Lead Committee: Taxation and Government Finance
Level of Government Committee: Legislative

Spring 2014

BUSINESS LICENSE TAXES MUST REFLECT THE PORTION OF BUSINESS ACTIVITY TAKING PLACE WITHIN THE TAXING JURISDICTION

THE QUESTION

Should the statutes requiring that business license taxes (BLTs) be levied based on the proportion of the business activity taking place within the taxing jurisdiction be amended to specifically provide that flat rate BLTs are prohibited?

ACTION REQUIRED?

Optional.

POSSIBLE POSITIONS

1. Sponsor legislation prohibiting flat rate BLTs.

2. Support legislation prohibiting flat rate BLTs.

3. Other.

4. Nothing.

DISCUSSION

Cities have as part of their inherent "police" powers the authority to raise revenues by taxing the privilege of doing business within their jurisdiction. Over the years, the courts have affirmed that power, so long as the tax levied is properly apportioned to the amount of business activity actually occurring within the jurisdiction. For that reason, a flat fee BLT is inconsistent with the law – but is often not challenged by REALTORS® and other businesses because the flat fee is so nominal that any apportioned fee is bound to end up being more expensive and more difficult with which to comply.

In order to comply with current law, more progressive cities have sought to assess a tax based upon a business' gross receipts generated within their jurisdiction. Note that simply assessing a BLT on multi-jurisdictional business based on its total gross receipts is just as legally flawed as imposing a flat fee, unless the gross receipts are those earned only *within the jurisdiction*. Even if the BLT is based on gross receipts, the BLT may not reflect the amount of business activity within the city because of the multiple cities within which many REALTORS® work on any one transaction.

One of the major problems confronting REALTORS® regarding BLTs is that in highly urbanized areas a single agent may, for example, have a home office in one city, an employing broker in another city, and list and sell properties in as many as ten or more surrounding cities. Each of those cities may attempt to charge a BLT for granting the agent the privilege of doing business within its boundaries. While one might argue (and, certainly, city representatives do) that a BLT is a small price to pay for being able to sell half-million dollar properties, the agent may soon feel that he or she is being "nickeled and dimed to death." In addition, if a real estate licensee does practice across multiple city boundaries, inappropriately apportioned taxes may tax the <u>same</u> income in multiple cities and ultimately force the licensee to pay a much higher amount in taxes.

C.A.R. task forces have twice (in 1998 and 2004) rejected the approach of characterizing real estate salespersons and broker associates as "employees" for BLT purposes while at the same time preserving the status as an "independent contractor" for all other purposes and have been unequivocal in their recommendations to the Board of Directors. Such an approach would have reduced the number of real estate licensees having to pay a BLT under some local ordinances. The task forces, however, reasoned that C.A.R. has always maintained that agents are *independent contractors* and has not conceded that they are *employees* for <u>any</u> purpose. They were concerned that opening the door to treatment as *employees* for one purpose would make it politically difficult to resist the efforts of others to classify them as *employees* for other purposes. Indeed, the concern has been that yielding on employment status for BLTs might actually encourage efforts to re-classify real estate agents.

Independent contractor status carries significant advantages for agents in the form of tax deductions (automobile, home office, and no income tax withholding) and for employing brokers (administrative savings, reduced liability, and avoiding the FICA/Social Security match). While some administrative decisions have gone against C.A.R. (most notably the assertion by the state that workers' compensation must be purchased to cover sales agents), C.A.R. has continued to maintain that agents can be employed as independent contractors if they choose that status. Consequently, taking this approach would have represented a departure from existing C.A.R. policy.

A second proposal was considered and rejected in Fall 2006. That proposal and one that would also have represented the adoption of new policy would be to attempt to change the administration of the BLT itself. The approach would be to change the law so that a city could tax a state regulated business activity (for example, real estate) only at the location where the state regulator's records show the business to be located. In this approach, each city would be able to assess all the real estate companies that "hang" a license within the city, but not those whose regulatory address is outside the jurisdiction – even if they sell properties within the city. Taxing only real estate offices that are located within a city would deprive the city of jurisdiction over brokers and agents from outside the city boundaries that sell properties within the city. However, such a system would also give the city the ability to tax all of a local office's business activity even if generated outside the city's boundaries.

