Council Meeting
March 4, 2008

Honorable Mayor and Members
of the City Council
City Hall
Torrance, California

Members of the Council:

SUBJECT: City Manager & Finance - Adoption of ORDINANCE clarifying the independence of the City's telephone tax from the Federal Excise Tax on Telephony

RECOMMENDATION

Recommendation of the City Manager and the Finance Director that the City Council adopt an ORDINANCE amending Section 225.1.3 of the Torrance Municipal Code to clarify that the City's application of the telephone users' tax to intrastate telephone communications services has been and will continue to be consistent with the Internal Revenue Service's interpretation of the Federal Excise Tax prior to May 25, 2006.

BACKGROUND

Since 1972, the City has imposed a telephone users' tax on every person using telephone services in the City. Presently, the tax is imposed at a rate of 6.5% of the charges billed.

For the ease of administration and for the convenience of the telephone communication service providers, the City has generally looked to federal interpretation of the Federal Excise Tax on Telephony (FET) for guidance on the scope and application of the City's utility users' tax with respect to telephone communication services. The City's tax has been applied consistently with the application of the FET upon local and long distance telecommunication services as the FET is interpreted by the Internal Revenue Service (IRS).

With the growth of wireless communications, a national dispute arose regarding the application of the FET to cell phone calls. The FET taxes long distance or "toll" calls as those for which charges varied according to both the elapsed time of the call and the distance between the persons on the call, local calling services which allow unlimited calls for a flat monthly fee in a limited geographic area and wide-area-telephone service (WATS) which allowed a large volume, or unlimited volume, of telephone services between two defined geographic areas. Unlike traditional "land line" services, cell phone providers began to offer service on a flat rate per minute or fixed monthly charge without consideration to the distance between the two telephones served by a call.

In 1979, the IRS had issued a Revenue Ruling (79-404) determining that a variable for distance was not necessary for a toll call to be subject to the federal tax. The IRS defended lawsuits around the country challenging the application of Revenue Ruling 79-404 and the FET to such phone charges.

On May 25, 2006, the IRS issued Revenue Notice 2006-50 which announced that the IRS was reversing its 1979 position, and would no longer interpret the FET as applying to communications which were billed based on time only, and not both time and distance. Revenue Notice 2006-50 goes on to create a new service category called "bundled services" which could extend the reach of this interpretation to different billing practices by traditional phone companies as well as the wireless providers. Consequently, effective August 1, 2006, the IRS no longer applies the FET to long distance and bundled service.

Bundled service is local and long distance service provided under a single plan that does not separately state the charges for local telephone service. The Treasury Department's May 25, 2006 Notice reversed its prior Revenue Rulings and interpretation of the FET, which the City has relied upon in applying its telephone users' tax to telecommunication services. Adopting the IRS new standard would substantially reduce the telecommunications services subject to the City's tax and revenues to the City for such general fund services as police and fire services.

In addition the Treasury Secretary has further urged Congress to repeal the FET entirely, arguing that it does not make sense to continue the tax on such a small segment of the telecommunications industry. There are Congressional amendments pending which would accomplish that total repeal although their passage by a Democratic Congress and in the current fiscal climate in Washington may not be certain.

DISCUSSION

Since the interpretation of the FET by the IRS is not necessarily binding on the City for purposes of levying or collecting the UUT on telephone communications services, staff recommends that the UUT be amended to clarify that the reference to the FET in the utility users' tax ordinance is as interpreted by the IRS prior to the issuance of Revenue Notice 2006-50. In doing so, the City will continue to apply its UUT to telephone services as it has historically, and consistent with IRS Ruling 79-404. This proposed amendment will also eliminate the need for future clarifications of the City's ordinance to address further changes in the FET.

The proposed ordinance is not intended to impose a new tax, extend or increase an existing tax and therefore Proposition 218 does not apply to these ordinances. Instead, by this amendment to the telephone users' tax, the City reaffirms that it will continue its long-standing practice of applying its tax in a manner consistent with the IRS' interpretation of the FET prior to Notice 2006-50 issued by the U.S. Treasury Department on May 25, 2006. Voter approval of a measure on June 3, 2008 to clarify and update the UUT on this and other issues will eliminate any question on this point.

