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COURT SLIGHTLY NARROWS LA'S CELLPHONE TAX AND CLARIFIES PROPOSITION 218'S REQUIREMENT FOR VOTER APPROVAL OF TAX INCREASES

by

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On May 9, 2007, the Second District Court of Appeal affirmed a trial court ruling that Los Angeles could not direct cellphone carriers to tax all calls billed to an address in the City – as the federal Mobile Telecommunications Sourcing Act of 2000 (MTSA)[1] allows – without voter approval. However, the Court allowed the City to reimpose a 1993 instruction to carriers requiring them to tax all calls which originate or terminate in the City even though Los Angeles had acquiesced in carriers' refusal to do so while the technology to track calls was developed. The result is that Los Angeles preserved the great majority of the tax base in dispute in this case and local governments throughout California have greater clarity as to what administrative actions regarding a tax will be construed as a tax "increase" for which Proposition 218 requires voter approval. Los Angeles may have lost the case, but it won most of what was really in issue. The case is *AB Cellular LA, LLC v. City of Los Angeles*.[2]

Background. In 1993, before Proposition 218 was adopted to require voter approval of general taxes imposed by charter cities (and while Proposition 62's similar requirement for general law cities was understood to be unenforceable), the Los Angeles City Council amended the City's telephone utility users tax to extend the tax to "services for mobile cellular telephone communication when the owner or lessee of the telephone has a billing address in the City."[3] The cellular carriers objected that the Commerce Clause of the U.S. Constitution, as construed in the 1989 decision in *Goldberg v. Sweet*,[4] required the City to limit its tax to calls which originate or terminate within the City. The City accepted this contention and the City Council approved instructions to carriers authorizing them to tax only the base portion of a cell bill – *i.e.*, the portion other than the airtime or call detail – until a means to track the origin or destination of calls was available.

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[1] 4 U.S.C. § 116 et seq.
[2] 2007 Westlaw 1346505; 2nd District Court of Appeal Case No. B185373. Colantuono & Levin represented the City in the case; counsel included Sandra J. Levin, Amy C. Sparrow, Lawrence G. Permaul and the author of this paper.
[3] Los Angeles Municipal Code § 21.1.3(a).
[4] 488 U.S. 252 (1989).

New carriers entered the LA market and began taxing the entire portion of cell bills, leaving the original cellular carriers – AT&T Wireless and Verizon Wireless – in the enviable position of collecting lower taxes than their competitors. At the urging of the telecommunications industry, Congress adopted the MTSA in 2000 to eliminate the pressure on carriers to identify the origin and destination of calls for tax purposes and to allow a nationally uniform tax base for telephone taxes. Under its power under the Commerce Clause, Congress declared that a state or local government could tax all calls made to or from a cell phone that has its "principal place of use" within that state or locality. The MTSA declares that principle place of use to be the address to which the bill is sent unless there is evidence to the contrary.

When MTSA took effect in 2002, Los Angeles gave instructions to carriers to impose the telephone tax on all calls to and from cell phones with Los Angeles billing addresses. Two carriers – AT&T Wireless and Verizon Wireless – sued for a writ to compel the City to rescind its 2002 instructions and to reinstate the 1993 instructions, including the City's forbearance from insisting that carriers collect the tax calls which originate or destinate in the City due to the absence of technology to do so. The Los Angeles County Superior Court ruled that the 2002 instructions amounted to a "change in methodology" and were thus a tax "increase" under Government Code § 53750(h), a provision of the Proposition 218 Omnibus Implementation Act, and could not be imposed without voter approval under Proposition 218.

Legal Arguments. The central issues in the case are: (i) what was Los Angeles' "methodology" for implementing its cell phone tax? and (ii) Did the 2002 instructions change that methodology in a way that required voter approval? The City argued its methodology was to implement the tax to the limit of the City's constitutional authority and that, when MTSA took effect in 2002, the tax automatically attained the additional reach allowed by Congress (*i.e.*, taxing calls billed to the City whether or not made to or from a place in the City) without need for voter approval. The carriers argued that the City's methodology was reflected in the 1993 instructions minus the demand of those instructions that the carriers find a way to determine the origin and termination of calls so those which start or end in the City could be taxed. Thus, the carriers argued that Los Angeles' methodology was to tax monthly base charges but not air time and the 2002 instructions could not be imposed without voter approval.

The Court of Appeal rejected both parties' claims. In the Court's view, the City's methodology was to tax base charges *and* airtime charges for calls which originate or destinate in the City and that its forbearance from enforcing that second aspect of the rule was an administrative enforcement action which the City could change without voter approval, rather than a binding element of its methodology. Thus, while the carriers won the appeal and were awarded their costs, Los Angeles retained the great majority of the disputed tax base.

