

REPORT FROM

## OFFICE OF THE CITY ADMINISTRATIVE OFFICER

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Date: October 1, 2007

CAO File No. 0220-03122-0011

Council File No.

Council District: All

To: The Mayor  
The City Council

From: Karen L. Sisson, City Administrative Officer 

Subject: **MODERN COMMUNICATIONS TAX ORDINANCE**

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### SUMMARY

At the request of the Mayor, we are reporting on a modern communications tax. The City receives \$270 million in telephone users' taxes annually; this is six percent of all General Fund revenue. This tax revenue is critical to the public welfare and the City's financial ability to provide essential municipal services such as police, fire, street services, parks and libraries. The City's telephone users' tax ordinance is now the subject of litigation challenging application of the tax to certain telecommunications services as a result of outdated ordinance definitions or references to outdated federal laws. One case has been decided against the City at the appellate level and another case is pending. Still others are in earlier stages. The City requires reasonable certainty in the collection and receipt of its General Fund taxes; it needs to take steps to eliminate the legal issues to ensure continued provision of essential public services. The best step at this time is to adopt a modern communications tax which would use modern terminology and treat similarly situated users of telecommunications services equally. After adoption of Proposition 218 in 1996, any change to a tax ordinance can be challenged by asserting the change is a new tax or a tax increase. Voter approval of a modern communications tax would best resolve those types of issues. Tax elections must be consolidated with a regularly scheduled general election for members of the governing body of the local government. An exception from this requirement is cases of emergency declared by a unanimous vote of the governing body. Since the next scheduled municipal election will not occur until April 2009, the best option is to seek voter approval for a modern communications tax at a special municipal election which can be consolidated with the February 2008 statewide Presidential Primary Election Ballot.

Given the threats to General Fund revenue, it is prudent that the electorate be presented with a modern communications tax ordinance that would:

- eliminate outdated terminology which is currently the subject of litigation;
  - provide new definitions which are technology-neutral so that similarly situated users of communications services will be treated the same; and
  - reduce the current tax rate from ten percent to nine percent.
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**RECOMMENDATION:**

That the City Council request the City Attorney to prepare and present all resolutions, ordinances and related documents necessary to place the modern communications tax ballot measure on the February 5, 2008 Presidential Primary Election Ballot.

**FISCAL IMPACT STATEMENT**

Adverse judicial decisions could result in the partial or complete annual loss of \$270 million from the telephone users' tax. A modern communications tax, coupled with a rate reduction from ten percent to nine percent, would remove uncertainty regarding the City's ability to continue to provide essential services. This would ensure continuation of approximately 90-percent of telephone tax revenue but could result in reduced revenue of as much as \$27 million from the existing tax base. Some of that loss would likely be made up in future years, as the modern ordinance would more fairly distribute the lower tax burden and facilitate tax compliance.

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## FINDINGS

### 1. Basis for Report

The Mayor requested a report on a modern communications tax to replace the existing telephone users' tax. The telephone users' tax was imposed in 1967 in a different technological and legal environment. While the telephone users' tax contains references to outdated technology, it does not address paging; broadband telephone from new providers; and taxation of telephone-type communications services. There is no intention to tax internet access (e.g., charges from AOL and other ISPs), including email and digital downloads such as books, music, ringtones, games, and similar digital products. The intent is to have an equitable tax that applies to all users of telephone services, whether traditional "land line," wireless, or broadband telephone service (to the extent permitted by federal law, as there is currently a federal moratorium on some aspects of broadband service). The City's tax is being challenged on various legal theories that essentially assert the current tax either references outdated federal law or is improperly being applied to new federal law. Article XIII C of the California Constitution (enacted as Proposition 218 in 1996) prohibits any municipal tax increase without voter approval. The City maintains that technical adjustments in the tax in response to changes in federal law are not tax increases. But one case has been decided against the City at the appellate level and other cases are in various stages of proceedings. These circumstances create uncertainty in City financial planning and could jeopardize the City's ability to provide essential services. The City's tax should be modernized to reflect current conditions. Given the uncertainty created by continuous legal challenges, it is prudent to submit a modern tax to the electorate for approval as is being done by a number of other California public agencies which also impose a utility users' tax on telephone service.

