



CITY OF SANTA BARBARA

COUNCIL AGENDA REPORT

AGENDA DATE: February 21, 2008
TO: Mayor and Councilmembers
FROM: Administration Division, Finance Department
SUBJECT: Utility Users Tax Work Session

RECOMMENDATION:

That the City Council hold a work session to discuss options available to the City in order to avert the potential loss of approximately \$3.8 million derived from the City's Utility Users Tax on Telecommunications.

DISCUSSION:

Since 1970 the City has received revenues from a utility users tax (UUT). Half of the UUT revenue is used to fund critical services including police and fire services, parks maintenance and recreation activities. The other fifty percent is used for the reconstruction, maintenance and repair of city streets. Public safety, parks and recreation activities and the safety and quality of our streets are all dependent on the UUT.

The City's UUT is a 6% tax is levied on utility services including water, electric, natural gas, refuse, cable television and telephone. The UUT is one of the City's largest revenue sources, providing over \$13 million annually. The revenue is split evenly between the City's General Fund and the Streets Fund providing significant resources (over \$6.5 million) to both funds. The following table summarizes the City's total UUT revenue for fiscal year 2007.

<u>Utility Service</u>	<u>Amount</u>
Electric	\$ 4,198,045
Telecommunications	3,879,244
Water	1,497,254
Natural Gas	1,336,518
Cable TV	1,255,510
Trash	966,310
Total	<u><u>\$ 13,132,881</u></u>

REVIEWED BY: _____ Finance _____ Attorney _____ Name of Additional Department(s) That Need to Review CAR

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Unfortunately, due to rapidly changing telecommunications technology and developments in the legal environment, the City's UUT revenue derived from telecommunications services (telephone) is now possibly at risk. As the table above indicates, the telecommunications UUT is the City's second largest source of UUT revenue providing almost \$3.9 million annually.

Santa Barbara is similar to more than 100 California cities which fund local programs and services with a UUT. Typically, a UUT is levied on each user of a utility (e.g. telephone, electricity, gas, water, or video services) within an agency's boundaries. Most UUT ordinances in California date from a model ordinance developed by the League of California Cities in the 1970s after negotiations with the major utilities intended to standardize collection and to ease the administrative burdens for utilities companies. Since that time however, communication technology has changed dramatically with the demise of telegrams and the rise of cell phones, internet communications, satellite communication, and other communication media, as well as the advent of fixed-fee calling plans and other marketing trends that simplify billing and reduce costs. Meanwhile, UUT ordinances have not kept pace with rapidly evolving technology because modernization of tax ordinances has been made more difficult by the voter-approval requirements of Propositions 62 and 218. This growing gap between 1980s ordinances and a rapidly changing marketplace has fueled a number of legal and practical challenges to utility users taxes on telephony.

The Federal Excise Tax Issue: Most UUT ordinances, including the City's, are based on the old League model ordinance and exclude from the tax base payments for services "exempt from" or "not subject to" the Federal Excise Tax (FET). For many years, the Internal Revenue Service (IRS) imposed the FET on most telephone charges, including charges based on *either* time *or* distance. This cross-reference to the FET exemption in local ordinances allowed the phone companies to standardize their billing methodology (which, of course, covered many cities and counties) and, thus, to only worry about one "exemption" in their billing practices despite providing phone service to many cities and counties. However, in May 2006, following a number of court decisions adverse to the IRS, the IRS announced it would no longer collect the FET on telephone charges not based on time *and* distance. Because most of the California UUT ordinances, including Santa Barbara's, cite the FET, some carriers now argue that the IRS' policy change applies to California local agencies UUT. If true, this would virtually eliminate UUT revenue on telephony, since charges for almost all telephone plans today, especially for cellular plans, are based on time only, regardless of the distance between the two phones served by a call.

A number of California cities have amended their UUT ordinances to clarify that they did not wish to adopt the IRS' new practice, but rather intended to continue to impose their UUT as they had historically been imposed (*i.e.* on charges based on time *or* distance). Lawsuits challenging the right of local taxing authorities to amend their ordinances without voter approval, or to continue to

collect this revenue without amendment, are now pending against the County and City of Los Angeles, the City of Sacramento and the City of Long Beach. Consequently, a number of cities have opted to seek voter approval of modernized and clarified ordinances in order to prevent this sort of challenge.

Technological Change: It is likely that older technologies (e.g., landlines) will continue to be replaced by newer technologies. Indeed, some predict that web-based communications, like voice-over-the-internet protocol (VoIP) as offered by Vonage or Skype, will take over a significant portion of the market in the next decade, perhaps even overtaking cellular telephony. Therefore, as technology continues to evolve, local agencies can expect continuing challenges to tax ordinances dating from the League's 1970s model ordinance. Such challenges could be troubling, both because failure to tax newer technologies would result in a substantial reduction in revenue for local services and also create an inequitable situation where those who can afford newer technologies are not taxed, while those who cannot continue to be taxed. Similarly, the convergence of voice, data, video, and other services also poses challenges for the application of older UUT to new service plans offered by so-called "triple play" providers. These issues, too, can be addressed by voter approval of an updated UUT ordinance. The February 2008 ballot saw proposals to do so in Los Angeles, Pasadena and other cities around California – all of which were approved by voters.

Unless Santa Barbara addresses these concerns, the City is at risk of losing virtually all of its telephone UUT revenue – revenue dedicated to essential services such as police, fire, park maintenance, recreation programs and street maintenance.

Work Session Agenda:

At the Work Session staff will:

- Provide background information – what is the Utility Users Tax?
- Explain the potential exposure - why is the city at risk of losing virtually all of its \$3.8 million in telecommunications Utility Users Tax?
- Describe services at risk – what services would be affected by the loss of this revenue?
- Present options – what can we do?
- Discuss next steps and timelines for policy decisions and seek general direction on how to proceed.

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Assuming Council is interested in proceeding to protect these critical revenues, following the Council Work Session staff proposes to work with the Ordinance and Finance Committees to craft final recommendations to be presented to the City Council and a later date.

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SUBMITTED BY: James L. Armstrong, City Administrator