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Charging Taxpayers for Tax Collection Is a Tax: *Weisblat v. City of San Diego*

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Executive Summary

The Tax Foundation has filed a friend-of-the-court brief in *Weisblat v. City of San Diego*, currently pending before the California Court of Appeal. The case involves San Diego's tax on landlords who rent their property, which raises \$11 million per year. Barred by Proposition 218 from raising this tax without a public vote, city officials instead opted to impose a processing "fee" to pay for the collection of the RUBT. This processing charge raises \$3.5 million a year.

The Tax Foundation brief reviews standards for defining taxes and fees in California and throughout the country, and concludes that the charge is a tax because its purpose is to raise revenue for a quintessential government activity (tax collection). San Diego imposed the charge in response to a revenue shortfall, and the revenue that is raised funds no services to those who pay it, nor does it confer any exclusive benefits or privileges to them, nor does the revenue from the charge fund any program that regulates the conduct of landlords or rental businesses.

Contrary to San Diego's assertion, whether tax collection is a "special project" or a general governmental enterprise does not alter the conclusion that the charge is a tax and not a fee. Further, a law restricting the use of fee revenue does not substitute for the constitutional tax/fee inquiry.

Finding that the processing charge imposed by Resolution R-299382 is a tax would also uphold the purpose and meaning of Propositions 13 and 218, which sought debate and voter consent where discrete groups are targeted for revenue increases but the benefits accrue to society at large.

The RUBT, the Processing Charge, and Proposition 218

Since 1942, the City of San Diego has imposed a Rental Unit Business Tax (RUBT) on landlords who rent out their property (approximately 139,000, who pay \$11 million a year in RUBT). The revenue raised is deposited in the General Fund and not used for any landlord-specific purpose. All parties concede that the RUBT is a tax and not a fee, and consequently, concede that it cannot be raised without a public vote.

This public vote requirement was added to the California Constitution as part of Proposition 218, approved by the voters in 1996.¹ These provisions define the terms "general tax" (any tax imposed for general governmental purposes) and "special tax" (any tax imposed for specific purposes, including a tax imposed for specific purposes which is placed into a general fund). Local governments may not impose, extend, or increase general taxes without approval by a majority of the electorate, and special taxes require a two-thirds vote.² Fees (defined as anything other than a tax) may be imposed by local governments without voter approval as an outgrowth of inherent health-safety-welfare regulatory power.

In 2004, faced with a revenue shortfall and not wanting to submit a RUBT increase to public vote, San Diego instead adopted Resolution R-299382, which imposes a processing charge (termed a "fee") on landlords and all businesses. The City at the time estimated that the costs of collecting the RUBT was \$3.5 million per year, and allocated that amount evenly among all the payers.

Sidney Weisblat and Kenneth Ledgerwood paid the processing charge under protest and filed a claim for refund, alleging that the charge was in fact a tax, and invalid for failing to be approved by the electorate. Eventually it reached court, where the trial judge upheld the charge as a valid fee.

A Tax's Purpose Is to Raise Revenue; A Fee's Purpose Is to Cover the Cost of Providing a Service

The paramount difference between a tax and a fee is based upon the purpose of the charge. A charge that covers the cost of providing a service to the payer or regulates the payer's conduct is a fee. A charge that raises revenue for general spending without conferring any exclusive benefit to the payer is a tax.

In 2008, the California Court of Appeal decided *Bay Area Cellular Telephone Co. v. City of Union City*.³ That case involved a government charge on telephones, with the revenues funding the city's 911 emergency response system. Because the charge is used to fund a program benefitting all systems, and not exclusively those who pay, it is a tax. The Tax Foundation brief reviews a number of authorities in California and other states that have similarly concluded that the purpose of the charge is what matters in determining whether a charge is a tax. Most notably, the *San Juan Cellular* test devised by now-Justice Stephen Breyer while he was on the First Circuit Court of Appeals evaluates (1) the entity that imposes the assessment, (2) the parties upon whom the assessment is imposed, and (3) whether the assessment is expended for general public purposes (tax) or used for the regulation or benefit of the parties upon whom the assessment is imposed (fee).⁴

Voluntariness Is Not Material in the Tax/Fee Determination

One seemingly logical definition—that taxes are "mandatory" while non-taxes are "voluntary"—is actually of little help in identifying taxes. That standard has proved problematic because it conflates the payment of the *charge* with the payment of the *underlying service*.

One may purchase a product "voluntarily" but this does not make the sales tax paid on the transaction "voluntary." Use of a toll road is a result of a voluntary decision but that fact is irrelevant to the question of whether the toll collected is a tax or a fee; it is a fee only if the revenue is used to defray the costs of providing a service to the payer and is not levied to generate revenue for general spending.

