

August 5, 2008

TO: Mayor and City Council

FROM: J. Gordon Palmer, Jr., City Manager

SUBJECT: **MEASURE ON THE NOVEMBER 4, 2008 GENERAL MUNICIPAL ELECTION TO MAINTAIN AND UPDATE THE UTILITY USERS' TAX CONTINUING UNCHANGED THE EXISTING TAX RATE**

RECOMMENDATION

Adopt a resolution submitting to the City of Stockton qualified voters at the November 4, 2008 General Election, a ballot measure seeking voter approval to amend the City's Utility Users' Tax by updating the City's Utility Users' Tax telecommunications and video services without raising the tax rate, and authorize the City Attorney to prepare an impartial analysis of the measure.

DISCUSSION

Summary

This is not a new tax; rather, the measure protects existing revenue and applies the tax equally, regardless of the technology used to provide telecommunication and video services.

Background

The City's adopted budget assumes the continuance of \$9.5 million of the City's Utility Users' Tax on telecommunications, and \$2.15 million on video services. This tax has been in effect since 1969 and helps maintain funding for general municipal services such as police and fire protection, street maintenance, parks and libraries, and other support services. Given changes in technology, the City wishes to update its ordinance without raising the tax rate of 6% so that taxpayers are treated equally, regardless of the how the communication services are provided. Starting in Fiscal Year 2004-05, the City voluntarily phased in the reduction of the Utility Users' Tax rate which was 8%, and completed final reduction to 6% occurring in Fiscal Year 2006-07.

Technological changes not anticipated when the Utility Users' Tax was initially developed result in the current tax not being applied equally to some services due to the technology used to deliver the service. In contrast users of traditional telephone and cable television services potentially shoulder a disproportionate share of the tax burden. The update will close these technology imbalances, and ensure that all communications services are taxed equally. There will be no increase in the tax rate. Pursuant to Proposition 218, any future tax rate increase would require voter approval.

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Present Situation

The majority of the City's \$9.5 million of telecommunications Utility Users' Tax is at risk because of legal challenges and technology changes. These risks are not unique to Stockton, but are common to 150 other Utility Users' Tax public agencies.

The legal challenges pose a serious and immediate threat to this source of revenue. Nearly every Utility Users' Tax ordinance in California, including the City's, references the federal excise tax, specifically adopting the federal excise tax exemptions and exclusions. This was done many years ago for administrative convenience. As a result of numerous federal lawsuits successfully brought by taxpayers against the Internal Revenue Service, the Internal Revenue Service last year issued a Notice directing the telephone companies to discontinue collecting the federal excise tax on long distance (wired and wireless, including Voiceover Internet Protocol) and prepaid cards) by August 1, 2006, which has now taken place. This ruling resulted in a 75% reduction in the federal excise tax base. This ruling raises the question as to whether the Internal Revenue Service ruling applies to the City's Utility Users' Tax due to the reference to the federal excise tax law in the City ordinance. This issue is now in class action litigation in at least three other jurisdictions. A final appellate court decision could occur as early as 2009.

There was also an appellate court decision last year involving the City of Los Angeles' Utility Users' Tax ordinance on another legal issue that could potentially affect the city's Utility Users' Tax on wireless charges.

Viewing all of the outstanding legal risks, and assuming a worst-case scenario, most, if not all, of the City's current \$9.5 million of telecom Utility Users' Tax is at risk. In addition to the legal challenges, there are technological ones as well; including some that may impact the City's budgeted \$2.15 million in video services Utility Users' Tax. In 1969 when the City first adopted the Utility User's Tax, the technology used to provide telephone and video services was very different; nonetheless, the services themselves are still a utility and the tax should apply regardless of the how the technology is bundled to provide the service. Today, instead of an older style of telephone service from one or two monopoly providers, we now have a variety of technologies, providers, and systems that simultaneously offer data, internet access, video (IP-TV), and Voiceover Internet Protocol. The "bundling" and "convergence" of these services and technologies is rapidly expanding. Private communications systems (e.g., T-1 lines), using internet protocol and high speed, broadband services, are now the method of choice for many businesses. AT&T (formerly SBC) and Verizon are also installing fiber to enable residential customers to opt for Voiceover Internet Protocol, internet access, and IP-TV (cable-like) services.

Although these new converging technologies and services offer economic opportunities in our city, they also present legal problems for our Utility Users' Tax ordinance, which

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references the archaic language in the federal excise tax statutes dating back to 1898. Modernizing the Utility Users' Tax ordinance requires Proposition 218 voter approval.

To address the problems of litigation and technology changes, a number of California cities are looking to adopt a modern telecom/video Utility Users' Tax ordinance, with definitions designed to address the twenty-first century, and beyond, modes of communications. The modern ordinance will eliminate the language from the old ordinance that is the subject of current litigation, and will include new language that is more technology neutral, since it is the service that is being taxed. A major overhaul of the City's Utility Users' Tax ordinance, requires voter approval, as the new definitions would create a new tax base, for example, by adding paging, text messaging, private communication services (e.g., T-1 lines) and IP-video.

Since November, 2006, twenty-four Utility Users' Tax cities and agencies have adopted modern Utility Users' Tax ordinances, with voter approval, that addressed the above mentioned legal concerns. A number of Utility Users' Tax cities are now actively considering this option for the November 4, 2008 general election. Under California law, a tax measure must be scheduled at the same time as a local election, unless the City Council unanimously calls for a special election based on an "emergency."

FINANCIAL SUMMARY

The Utility Users' Tax is an important revenue source to the City. This is not a new tax, and this measure simply replaces the outdated telephone/video ordinance language to respond to new communications technologies. The goal in changing the ordinance is to keep the same level of revenue that we now have, which is vital to the delivery of the services we currently offer.

The cost of placing the measure on the ballot will be covered by the Fiscal Year 2008-09 election budget. Voter approval of the measure would safeguard \$9.5 million in revenue generated by utility users' taxes on telecommunication services, and \$2.15 million in revenue on video services, as adopted in the budget.



J. GORDON PALMER, JR.
CITY MANAGER

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