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Guest Commentary



In-lieu Franchise Fees: Illegal Under Proposition 218

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Proposition 218, the Right to Vote on Taxes Act, was enacted by the people of California last November by a more than one-million vote margin. The underlying policy of the new law declares that taxes should not be imposed on Californians without their consent. Also, to protect all Californians from unreasonable tax increases, limitations should be placed on the methods by which local governments exact revenue.

The first part of the initiative, which creates Article XIIC of the California Constitution, imposes voter approval requirements similar to those enacted by Proposition 62 (a statutory initiative approved by voters in 1986) for the imposition of local taxes. The second part of the initiative, Article XIID, imposes substantive and procedural requirements for the imposition of local "benefit assessments" as well as property related fees. ([Note 1](#)) The restrictions and requirements for fees are set forth in Article XIID, Section 6. ([Note 2](#))

There are five substantive requirements for existing, new or increased fees and charges set forth in Section 6(b). Combined, they generally mandate that fees not exceed the "cost of service." A fee or charge cannot be extended, imposed or increased by any agency unless it meets all of the requirements.

(1) Revenues derived from the fee or charge shall not exceed the funds required to provide the property related service.



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(2) Revenues derived from the fee or charge shall not be used for any purpose other than that for which the fee or charge was imposed.

(3) The amount of a fee or charge imposed upon any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel.

(4) No fee or charge may be imposed for a service unless that service is actually used by, or immediately available to, the owner of the property in question. Fees or charges based on potential or future use of a service are not permitted. Standby charges, whether characterized as charges or assessments, shall be classified as assessments and shall not be imposed without compliance with Section 4.

(5) No fee or charge may be imposed for general governmental services including, but not limited to, police, fire, ambulance or library services where the service is available to the public at large in substantially the same manner as it is to property owners.

One of the questionable practices by local governments which is significantly impacted by Proposition 218 is the transferring of fee revenue to supplement a general fund. This practice, sometimes known as charging an "in lieu franchise fee," currently occurs in several municipalities. To understand the theory upon which local governments impose these "in lieu franchise fees," one first has to understand what a franchise fee is.

Generally, a franchise agreement is granted by a governmental agency to enable an entity to provide public services with some degree of permanence and stability, such as franchises for utilities. According to California case law, a franchise is a negotiated contract between a private enterprise and a governmental entity for the long-term possession of land. Franchise fees are paid as compensation for the grant of a right of way, and are usually not considered a license or tax. Several provisions of law permit local governments to grant franchises to the highest bidder, not based on cost. *See, e.g.,* Gov't Code, 25530 permitting counties to rent property based on the highest bid, not based on costs. ([Note 3](#))

"In lieu" franchise fees are a unique form of revenue created by local governments as a form of hidden tax. The theory is as follows: Because a municipality *could* contract out a service and charge a franchise fee, it should be able to charge an "in lieu" franchise fee *on its own enterprise activity departments*. For example, in addition to collecting fees for refuse collection, a city may also demand that its solid waste department set its rates at a level to generate *excess funds over the cost of service for a direct transfer into a general fund*.

The practice of municipalities charging in-lieu franchise fees on their own enterprise activity departments is clearly prohibited by Proposition 218. The first two substantive requirements of Section 6(b) are that revenues derived from the fee or charge cannot exceed the funds required to provide the property-related service and that revenues derived from the fee or charge shall not be used for any purpose other than that for which the fee or charge was imposed. Moreover, in-lieu franchise fees are bad policy. Government does not exist to make a profit and it should not receive a windfall by skimming funds from its enterprise departments which, given their monopolistic nature, are not subject to competitive pressures.

Several municipalities openly transfer moneys from their enterprise funds to their general funds without any pretense that the transfers are anything other than a subsidy. Less clear are situations where the city claims that the transfers are, in whole or in part, reimbursement for actual administrative costs to the city associated with the provision of the service. For example, billing costs, information system costs, and other overhead costs might be claimed to be part of the "costs of service." As long as such overhead costs are reasonable and well-documented, they may very well be properly reflected in the rate structure. However, if those costs are merely approximated and/or cannot be justified, the municipality would be in violation of Proposition 218. In the event of a legal dispute, the burden of proof has been shifted to the government entity to show compliance with the new law (Section 6(b)(5)).

Despite the clear dictates of Proposition 218, several cities have indicated that they will continue to impose in-lieu franchise fees on their enterprise activity departments. This issue will be tested in the courts. It is imperative that the taxpayers prevail because, if not, there would be nothing to prevent a city from completely circumventing the cost of service requirements of Section 6. The

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rates paid for property related services by residential and business taxpayers will increase dramatically unless Proposition 218 is given its proper interpretation.

Footnotes

1. Although the principal target of Proposition 218 was to correct "benefit assessment" abuses, the reason "property related fees" were addressed was to prevent similar exploitation as a means to avoid the new restrictions on assessments. Because flat rate parcel taxes had avoided the strictures of Proposition 13 simply by being called "assessments," the drafters were concerned that the same would happen with "fees" - that is, circumventing taxpayer protections by manipulating the label of the levy.

2. Section 6 does not purport to control all local government fees. It is applicable to any fee imposed on a parcel basis or for fees which provide a property related service. It does not affect fees that are not property related such as DMV fees, park fees, or administrative charges imposed by a local government. The text of Proposition 218, along with drafters' commentary, can be found in the February issue of *Cal-Tax Digest*, page 7, *et seq.*

3. See, discussion of franchises in *Santa Barbara County Taxpayers Association v. Board of Supervisors* (1989) 209 Cal.App.3d 940, 257 Cal.Rptr. 615. The impact of Proposition 218 on franchise fees is beyond the scope of this article. However, in determining whether fees for public services (refuse collection, water and sewer) which are provided by a private entity are subject to Section 6, the focus must be on who imposes the levy, not who performs the service. It is therefore possible for a refuse collection charge to be governed by the cost of service requirements notwithstanding the fact that the service is provided by a private entity. Various factors may determine who actually levies the charge. These include who does the billing, the extent to which the private entities are regulated, who sets the fee amount and whether the granted franchises are "exclusive."