Taken to its logical extent, the "voluntariness" rule would mean that all charges collected for government general revenue other than perhaps a head tax are in fact not taxes. As one academic has put it, "[T]he definition is stretched to its logical limits when the court concludes that a fee is voluntary because the individual complainant can avoid the fee by ceasing to engage in the activity being assessed. By that reasoning, many taxes are likewise voluntary—to avoid income taxes, a taxpayer need only stop earning income."⁵

In *Bay Area Cellular*, the city argued that the 911 charge was not a tax because those who paid had "voluntarily consented" to pay it by signing up for phone service. The court rejected that argument, holding that the purpose of the charge is what matters, not the voluntariness of the decision made to purchase the taxed service. The Tax Foundation brief reviews other cases reaching similar conclusions.

The Charge in this Case Provides No Benefits to Those Who Pay It

Examples of charges accurately described as fees include filing fees paid to a court, tolls paid to drive on a government-operated road, user charges paid to a government-operated utility, or licensing fees paid to engage in a regulated occupation. These examples share two features: (1) provision of a service to a particular user, independent of society at large; and (2) the revenue is used to cover costs of that program, not transferred to other governmental programs.

In some cases, regulation by the governmental entity providing the service accompanies the charge, but not always. Mere regulation by itself, however, does not make a charge a fee. (Excise taxes, often justified as a way of discouraging the taxed behavior, are taxes notwithstanding their regulatory purpose, for instance.) If the city were to charge landlords for safety inspections or to cover rent from tenants of city-operated housing, such charges could be a fee. The charge would be imposed on specific individuals who receive government-provided services, with the charge generally related to services provided to those specific individuals.

Here, the City's fee-is-for-a-service argument can only succeed if being taxed is a "service" provided by government to an individual. The City argues that the charge "reimburse[s] Respondent for the cost to process RUBT applications, RUBT renewals, and rental unit business billing statements."⁶ In other words, the purpose is to cover the City's costs of levying a tax. It is mistaken to speak of tax collection as a "service." The costs associated with

tax collection, and taxes themselves, provide no particularized benefit to an individual, but rather a societal benefit not limited to those who happen to pay a tax.

All parties concede that the underlying RUBT is a tax. If a payment made to government is a tax, then it follows logically that payments made to government to collect that tax are also a tax, for collection of a tax is more of a core governmental function than activities funded by a tax. The City has conceded that its RUBT program benefits citizens as a whole, and not the landlords who pay it. The City fails to show that landlords receive any additional benefit from the processing charge.⁷ (The City does send out bills to collect the processing charge, although it is unclear whether this is what they point to as the "service" provided to landlords. However, it would be circular to argue that the City may send out bills for a charge so long as it provides the "benefit" of sending out bills for a charge.)

Because the benefits of the RUBT program and the processing charges that facilitate its collection are not particularized "services" provided to the landlords, but revenue-raising measures designed to benefit society as a whole, the charges involved are taxes. To hold otherwise would require denying that collection of taxes is a governmental function that exists to benefit society, not individual taxpayers, and would also require denying that payers of proper fees must receive a benefit beyond that enjoyed by society as a whole. If tax collection is not a governmental activity but rather one that provides services and bestows individual benefits, then every governmental activity could be so characterized.

The Charge in this Case Raises Revenue Beyond the Cost of Providing a Service

The City has admirably sought to track revenues from the processing charge separately from general revenues, and to adjust the charge's rate as the City's tax collection expenses change, so as to prevent "overcharging." These actions, however, are immaterial because the revenues raised are far in excess of the amounts needed to provide whatever services the landlords receive from the City.

As explained above, the processing charge provides no benefits to the landlord taxpayers aside from the benefits as members of society accruing from the collection of the RUBT. Since no service is therefore provided to the landlords, the amount of funds required to provide such services is zero. Since the processing charge raises \$3.5 million, that \$3.5 million is in excess of the funds required to provide the service.

Assuming, however, for the sake of argument that the collection of taxes is the "service provided" in exchange for the payment of the processing charge, the idea that \$3.5 million represents a rational amount of benefits accruing to the landlords is unbelievable. The RUBT generates about \$11 million per year in revenue, so in essence the City argues that it costs 31.8 cents for every \$1 in tax it collects. This is either inflated or woefully inefficient; the federal Internal Revenue Service (IRS), with elaborate refund mechanisms and auditing powers, in 2006 spent about \$10 billion collecting \$1.236 trillion in individual income tax revenue (about 0.8 cents for every \$1 of tax).⁸ The California Franchise Tax Board in Fiscal Year 2006 spent \$715 million collecting \$93 billion in tax revenue, or about 0.7 cents for every \$1 it collected.⁹ It is likely that the \$3.5 million cost is greatly in excess of actual tax collection expenditures, and consequently unreasonable and therefore in violation of

Government Code §50076 (which restrict fees to reasonable amounts of revenue to pay for services).

Whether a Tax Is "General" or "Special," It Is Still a Tax

The California Constitution divides the entire universe of taxes into two categories, each with separate constitutional treatment.¹⁰ Taxes imposed for no specific programmatic purpose, such as a general income tax increase or sales tax increase, are treated differently than taxes imposed for a particular purpose, such as a tax on phones to support the 911 system or a sales tax increase to fund transportation. Special taxes, because they shift funds from all taxpayers to a smaller subset of beneficiaries, are subjected to a higher threshold of two-thirds support from local voters to become effective, as opposed to a simple majority required for general taxes.

