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California Supreme Court Upholds Franchise Fees

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On June 29, 2017, the California Supreme Court decided *Jacks v. City of Santa Barbara*, the Court's latest opportunity to consider the impact of 1996's Proposition 218 on municipal finance. The case makes important contributions to the law, confirming that:

- fees for use of government property are not taxes requiring voter approval,
- such fees generate discretionary (i.e., general fund) revenues to be used for any lawful purpose of the agency, and
- standing to challenge a revenue measure is limited to those who have a legal duty to pay it.

The Court establishes a new limit on franchise and other fees for use of government property, however — such fees must not "exceed any reasonable value of the franchise," but must be "reasonably related to the value of the franchise." This will require real estate leases, franchise agreements, and the like to document the exchange of value, but this should not be a high hurdle for governments to overcome.

The case involved a 2 percent franchise fee imposed by the charter city of Santa Barbara on Southern California Edison. Under a 1989 decision of the Public Utilities Commission, when an investor-owned utility is subject to a fee which significantly exceeds the "aggregate" of other such fees in its service area, it must recover the cost of that fee only from customers in the city imposing the fee and show it as a separate line item on customers' bills. A Santa Barbara hotelier argued this made the 1 percent increase in Santa Barbara's fee over the rate general law cities and counties may charge under state law a utility users tax requiring voter approval. The trial court concluded the increase was subject to Proposition 26, rather than Proposition 218 (which exempts fees for gas and electric service), and grandfathered by it.

The Court of Appeal reversed, concluding the 1 percent increment was a de facto utility users tax requiring voter approval under Proposition 218. Its reasoning was troubling because it turned on the economic incidence of the fee (who actually bears the burden to pay it in a given transaction) rather than the legal incidence (on whom the City imposed it as a matter of law). Fortunately, the Supreme Court rejected that analysis (as did Justice Chin's dissent).

Because the franchise fee was negotiated in 1999 — before the 2010 adoption of Proposition 26 — that measure does not apply. Proposition 26 is not retroactive as to local government. Proposition 218, adopted in 1996, does apply to local taxes — including those of charter cities like Santa Barbara — but does not define "tax." Thus, the Supreme Court applied case law developed under 1978's Proposition 13 to conclude that a fee for the use of government property is not a tax because the fee payor gets something of value in exchange: "receipt of an interest in public property justifies the imposition of a charge on the recipient to compensate the public for the value received." That same reasoning

underlies a recent decision of the Sacramento Court of Appeal rejecting a challenge to cap-and-trade auction fees under the A.B. 32 greenhouse gas law.

However, the Supreme Court found it necessary to place some limit on what a local government charges for use of its property, especially where alternatives to that property may not be practically available. How else was Edison to get power to customers in Santa Barbara if not via City streets? Thus, it fashioned a new test to distinguish bona fide fees for use of government property from de facto taxes masquerading under that label: "we hold that a charge imposed in exchange for franchise rights is a valid fee rather than a tax only if the amount of the charge is reasonably related to the value of the franchise." At another point, the Court states the test even more deferentially: "To the extent a franchise fee exceeds **any** reasonable value of the franchise, the excessive portion of the fee does not come within the rationale that justifies the imposition of fees without voter approval." (Emphasis added.)

"VALID FEES DO NOT BECOME TAXES SIMPLY BECAUSE THEIR COST IS PASSED ON TO THE RATEPAYERS."

The Court found nothing in Proposition 218 was intended to change the historic treatment of franchise fees as not taxes or to limit the use of the proceeds of such fees: "Nothing in Proposition 218 reflects an intent to change the historical characterization of franchise fees, or to limit the authority of government to sell or lease its property and spend the compensation received for whatever purposes it chooses." "Consequently, the revenue generated by the fee is available for whatever purposes the government chooses rather than tied to a public cost." This logic encompasses all fees for use of government property, such as parking meter fees, fees for the use of community meeting rooms, fees to rent recreation equipment, rents under leases of municipal property, etc.

The Court does not explain precisely how a local government may prove a fee for the use of its property is reasonably related to the value of that use of property. It suggests judicial deference to a local legislative judgment will be appropriate if "bona fide negotiations" lead to the imposition of a fee by one who "has incentive to negotiate a lower fee." It also notes that, even absent such negotiations, "other indicia of value" including "expert opinion" will be helpful.

On the standing issue, the Court firmly restated an earlier rule that has recently been tested by class action plaintiffs' lawyers arguing for broad standing to allow any voter to challenge any local government revenue measure simply by alleging it is a tax which should be put to a vote. The law has long distinguished the "legal incidence" of a revenue measure — who must pay it under the language of the legislation imposing the tax, assessment or fee — from its "economic incidence" — who ultimately pays it when private transactions play out. Sales taxes, for example, are legally incident on sellers, but frequently passed on to buyers. Here Santa Barbara's franchise fee was legally incident on Edison, but Public Utilities Commission rules allow Edison to pass it on to customers in Santa Barbara.

The Court maintained the rule that only legal incidence matters for standing. To challenge a revenue measure, you must have a legal duty to pay it under the local legislation. It is not enough to do business with a taxpayer who passes it on to you: "[T]he City contends ... the economic

incidence of a charge does not determine whether it is a tax. We agree. Valid fees do not become taxes simply because their cost is passed on to the ratepayers." Justice Chin's dissent adopts this view, as well, although he concludes language in Santa Barbara's ordinance and in the stipulated facts on which the case was tried establish that the legal incidence of Santa Barbara's fee was on SCE customers, not the utility.

The reasonable value test for franchise fees is new and, accordingly, the parties and lower courts did not apply it. Thus, the Supreme Court remanded the case for trial.

The Court also decided a documentary transfer tax case on June 29, 2017, concluding county recorders can collect such a tax when "an actual transfer of legal beneficial ownership made for consideration" occurs even if nominal title to real property does not change hands. *926 North Ardmore Avenue, LLC v. County of Los Angeles* is therefore another win for cities and counties which benefit from documentary transfer taxes, as nearly all do. Both *Jacks* and *926 North Ardmore* had sole dissents (Chin in *Jacks* and Kruger in *926 North Ardmore*), suggesting that Justice Werdegar's retirement from the Court in August may not fundamentally change the Court's approach to municipal finance issues.

This may bode well for local government in two other cases still pending in the California Supreme Court: *Ventura v. United Water Conservation District* and *Citizens for Fair REU Rates v. City of Redding*. *Ventura* is a Proposition 218 and 26 challenge to a groundwater agency which imposes a 3:1 ratio of fees on municipal and industrial users of groundwater to those imposed on agriculture without cost justification for the favorable agricultural rate. It should be argued this fall. *Redding* is a challenge to a City's payment in lieu of taxes (PILOT) from its power utility to its general fund, which the trial court upheld against a Proposition 26 challenge as grandfathered legislation predating the measure. That case has been fully briefed and awaiting argument since July 2015 and may be argued in late 2017 or early 2018.

The law continues to develop but, as always, we'll keep you posted!

Colantuono, Highsmith & Whatley is a law firm with offices in Pasadena and Grass Valley which represents public agencies throughout California. Its municipal law practice includes appellate representation, public revenues, marijuana enforcement and taxation, land use, housing, CEQA, LAFCO matters and associated litigation. We are committed to providing advice that is helpful, understandable, and fairly priced.

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