### 2. Litigation

**2. (a) Challenge:** The portion of the City's telephone users' tax on wireless telephone service has been challenged under a Superior Court action entitled AT&T Wireless et al. v. City of Los Angeles. The case challenged the City's request – as a result of other changes in federal law – that, effective March 2003, all wireless carriers collect utility users' tax on the calling portion of wireless telephone bills regardless of whether they had previously collected the tax on that portion of the bill. The suit alleges that the City's actions represented a change in the taxing methodology for wireless phone calls, representing a tax increase that required voter approval under Proposition 218. The judge in this Superior Court case decided the issue against the City and that decision was upheld on appeal. Pending clarification, the City continues to collect such taxes, as it has since 2003. The portion of the telephone users' tax that is derived from wireless telephone service is estimated to be \$162 million (of the \$270 million total telephone tax revenue) in Fiscal Year 2007-08. Other litigation may be necessary to determine the full extent of the revenue loss.

**Solution:** A modern communications tax ordinance approved by the electorate would eliminate this wireless "airtime" issue by adopting the federal sourcing rule.

**2. (b) Challenge:** The City has received one request for the cessation of the collection of the telephone users' tax on long-distance service where the charge varies only by time and on charges for services where long-distance and local services are bundled. This request was filed on behalf of a single resident of the City, and "all similarly situated taxpayers in the City of Los Angeles," and also seeks a one- or two-year refund. The City Attorney is considering the appropriate response to this request. Similar lawsuits have been filed against three other public agencies (County of Los Angeles, Long Beach and City of Sacramento). The ongoing risk of this case is losing 75% or more of the annual \$270 million telephone users' tax.

This case is tied to actions at the federal level which may have a negative impact on the City's collection of taxes on telephone use. On May 25, 2006, the U.S. Treasury Department, in response to a series of appellate court losses, announced it is conceding a series of legal disputes over the federal excise tax ("FET") on long-distance telephone service. These appellate court decisions held that a telephonic communication for which there is a toll charge that varies with elapsed transmission time and not distance (time-only service) is not taxable as toll telephone service as defined in the FET. As a result, amounts paid for time-only service, as such service is most-commonly billed today, were found not to be subject to the tax. The Internal Revenue Service has ceased collecting the FET on all forms of long distance service, including wired telephone, wireless, and VoIP, and has issued refunds of the FET on long-distance service for the past three years. In addition to ending the litigation, the Secretary of the Treasury announced that he will call on Congress to terminate the remainder of the FET altogether by repealing the excise tax on local service as well.

The City's tax ordinance, like those of many other local telephone users' taxes, references the FET's exemptions. The City's ordinance states that the telephone users' tax "shall not be imposed upon any person for using telephone communications services or teletypewriter exchange services, to the extent that the amounts paid for such services are exempt from or not subject to the tax imposed under Sec. 4251 of Title 26 of the United States Code [the FET], as such Section existed on November 1, 1967." The City is reviewing the Department of Treasury's May 25, 2006 announcement, as well as IRS Notice 2006-50, 2006-25 I.R.B. 1141, issued in connection with this announcement, to determine the effect of these changes on the application of the City's telephone users' tax ordinance, if any.

**Solution:** A modern communications tax ordinance approved by the electorate would eliminate the FET issue.

Other pending challenges to the City's continued collection of its telephone users' tax could be cured by a modern communications ordinance approved by the electorate.

### **3. Communications Users' Tax**

A modern communications' users' tax would improve tax equity by treating similarly situated users of communications services in the same manner, to the extent that is permitted by federal law. The ordinance would no longer reference the federal excise tax, but instead would adopt modern definitions similar to those adopted by a number of other jurisdictions that wish to update their taxation laws to reflect the latest technologies.