What's a Tax Methodology? The tax provisions added to California's Constitution by 1996's Proposition 218[5] are modeled on those of 1986's Proposition 62,[6] a statutory initiative

[5] Proposition 218 added Articles XIII C and XII D to the California Constitution. Its tax provisions are Article XIII C, §§ 1 and 2.

which preceded it, but which was understood to be unenforceable when Proposition 218 was drafted.[7] Among other things, those provisions state:

> "No local government may impose, extend, or increase any general tax unless and until that tax is submitted to the electorate and approved by a majority vote. A general tax shall not be deemed to have been increase if it is imposed at a rate not higher than the maximum rate so approved."[8]

Proposition 218 does not define the word "increase," but the Legislature did so in the Proposition 218 Omnibus Implementation Act of 1997. Government Code § 53750(h) states:

> "'Increased,' when applied to a tax, assessment, or property-related fee or charge, means a decision by an agency that does either of the following:
>
> (A) Increases any applicable rate used to calculate the tax, assessment, fee or charge.
>
> (B) *Revises the methodology by which the tax, assessment, fee or charge is calculated, if that revision results in an increased amount being levied on any person or parcel*.
>
> (2) A tax, fee, or charge is not deemed to be 'increased' by an agency action that does either or both of the following:
>
> (A) Adjusts the amount of a tax or fee or charge in accordance with a schedule of adjustments, including a clearly defined formula for inflation adjustment that was adopted by the agency prior to November 6, 1996.
>
> (B) Implements or collects a previously approved tax, or fee or charge, 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*.
>
> (3) A tax, assessment, fee or charge is not deemed to be 'increased' in the case in which the actual payments from a person or property are higher than would have resulted when the agency approved the tax, assessment, or fee or charge, *if those higher payments are attributable to events other than an increased rate or revised methodology, such as a change in the density, intensity, or nature of the use of land*." (Emphasis added.)

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[6] Government Code §§ 53720 – 53730.
[7] That understanding proved wrong with the 1995 decision of *Santa Clara County Local Transportation Authority v. Guardino*, 11 Cal.4th 220.
[8] Article XIII C, § 2(b).

Prior to *AB Cellular*, no court has had opportunity to determine what constitutes "the methodology by which the tax … is calculated." The *AB Cellular* Court wrote:

> "We hold that methodology, under section 53750, refers to *a mathematical equation for calculating taxes that is officially sanctioned by a local taxing entity*. In most instances, the equation will be established by legislative action, such as the enactment of an ordinance. But if a local tax law is ambiguous, or is ostensibly restricted by state, federal or other local laws, and the local taxing entity develops a policy regarding how those local taxes shall be calculated in light of the ambiguity, or it interprets the limits of the local tax law in light of ostensible restrictions imposed by state, federal, or other local laws, then *the methodology is the equation the local taxing entity adopts as a uniform compromise of its legal dilemma*. Restated, this equation is its interpretation of the outer boundaries of its taxing authority."[9] (Emphasis added.)

Thus, a methodology is a mathematical formula for applying the rate of a tax to the transactions or other elements within its tax base that is adopted by "officially sanctioned" action of the taxing agency – typically an ordinance or other legislation but, where a legal restriction or ambiguity exists, a "methodology" can be an interpretation formally adopted by administrative staff who are authorized to do so.

The Court also tells us that a "methodology" cannot be a flexible principle that changes with the scope of the taxing agency's constitutional power:

> "A taxing methodology must be frozen in time until the electorate approves higher taxes …. Contrary 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 submitting it to voter approval."[10]

Nor can a tax methodology be discriminatory:

> "[W]e interpret 'methodology' so that it does not enshrine taxes that are discriminatory, i.e., taxes that are imposed upon one taxpayer but not others who are similar situated."[11]

Finally, a methodology cannot be taxpayer-specific, but must be a rule of general application to all who are subject to the tax.[12]

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[9] 2007 WL 1346505 at *8, slip. op. at 15.
[10] *Id*. at *7, slip op. at 13. Elsewhere the Court refers to a "methodology" as "set in stone absent submission of higher taxes to the electorate and a favorable vote." *Id*. at *7, n.8; slip. op. at 13, n.8.
[11] *Id*. at *8, slip op. at 15.
[12] *Id*. at *10, slip op. at 19.

