December 3, 2009

Economic and Allocation Advisory Committee
California Air Resources Board
1001 I Street
Sacramento, CA 95814

Re: Greenhouse Gas Auction Revenue and Reduction of Income Taxes

Dear Members of the Economic and Allocation Advisory Committee:

The California Air Resources Board (“CARB”) has proposed to establish a cap-and-trade program as a market-based compliance mechanism pursuant to Health and Safety Code § 38570, in furtherance of California’s Global Warming Solutions Act of 2006 (“AB 32”) mandate to reduce statewide greenhouse gas (“GHG”) emissions to 1990 levels by 2020. A novel and controversial component of the cap-and-trade program would be the auction of GHG allowances to regulated parties prior to the start of any allowance trading. This letter summarizes our views on whether CARB may provide for the use of GHG allowance auction revenues to reduce income tax for California taxpayers as an element of the proposed cap-and-trade program.

The threshold issue is whether the collection of revenues for this purpose would itself constitute a “tax” rather than a “fee” under California law. The California Supreme Court, in *Sinclair Paint Co. v. State Board of Equalization*, 15 Cal. 4th 866 (1997), held that in order to distinguish a fee from a tax, the government agency collecting the revenue must show that (1) the purported fee is charged in connection with a regulatory activity, (2) the purported fee does not exceed the reasonable cost of providing necessary “regulatory services,” and (3) the purported fee is not levied for revenue purposes unrelated to the regulated activity. If the amount of a fee does not bear a reasonable relationship to the regulated party’s burden or benefit from the regulatory activity, the fee is considered a tax.

Additionally, whether a fee is in fact a tax depends not just on the amount of revenue collected, but how any collected revenue is spent. The *Sinclair* court held that a fee is not a tax when “the state must use the funds it collects…exclusively for [regulatory work], and not for general revenue purposes.” *Sinclair*, 15 Cal. 4th at 881. In *Collier v. City and County of San Francisco*, the Court of Appeals elaborated on *Sinclair*,
holding that “regulatory fees may not be spent for purposes unrelated to the specific regulatory activities for which they were assessed.” 51 Cal. App. 4th 1326, 1341 (2007)

Proposition 13 requires a two-thirds majority vote of the Legislature in order to change the rate of state taxes. See CAL. CONST., art. XIII A, § 3. Therefore, any exaction imposed by a state agency that is determined to be a tax rather than a regulatory fee is invalid unless approved by a two-thirds majority vote of the Legislature.

Here, any use of revenues from the proposed GHG allowance auction for the purposes of reducing income tax fails the Sinclair test on two grounds: (1) the use of revenue is not connected to the regulatory activity, and (2) the fee would be levied for revenue purposes unrelated to regulatory activities. The regulated activity in this case is the operation of the cap-and-trade program and the overriding goals of AB 32 to reduce GHG emissions in California. There is no relationship between these regulatory activities and the expenditure of revenue to reduce income taxes. The use of GHG auction revenues to reduce income tax would violate Sinclair principles, and, therefore, would constitute a tax and an invalid use of revenue from the auction allowance fee. Accordingly, in our view, CARB does not currently have the authority to use GHG allowance auction revenues to reduce income taxes.

Please do not hesitate to let me know if you have any questions or comments or would like us to elaborate on any of the issues raised in this letter.

Very truly yours,

David R. Farabee