The proposed ordinances clarify that the City is not changing its application of its telephone users' tax based on the IRS' decision to discontinue taxing services charged without reference to the distance between the phones service and bundled services in order to resolve legal disputes with telephone customers. Rather, the City wishes to continue to tax intrastate local, long distance, and bundled services as it always has - based upon the IRS' interpretation of the FET prior to May 25, 2006.

Further, the ordinance clarifies that when the City limited its tax base to charges "subject to" the Federal Excise Tax, it did not intend, and did not adopt, either federal law or federal enforcement policy as to how to treat bundled charges, some of which are "subject to" the FET and some of which are not. The City's current practices regarding the taxation of bundled plans (when a non-taxable service and a taxable service are billed together under a single charge) makes collection of the tax, as currently done, obligatory. This ordinance will formally document this existing administrative practice, as well.

FISCAL ANALYSIS

This measure clarifies the City's existing telephone tax and will have no impact on revenues received under that ordinance. It may accomplish savings by clarifying the meaning and administration of the tax and reducing the need for legal services with respect to the administration of the tax.

The City Manager and the Finance Director request that the City Council waive full reading and adopt the attached Ordinance to clarify the independence of the City's telephone users tax from the Federal Excise on Telephony and to document the City's existing administrative practice regarding the taxation of bundled taxable and tax-exempt telecommunications services.

Respectfully submitted,

Eric E. Tsao
Finance Director

CONCUR:

LeRoy J. Jackson
City Manager

Attachment: Ordinance

ORDINANCE NO. 2008-_____

AN ORDINANCE OF THE CITY COUNCIL OF THE CITY OF TORRANCE, CALIFORNIA AMENDING THE TORRANCE MUNICIPAL CODE TO CLARIFY ITS ORIGINAL INTENT AND TO REMOVE OBSOLETE REFERENCES IN THE TELEPHONE AND TELETYPEWRITER EXCHANGE USERS TAX

WHEREAS, Chapter 25 of the Torrance Municipal Code imposes a tax on telephone communications services by referring to definitions in the federal excise tax on telephone services administered by the Internal Revenue Service (IRS). The common understanding of those definitions when the City gave the tax its current scope upon the adoption of Ordinance No. 1983 in 1991 was set forth in the IRS' Revenue Ruling 79-404;

WHEREAS, on May 25, 2006, the IRS announced in Notice 2006-50 that it has now changed its interpretation of the definitions in the federal excise tax and specifically revoked notices adopted in 2005 which had reaffirmed Revenue Ruling 79-404;

WHEREAS, subsequent to the issuance of Notice 2006-50, the IRS issued Notice 2007-11, announcing that Notice 2006-50 does not affect the ability of state or local governments to impose or collect telecommunication taxes under the respective statutes of those governments;

WHEREAS, the City Council does not wish to adopt the Internal Revenue Service's new understanding of the definitions of the federal excise tax in implementing the City's tax, but rather wishes to continue to impose the City's telephone and teletypewriter exchange users tax as it has been historically imposed;

WHEREAS, the amendments made under this Ordinance are not intended to make any change in the way in which the utility users tax on telephone services is calculated, imposed or administered. Therefore the changes made by this ordinance describing the base of the telephone and teletypewriter exchange users tax, and clarifying certain administrative requirements, are not intended to constitute a change in methodology or otherwise constitute a tax increase for purposes of Proposition 218 and this ordinance shall be interpreted in light of that intent;

NOW, THEREFORE, THE CITY COUNCIL OF THE CITY OF TORRANCE DOES ORDAIN AS FOLLOWS:

Section 1. *Code Amendment.* Section 225.1.3 of the Torrance Municipal Code is hereby amended to read as follows:

"TELEPHONE AND TELETYPEWRITER EXCHANGE USERS' TAX.

a) There is hereby imposed a tax upon every person in the City using interstate, intrastate or international telephone communication or teletypewriter exchange services in the City, or mobile or cellular telephone communication when the owner or lessee of the telephone has a billing address in the City. The tax imposed by this Section shall be six and one-half (6½) percent of the charges made for such service and shall be paid by the person paying for such services.

b) The tax imposed in this Section shall be collected from the service user by the person providing the telephone communication services or teletypewriter exchange services. The amount of tax collected in one (1) month shall be remitted to the Director on or before the 20th day of the following month.

c) The following shall be exempt from the tax imposed by this section:

(1) Charges paid for by inserting coins in coin-operated telephones available to the public with respect to local telephone service, or with respect to long distance telephone service if the charge for such long distance telephone service is less than 25 cents; except that where such coin-operated telephone service is furnished for a guaranteed amount, the amounts paid under such guarantee plus any fixed monthly or other periodic charge shall be subject to the tax.

