



Information Item

Date: June 13, 2006

To: Mayor and City Council
From: Steve Stark, Chief Financial Officer
Subject: Utility Users Tax – Telecommunications

Introduction

In the City Manager's budget message we mentioned that legal challenges in other jurisdictions could potentially reduce or eliminate the City's Utility Users Tax (UUT) on telecommunication services. A recent Internal Revenue Service ruling that dramatically reduces the scope of the Federal Excise Tax (FET) on telecommunications will undoubtedly introduce more legal questioning regarding our telecommunications UUT, as the City's ordinance (like nearly all other UUT ordinances in California) references the FET. This Information Item generally discusses the status of these legal actions and what prudent steps the City may take to minimize the effect on its General Fund and budgetary planning in the event of one or more adverse legal rulings in the future. Nothing in this information item, however, is intended to predict the outcome of any litigation or should be construed as assessing the validity of any particular legal claim or theory.

Background

The Utility Users Tax (UUT) is a 10% tax applied to electricity, natural gas, telephone (both hardwire and wireless), cable and water/wastewater services. The total UUT generates over \$31 million in revenue for the City's General Fund and represents approximately 13% of the General Fund revenue budget. The total telecommunication service portion of UUT revenue collections represents \$12 million or 5% of General Fund revenue, and 75% to 100% of this amount is potentially at risk.

Discussion

Legal Issues

On May 25, 2006, the IRS issued a notice that it intended to stop applying the FET to nearly all telephone communication services, except local exchange services, which leaves only about 25% of all the telecommunication services as federally taxable. The IRS' action followed a series of federal court losses involving taxpayer challenges to the archaic statutory definition of "toll telephone service" (or long distance) in the FET. In addition to conceding that the FET no longer applies to wired and wireless long distance (and other bundled services such as VoIP, prepaid cards), the Treasury Secretary has further urged Congress to repeal the FET, arguing that it does not make sense to continue the tax on such a small segment of the telecommunication industry. There are two bills that would accomplish that repeal (HR1898 and SB1321).

Like 150 other California cities, Santa Monica imposes a Utility Users Tax on telecommunication services. Also, like the vast majority of these cities, Santa Monica's

UUT ordinance refers to the FET and its many exemptions, in response to the telephone companies' request of many years ago to do so to achieve administrative ease. The legal question now arises, does the FET reference in the City's ordinance mean that the City's UUT ordinance automatically incorporates the recent IRS ruling, even though the City never adopted the FET definition of "toll telephone service" in its UUT ordinance?

The answer would appear to be no. However, because of less than precise UUT language some uncertainty exists, especially since there is no final appellate court decision on this issue in California. In the meantime, it is expected, but not completely assured, that the telephone companies will continue to collect the City's UUT as directed by the City until a California appellate court issues a final ruling on these complicated matters.

Litigation is pending elsewhere in California that raises similar although not identical issues. For instance the City of Palo Alto and Verizon Wireless are involved in a lawsuit over the scope of Palo Alto's UUT and whether it can be applied to wireless carriers. This lawsuit is presently at the trial level, with an appellate ruling, if any, being a few years away.

In addition to the Palo Alto/Verizon Wireless lawsuit, there is a lawsuit between the City of Los Angeles and Verizon Wireless and AT&T Wireless that if applied to Santa Monica, it could potentially affect up to 50% of the City's wireless UUT or \$4M annually.

This lawsuit is currently being briefed before the Court of Appeal with an argument being anticipated later this year. Again, until a final appellate court decision is rendered it is impossible to know the exact impact, if any, on the City's wireless UUT.

The IRS decision and the other lawsuits are being analyzed and monitored statewide by the League of California Cities and by many individual cities. A clearer legal response will be developed over the next few weeks.

One possible local response is to amend the City's UUT Municipal Code either in a comprehensive fashion to modernize it completely or in a more limited manner to clarify it by removing references to the FET and other language that is currently the focus of litigation. With respect to the latter approach the City Attorney's Office is reviewing whether clarifying changes in the City's UUT Municipal Code can be achieved by City Council action alone or whether voter approval in accordance with Proposition 218 is also necessary nevertheless, some California cities may conservatively decide to pursue voter-approved UUT ordinance amendments so as immunize their General Fund from future adverse court decisions, as described above. The League is also exploring other options such as state legislation.

Potential Revenue Impacts

The total amount of Utility User Taxes on telecommunication services collected by the City of Santa Monica is estimated to be approximately \$12 million in FY 2006/07. As mentioned above, if the IRS Ruling applies with equal force to the City's UUT ordinance,

and if the City did not or could not amend its UUT ordinance, then the City could permanently lose approximately 75% or \$8M of its total \$12M telecommunications UUT.

If a final appellate court decision were issued in the City of Los Angeles case that was adverse to that city and if the decision could be equally applied to the City of Santa Monica's UUT ordinance, then in a worst case this City could potentially suffer a permanent loss of up to 50% of its existing wireless UUT or \$4M annually. Such a final ruling could occur as early as one year from now. However, there are too many potential variables at play now to predict with any certainty what would be the possible effect, if any, on Santa Monica from this litigation.

Summary

Based on currently known facts, the City's revenues could potentially be impacted by: Palo Alto case (\$4 million), Los Angeles case (\$4 million), IRS ruling (\$8 million) or total telecommunications (\$12 million). Although it is unlikely that adverse legal precedents will arise during this coming fiscal year (FY 2006-07), in reality, we cannot predict with absolute certainty the timing and outcome of the numerous legal or other actions that may occur. It is, therefore, prudent to establish at this time a reserve that is sufficient to allow the City at least one year, without budgetary disruptions, to: i) find replacement revenues; ii) make sensible budget/service reductions; and/or iii) pursue local or state legislative solutions for the cities' existing telecommunications UUT, including deciding whether it is necessary to place any local legislation on the ballot for voter-approval. Accordingly, we recommend \$8.2M as a reasonable reserve amount to off-set the risk

of a sudden loss of tax revenue due to possible future adverse court rulings. This approach is very similar to the method that the City used in 2004 to set aside money for potential State takebacks.

During the next fiscal year, City staff will develop various budget scenarios for Council consideration if the UUT revenue losses actually occur. In the adopting the City's FY2006/07 budget that \$8.2 million in one-time General Fund monies would be used as a designation to offset any potential revenue loss during this or the following fiscal year so that on-going, essential services can be maintained. At the direction of the City Manager, staff has identified \$8.2 million available from the following sources:

\$3.0 million: Reduction in the PCD / Permit Center CIP proposed for FY2006/07 budget from \$5.0 million to \$2.0 million

\$2.2 million: Interest earnings on funds set-aside for bond payments on Santa Monica Place parking structure

\$1.0 million: Capital Improvements Projects Start-Up set-aside for projects now completed (courthouse mitigation, Main Library, Virginia Avenue Park)

\$2.0 million: Environmental Mitigation set-aside for capital projects

If ongoing actions are needed for future years, they can be considered at either mid-year or for Fiscal Year 2007/08.

In addition to the \$8.2 million set-aside, the City Manager has also asked City departments to hold off on filling certain new positions authorized in the FY2006/07 budget for a six month period. As additional information becomes available regarding the potential revenue loss, we will be better able to assess when the new positions can be filled on a permanent basis.

We will continue to keep Council informed as new information becomes available and will discuss the issue at our FY2006/07 budget adoption meeting on June 20, 2006.