing fee and instead require City departments that use the database for regulatory purposes to proportionately reimburse the City Treasurer for maintaining the database; or (2) maintain the database for their own day-to-day business operations thereby requiring the City departments that use the database for regulatory purposes to absorb these processes within their own departments.

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By 

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