(2) Except with respect to local telephone service, on any charges for services used in the collection of news for the public press, or a news ticker service furnishing a general news service similar to that of the public press, or radio broadcasting, or in the dissemination of news through the public press, or a news ticker service furnishing a general news service similar to that of the public press, or by means of radio broadcasting, if the charge for such service is billed in writing to such person.

(3) Charges for services furnished to an international organization or to the American National Red Cross.

(4) Charges for any long distance telephone service which originates within a combat zone, as defined in section 112 of the Internal Revenue Code, from a member of the Armed Forces of the United States performing service in such combat zone, as determined under such section, provided a certificate, setting forth such facts as the Secretary of the U.S. Treasury may by regulations prescribe, is furnished to the person receiving such payment.

(5) Charges for any long distance telephone service to the extent that the amount so paid is for use by a common carrier, telephone or telegraph company, or radio broadcasting station or network in the conduct of its business as such.

(6) Amounts paid by a nonprofit hospital for services furnished to such organization. For purposes of this subsection, the term 'nonprofit hospital' means a hospital referred to in Internal Revenue Code section 170(b)(1)(A)(iii) which is exempt from income tax under Internal Revenue Code section 501(a).

(7) Charges for services or facilities furnished to the government of any State, or any political subdivision thereof, or the District of Columbia.

(8) Charges paid by a nonprofit educational organization for services or facilities furnished to such organization. For purposes of this subsection, the term 'nonprofit educational organization' means an educational organization described in Internal Revenue Code section 170(b)(1)(A)(ii) which is exempt from income tax under Internal Revenue Code section 501(a). The term also includes a school operated as an activity of an organization described in Internal Revenue Code section 501(c)(3) which is exempt from income tax under Internal Revenue Code section 501(a), if such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

(9) Charges for maritime mobile services as defined in Section 2.1 of Title 47 of the Code of Federal Regulations as such section existed on October 1, 1967."

Section 2. *Code Addition.* Section 225.1.22 of the Torrance Municipal Code is hereby adopted to read as follows to read as follows:

"225.1.22 BUNDLING TAXABLE AND NONTAXABLE CHARGES.

If a non-taxable service and a taxable service are billed together under a single charge, the entire charge shall be deemed taxable unless the Service Supplier or taxpayer reasonably identifies actual charges not subject to the utility users tax based upon books and records that are kept in the regular course of business, in a manner consistent with generally accepted accounting principles. The Service Supplier or Taxpayer has the burden of proving to the reasonable satisfaction of the Director the proper apportionment of taxable and nontaxable charges."

Section 3. *Severability.* Should any provision of this Ordinance, or its application to any person or circumstance, be determined by a court of competent jurisdiction to be unlawful, unenforceable or otherwise void, that determination shall have no effect on any other provision of this Ordinance or the application of this Ordinance to any other person or circumstance and, to that end, the provisions hereof are severable.

Section 4. *Construction.* Sections 1 and 2 of this Ordinance are declaratory of existing law and express the intent of the City in the adoption of the

utility users tax on telephones by Ordinance No. 1983 in [YEAR]. The adoption of this Ordinance therefore does not constitute a revision in the methodology by which the City calculates the tax or otherwise constitute a tax increase for which voter approval is required, and this Ordinance shall be interpreted in light of that intent.

Section 5. *Effective Date.* This Ordinance shall take effect thirty days after adoption, as provided under § 726 of the Torrance City Charter.

Section 6. *Certification.* The City Clerk shall certify to the passage and adoption of this Ordinance and shall cause the same to be published according to law.

PASSED APPROVED AND ADOPTED on the ___ day of _____ 2008.

_____
Frank Scotto, Mayor

ATTEST:

_____
Sue Herbers
City Clerk

APPROVED AS FORM:

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John Fellows
City Attorney