The exact wording and structure of the ordinance will be developed by the City Attorney with the assistance of the City Administrative Officer and the Director, Office of Finance. Some areas to be addressed include:

- The “telecommunications services” tax base could be defined broadly and in a technology-neutral manner so as to include the means of transmission, conveyance, or routing of information or signals to a point, or between or among points, whatever the technology or protocol used, whether such content is voice, data, audio, video, or any other information or signals. It would not include the content itself (e.g., video programming).
- The “telecommunications services” tax base would treat all technologies the same including traditional telephone, wireless, VoIP (voice over Internet) and broadband telephony, 800 and 900 service, paging, and private communication services (e.g., T-1 networks);
- Such other changes which would make the City’s tax consistent with taxing practices of other jurisdictions, including the use of similar definition of terms as used by the telecommunications industry and other taxing agencies.

#### **4. Tax Rate Reduction**

Telephone users’ tax revenue accounted for about 7.5 percent of General Fund revenue throughout the 1990s. It has been declining as a share of General Fund revenue since then, and it is now about six percent of the General Fund budget. General Fund revenue grew by six percent in both FY 2005-06 and FY 2006-07. However, telephone users’ tax revenue grew by only one percent in those years. Attached Charts A and B provide perspective. A modern communications tax ordinance would provide for similar tax treatment for similarly situated users of telecommunications services and eliminate loopholes created by changing technology not currently included in the tax base. There is no basis to forecast revenue changes that might be associated with a modern communications tax ordinance, but there is a basis to hope the decline in the telephone users’ tax base could be reversed when loopholes created by changing technologies are closed.

If a modern communications tax is not enacted, there is a real likelihood that the tax base will continue to erode due to migration of telephone users from services included in the old tax to currently non-taxed services. It is also likely that adverse court decisions could eliminate all or a substantial part of the \$270 million annual revenue from the current telephone users’ tax.

Since there is a basis to believe a measure placed before the voters would result in additional revenue associated with a more equitable tax base, taxpayers should also benefit. A tax rate reduction from ten-percent to nine-percent would likely be offset in future years with revenue from the broader tax base.

#### **5. Voter Approval**

Article XIII C was added to the California constitution with voter approval of Proposition 218 in 1996. Among its provisions is Section 2 (b).

*“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 increased if it is imposed at a rate not higher than the maximum rate so approved. The election required by this subdivision shall be consolidated with a regularly scheduled general election for members of the governing body of the local government, except in cases of emergency declared by a unanimous vote of the governing body.”*

Given the uncertainty associated with current litigation, and the continued erosion in the tax base due to outdated terminology, a modern communications ordinance should be adopted as soon as possible. The City Clerk advises that the February 5, 2008 Presidential Primary Election Ballot is the next available election at which this measure can be consolidated. Waiting for the next regularly scheduled general election for members of the governing body, which will occur in April 2009, could result in the City's inability to continue to fund basic public services. To place the modern communications tax ordinance on the February 5, 2008 election ballot, the above-cited section requires an emergency be declared by a unanimous vote of the City Council.

#### **6. Basis for Emergency Declaration and Magnitude of a \$270 Million General Fund Loss**

The current telephone users' tax has an appellate court decision against it and other cases are in litigation; the outcome of these cases could have major financial impacts and attendant service reductions. There will no local election until April, 2009, and the loss of the City's utility users' tax on telecommunications prior to that time would result in major financial and service disruptions. As previously discussed in Section 2., estimates of annual revenue losses from these cases range up to \$270 million; there are no other potential ongoing revenue sources available to offset a loss of that magnitude.