Once a court concludes that a charge is a tax, it must then ask whether it is a general tax or a special tax. The answer to this question ultimately depends on whether the purpose for imposing the tax—raising revenue to fund tax collection efforts—is a "specific project" or a "general governmental purpose." On one hand, the population of taxpayers is substantially narrower than the population of general taxpayers at large and the City concedes that it tracks the revenue separately notwithstanding commingling in the General Fund. Such a conclusion is in line with Proposition 218, which sought to limit the ability of local governments to levy new taxes for popular programs and shift existing revenue to less popular programs. On the other hand, the benefits of tax collection accrue to society at large, and tax collection is about the most common of general governmental activities. But because the universe of taxpayers is limited, and because the revenue was ostensibly dedicated to a specific project, the processing charge is best described as a special tax. In any event, be it special tax or general tax, the charge is a tax and not a fee.

Conclusion

The American antipathy to taxes is rooted deeply in our nation's history. It is no surprise that lawmakers seek to avoid raising taxes, or at least, seek to raise revenue in ways that avoid the "tax hiker" label. Consequently, lawmakers increasingly seek to raise fees, or classify an obvious tax as something else. *See, e.g.,* George Skelton, "Gov.'s about-face on healthcare 'fees' is more than a matter of semantics," *Los Angeles Times* (Jan. 15, 2007) ("The Schwarzenegger camp has been trying out all sorts of convoluted explanations about why the doc and hospital 'fees' aren't taxes."); Joe Follick, "Budget blues lead lawmakers to eye raising cigarette tax," *Ocala Star-Banner* (Nov. 29, 2008) ("Seeking to exploit [anti-tax sentiment] is a not-so-subtle provision in Waldman's bill that changes the 'cigarette tax' to a 'user fee,' an obvious move to avoid the political poison of debating a 'tax increase.'"); "Fenty proposes raising 911 'fee'," *Washington Times* (Mar. 28, 2007) ("Although the mayor has balked at labeling the [911 telephone surcharge] rate rise increase a tax increase, others haven't split the semantic hairs so well.").

The California Constitution is designed to protect taxpayers from these types of shell games. Labeling charges like the one at issue in this case as taxes enhances transparency and helps enable California citizens to better understand the cost of government. If the government hides the true cost of government services, citizens are unable to make meaningful choices

about public priorities. Excessive hidden fees here and there on some people, instead of transparent and broad-based taxes on everyone, undermine this good-government objective.

The processing charge imposed by Resolution R-299382 is a tax because its purpose is to raise revenue for a quintessential government activity (tax collection), as demonstrated by the circumstances surrounding its adoption and statements made by Respondent. The revenue from the charge funds no services to the payers of the tax, nor confers any exclusive benefits or privileges to them, nor funds regulation of their activities. The benefits of tax collection are accrued to society as a whole, indicating the general governmental purpose behind the processing charge.

Finding that the processing charge imposed by Resolution R-299382 is a tax would uphold the purpose and meaning of Proposition 218, which sought debate and voter consent where discrete groups are targeted for revenue increases but the benefits accrue to society at large.

About the Tax Foundation and its Center for Legal Reform

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of neutrality, simplicity, transparency, and stability.

The Tax Foundation advances this mission by educating the legal community and the general public about economics and taxpayer protections and advocating that judicial and policy decisions on tax law promote principled tax policy. Since 2007, the Tax Foundation has participated as *amicus curiae* before the U.S. Supreme Court and appellate courts in five states in cases involving tax/fee distinctions, taxpayer protections, multiple taxation and tax discrimination, and the power to impose taxes.

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1. See Cal. Const. art. XIII C - XIII D.
 2. Special taxes require a higher threshold because voters naturally can find a tax increase for a specific project more attractive than a tax increase for general purposes. This can be dangerous because money is fungible: a government can convince voters to raise taxes for a popular project that would have to be built anyway, and divert the money that would have been used into other projects that could never get public approval.
 3. (2008) 162 Cal. App.4th 686.
 4. *San Juan Cellular Tel. Co. v. Pub. Serv. Comm'n of Puerto Rico*, 967 F.2d 683 (1st Cir. 1992).
 5. Laurie Reynolds, *Taxes, Fees, Assessments, Dues, and the "Get What You Pay For" Model of Local Government*, 56 Fla. L. Rev. 373, 412 (2004)
 6. Respondent Br. 13.

7. *Cf. Oakland Raiders v. City of Berkeley* (1976) 65 Cal.App.3d 623, 627-29 (holding that if the only regulatory feature of a charge is to ensure that a tax is being paid, the charge is a tax).

8. See Internal Revenue Service, *IRS Data Book: 2007*, at <http://www.irs.gov/taxstats/article/0,,id=168593,00.html>

9. See Franchise Tax Board, *2007 Annual Report*, at <http://www.ftb.ca.gov/aboutftb/annrpt/2007/2007ar.shtml>.

10. See Cal. Const. art. XIII C.

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