In *Brabant v. City of South Gate*, 66 Cal. App. 3d 764, the court explained the rationale for requiring that BLTs be apportioned. At issue was the $50 BLT that Davis Brabant, as "principal broker" was required to pay and the $10 BLT Robert L. Brabant, as "broker-salesman" had to pay to the City of South Gate. The court quotes from *City of Los Angeles v. Shell Oil Company*, 4 Cal. 3d 108, as follows:

> Although the Constitution of this state, unlike that of the United States, contains no provision specifically preventing its constituent political subdivisions from enacting laws affecting commerce among them, there is no doubt that many of the considerations relevant to problems of interstate commerce apply in microcosm to the problems of intrastate or intercity commerce in a heavily populated state such as our own. In the words of one perceptive commentator: 'The basic policy underlying the commerce clause of the Federal Constitution [art. 1, § 8, par. 3] -- to preserve the free flow of commerce among the states to optimize economic benefits -- is equally applicable to intercity commerce within the state. If fifty independent economic units within the United States are undesirable, 387 economic enclaves within California would be intolerable. A tax burden which places intercity commerce at a disadvantage in comparison to a wholly intracity business may have such an effect.' (Sato, Municipal Occupation Taxes in California: The Authority to

> Levy Taxes and the Burden on Intrastate Commerce (1965) 53 Cal.L.Rev. 801, 818, fn. omitted.)

There was no apportionment of the tax to reflect the amount of business activity actually done in the taxing city. In determining that the city ordinance was void with regard to the plaintiff, the court again quoted from *City of Los Angeles v. Shell Oil Company*, "provisions of the state and federal Constitutions forbid municipal taxation which, by encouraging multiple burdens through the levy of unapportioned or improperly apportioned taxes on intercity business, operates to place such businesses at a competitive disadvantage."

In addition, the fact that the amount of the BLT is relatively small is of no legal importance. In *City of San Jose v. Ruthroff & Englekirk Consulting Structural Engineers, Inc.*, 131 Cal. App. 3d 462, an annual BLT of $30 per year was challenged. The question facing the court was "whether that relatively small yearly tax, unapportioned on the one hand as to business activity entirely within San Jose, and on the other, as to occasional intercity business transactions therein meets the constitutional requirement explicated by *City of Los Angeles v. Shell Oil Co.*" The court concluded "that the amount of the tax in situations such as that before us is of little, if any, legal significance. Such taxes tend to encourage unconstitutional multiple burdens of taxation on those engaged in intercity business within the state's many jurisdictions."

The *Brabant* decision was ultimately codified in statute in Business and Professions Code Section 16000 and Government Code Section 37101(b). The text of the former code section provides: "Any legislative body, including the legislative body of a charter city, that fixes the rate of license fees pursuant to this subdivision upon a business operating both within and outside the legislative body's taxing jurisdiction, shall levy the license fee so that the measure of the fee fairly reflects the proportion of the activity actually carried on within the taxing jurisdiction."

These code sections require that a BLT be apportioned based on the amount of business activity taking place within the taxing jurisdiction. While the implication is that a flat rate BLT is prohibited, the statutes do not specifically provide as such. The two statutes could be amended to specifically prohibit a flat rate BLT. Such an amendment may make it easier for local REALTORS® to challenge flat rate BLTs as they would be able to point to a statute that specifically prohibits such BLTs.

If cities believe that their ability to raise revenues and their ability to control local business activity is under attack, they can be expected to strongly oppose the legislation. More importantly, if state legislation is adopted to change the manner in which BLTs can be administered, cities will almost undoubtedly attempt to amend their local ordinances to <u>increase</u> their BLT rates to compensate for any lost revenues and provide for some type of apportionment. Such a proposed change would require a city to hold a Proposition 218 vote on the tax increase and win voter approval of the increase prior to implementation. However, while the courts have called for apportionment, it is not clear that any individual city would even be able to apportion a BLT based on the amount of business activity taking place within the city. For example, how much of a transaction is represented by the mortgage broker being located in a particular city? The home being purchased may be in a second city and the employing broker in a third. It may be impossible for any one city to determine the quantum of business that a real estate company is doing within the city limits.

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