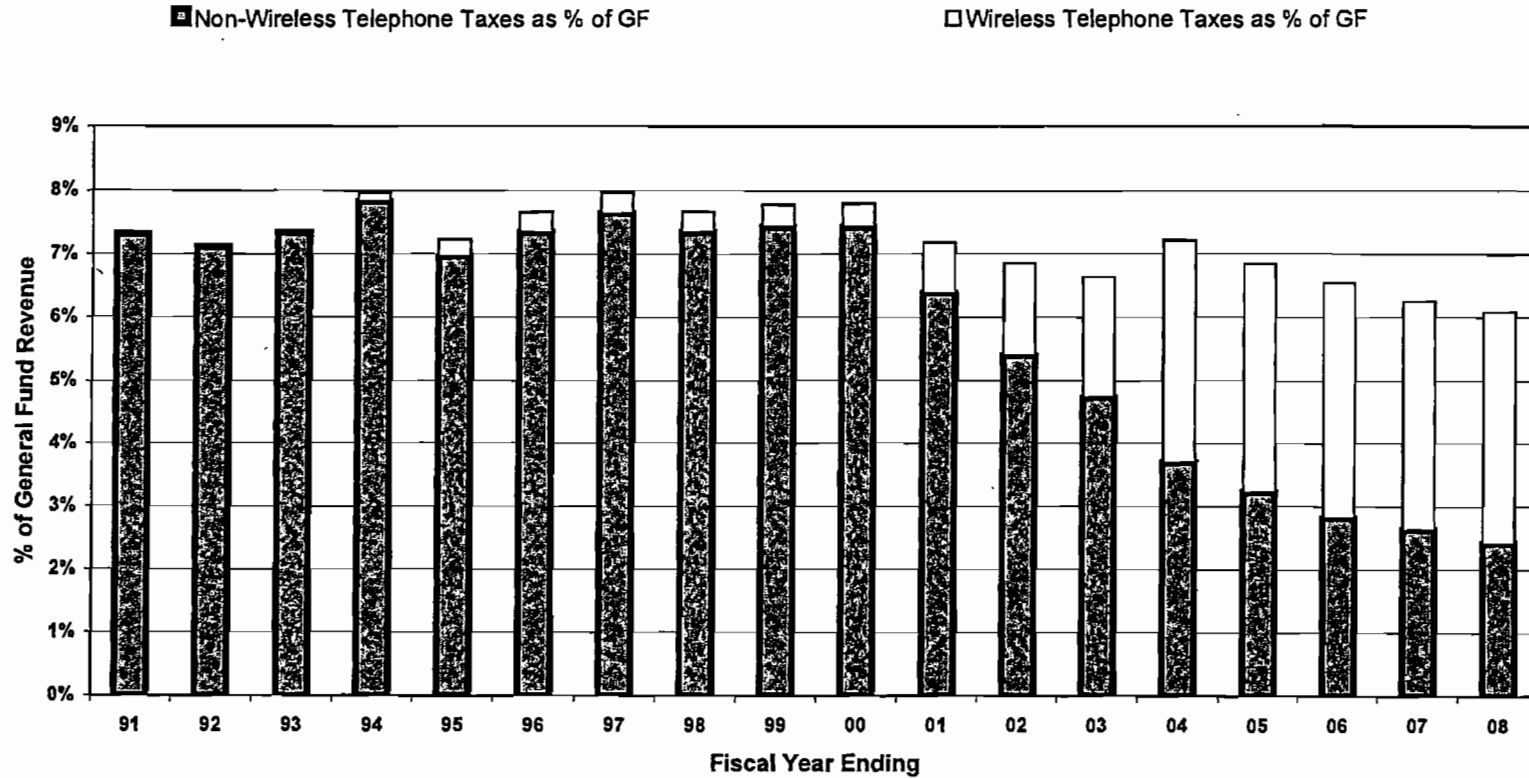
It is difficult to identify the specific services and functions which would be eliminated to achieve a \$270 million reduction to the City's General Fund Budget. If this reduction occurs, our recommendations to the Mayor and Council would weigh the relative priorities of services, including services related to public safety, services which are legally mandated services which are revenue-generating, or services which are fully reimbursed. Any recommendation would dramatically impact many City services, such as potential reductions of operating hours at libraries, parks, and recreation centers; reduced police hiring; and the closure of some essential City facilities (e.g., fire stations).