What is a "Change in Methodology" and a Tax Increase for Which Voter Approval is Required? Given this definition of "methodology," it becomes obvious that a change of methodology occurs when a taxing city or county takes authorized, official action to change the mathematical formula by which its tax rate and tax base are generally applied so as to increase tax revenues:

> "In practical terms, a tax is increased if the math behind it is altered so that either a larger tax rate or a larger tax base is part of the calculation."[13]

However, many actions a taxing agency takes that alter the amount a taxpayer must pay are *not* changes in methodology and nor tax increases for which voter approval is required. These include:

- A taxpayer-specific resolution of a tax dispute: "we decline to interpret section 53750 to rob local governments of the discretion to settle tax disputes."[14]

- A decision to refrain from enforcing a tax in all or part for a time: "we decline to interpret section 53750 to rob local governments of the discretion to … decide that all or part of a local tax should not be enforced."[15]

- A decision to renew enforcement of a tax which had not been enforced for a time: "Under this construction, a local taxing entity can enforce less of a local tax than is due under a voter approved methodology, or a grandfathered methodology, and later enforce the full amount of the local tax due under that methodology without transgressing Proposition 218."[16]

- A decision to lower taxes and then to raise them back to their original level: "A local taxing entity could even revise its methodology to decrease local taxes and then do an about face and return to the previously approved methodology. Proposition 218 allows it."[17]

- "Prosecutorial forbearance and other temporary exceptions under appropriate circumstances."[18]

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[13] *Id*. at *8, slip op. at 14.
[14] *Id*. at *8, slip op. at 15. *See also, id*. at * 8, slip op. at 16: "the settlement of local tax disputes and enforcement of local taxes may be taxpayer specific."
[15] *Id*. at *8, slip op. at 15.
[16] *Id*. at *8, slip op. at 16.
[17] *Id*. Both Prop. 218 and the Omnibus Implementation Act allow taxes to be lowered and raised back to previous levels without voter approval. Art. XIII C § 2(b); Gov't Code § 53750(h)(2)(B). *See also*, Gov't Code § 53739(a) (voters may approve a range of tax rates) and Gov't Code § 53739(b) (voters may authorize inflation adjustment of tax which is not collected on a percentage basis, as a flat-rate tax).
[18] *Id*. at *8 n.13, slip op. at 16, n.13.

- Allowing a disparity between taxpayers due to acquiescence by some, but not others, in an unauthorized taxing methodology.[19]

Practice Tips. So, what does this all mean? First, a taxing agency should not establish a "methodology" except intentionally, carefully, and with legal advice. As most tax methodologies will be found in ordinances drafted or reviewed by legal counsel, this ought not to be difficult advice to follow. However, whenever a taxpayer or private tax collector – like the carriers here – claims that a tax ordinance is ambiguous or that other laws apply to it in a way that limits the apparent effect of the ordinance, great caution is in order. Current complexities involving the application of telephone taxes in California arising from IRS rulings affecting the Federal Excise Tax on Telephony[20] and technological change have prompted telephone carriers to sent form letters to all taxing agencies in California requesting direction on how to apply these taxes. Care must be taken in responding to these letters and we advise agencies not to do so except after consulting legal counsel.

Second, when it is necessary to resolve an ambiguity regarding a local taxing ordinance, it is best to take the most expansive view of the tax possible and to narrow that position only after litigation or via a taxpayer-specific compromise. As court stated:

> "Because Proposition 218 would lose some of its intended efficacy if local taxes were not transparent and consistent until there is a voter approved increase, the logical extension of our opinion is that when a taxing authority is confronted with an ambiguous local tax, or a local tax that is restricted by other laws, it may well have to stake out a maximum tax position and then defend that position in litigation."[21]

Because prosecutorial forbearance and efforts to resolve disputes with individual taxpayers that do not amount to officially sanctioned, broadly applicable rules will not constitute tax "methodologies," these strategies will be preferable to issuing instructions or other broadly applicable rules. Thus, it is not wise to issue instructions on demand of telephone carriers!

Finally, when an agency chooses to lower a tax or to narrow its tax base, perhaps as a temporary discount (as many utility taxing agencies did when electricity prices spiked during the market turmoil of a few years back), it will be best to do via a temporary action that expires by its own terms, as by a resolution with a sunset date. Lowering a tax rate and raising it again without voter approval is approved by the *AB Cellular* court, but a discount that expires by its own terms can also be defended as not involving any agency action which could constitute an "increase" at all.

Conclusion. *AB Cellular* represents a substantial win for the City of Los Angeles, although the City nominally lost the case. Other local governments benefit from this decision,

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[19] *Id*. at *10, n.16, slip op. at 19, n.16.
[20] 42 U.S.C. § 4251 et seq.
[21] 2007 WL 1346505 at *8, n.10; slip op. at 10, n.10.

too, as it gives substantial guidance as to the range of actions a taxing agency can take in enforcing its tax without creating a risk that voter approval will be required to do so.

Proposition 218 continues to be a rapidly developing area of law, with decisions due in the coming months involving groundwater extraction charges, open space assessments, and regulatory fees on water permit holders. As always, we will keep you posted!