Funds are set-aside in the City's Reserve Fund to address contingencies. However, the City's Reserve Fund is currently \$138 million, \$63 million below the adopted budget, of which \$122 million is reserved for urgent economic necessity (e.g., earthquake or significant economic downturn). Even if the Reserve Fund were used to partially mitigate a telephone users' tax loss, the use of these one-time funds would not address the ongoing loss of telephone users' tax revenues.

In any event, the City will meet its financial obligations including debt repayments, to maintain its excellent credit ratings and to preserve its flexibility in obtaining future debt financing needs.

Chart A

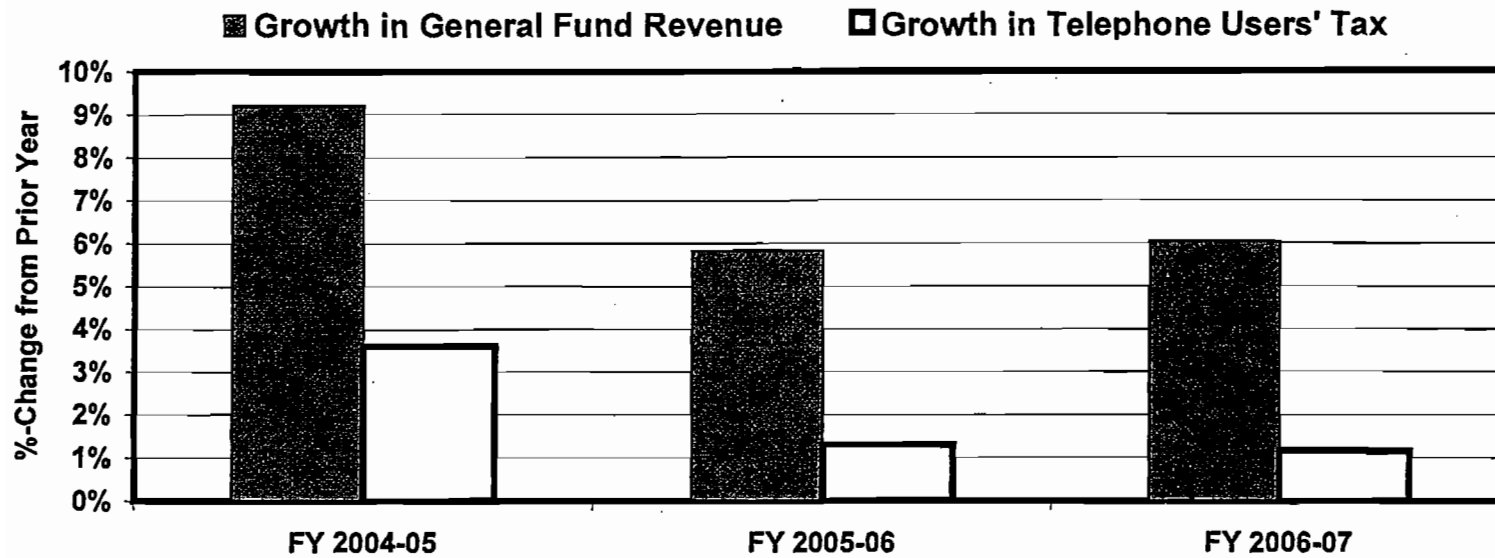
### Telephone Users' Taxes as % of General Fund Revenue



The telephone users' tax consistently provided more than 7% of General Fund revenue through FY 2000-01. The Federal Mobile Sourcing Act became effective in August 2002; FY 2003-04 was the first full fiscal year affected by that federal statute. Coincident with increasing revenue from wireless telephone users, non-wireless telephone taxes began declining as a percent of General Fund Revenue in FY 2000-01. Values for FY 2007-08 are budget estimates.

Chart B

## Comparison: Change in Rate of Growth in General Fund Revenue and Telephone Users' Tax



General Fund revenue grew by six percent in both FY 2005-06 and FY 2006-07. Telephone Users' Tax revenue grew by only one percent in those years. A modern communications tax ordinance would provide for similar tax treatment for similarly situated users of telecommunications services and eliminate loopholes created by changing technology not currently included in the tax base.