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## Calif.'s Cap-and-Trade System: Allowable Fee or Impermissible Tax?

***by Shannon S. Broome***

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"I'm mad as hell and I'm not going to take it anymore!" Movie aficionados will recognize this classic line from the 1976 movie, "Network." For many Californians, the line captures the feeling in the state just before Proposition 13 (Prop 13) was passed by about 65 percent of voters in 1978 to amend the state constitution. For a state that is used to sizable earthquakes, Prop 13 was a truly seismic event in California, restructuring the state property tax system. It was enacted in response to frustration over California's decades-old method of paying for government, which allowed property taxes to increase dramatically year to year, often resulting in senior citizens on fixed incomes being unable to afford to stay in their homes. On top of cutting and restricting increases in property taxes, Prop 13 contained language requiring a two-thirds majority in both legislative houses for future increases of any state tax rates or amounts of revenue collected, including income tax rates and sales tax rates.

Beside the fact that Jerry Brown was California's governor in 1978, when Prop 13 was passed, and is also governor today, why is Prop 13 relevant again, nearly 40 years after its passage? Because it was at the heart of a legal debate resulting in an April 6, split court of appeals decision upholding California Air Resources Board (ARB)'s cap-and-trade system. This system, implemented by ARB under the authority of the California Global Warming Solutions Act of 2006 (commonly referred to as AB 32), applies an aggregate greenhouse gas (GHG) allowance budget on covered entities and provides a trading mechanism for emission allowances. Covered entities must either reduce their emissions below a threshold point or obtain offset credits or emissions allowances, either from ARB or the open market. While ARB either retains or distributes some of these allowances for free, it auctions the rest periodically. The auction portion of California's cap-and-trade system has been enormously profitable for the state, has raised billions of dollars in revenue since FY2012. Laudable as the projects on which the revenue is being spent may be, e.g., water-energy efficiency programs and the high-speed rail project, the question is whether ARB should be raising money in this manner.

Specifically, plaintiffs (several business organizations and a taxpayer) raised the following issues before California's Third District Court of Appeal in *California Chamber of Commerce v. State Air Resources Board*, Nos. C075930, C075954 (Cal. Ct. App. Apr. 6, 2017):

• Whether ARB exceeded its authority when it created a cap-and-trade system that allowed for auctioning allowances; and

• Whether the revenue generated by the auction sales amounts to a tax that violates the two-thirds supermajority vote requirement of Prop 13.

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The court affirmed the lower court and the ARB program 2-1 on both of these issues, over a strongly worded dissent.

On the first issue, the only unanimous aspect of the decision, the court summarily rejected the plaintiffs' argument that the ARB exceeded its statutory authority when it included auctions as part of the cap-and-trade program, concluding that the legislature's 12-page statute vested significant discretion in ARB to craft a system of distributing allowances, including the possibility of auctioning them.

On the second issue, the court considered whether proceeds from the auction sales under the cap-and-trade program implemented under AB 32 were an impermissible tax under Prop 13, since passage of AB 32 did not garner a supermajority. This question required the court to consider the question, what's a tax? California courts have interpreted the word so that it also requires a supermajority for regulatory fees that are in essence taxes, such as when those fees exceed the reasonable cost of providing the funded service or are charged to raise funds for an unrelated purpose.

The majority nevertheless found that the auction portion of the cap-and-trade program is not a tax for two reasons.

• First, the court determined that the decision to purchase greenhouse gas allowances is a voluntary action that is not "compelled" by the government. The majority noted that regulated entities can comply in multiple ways, such as reducing their greenhouse gas emissions below the level covered by their free allowances, earning emission offsets or purchasing allowances or emission offsets from third parties. The majority determined that buying allowances is a business decision, not a requirement, and went on to state that there is no "vested right to pollute in California."

• Second, the majority noted that emission allowances are valuable property interests that may be sold or traded and observed that some have sought to earn a profit by buying allowances. The majority stated that these facts show that the fees paid for allowances are not taxes, since taxes are compulsory and do not provide the payer with an instrument of value in exchange for the tax. Finally, the majority stated that it did not need to evaluate prior precedent regarding when regulatory fees are actually taxes because auctioning allowances is "a different system entirely" than requiring polluters to pay a regulatory fee.

Judge Harry E. Hull dissented from the majority opinion on the second issue. He would have ruled that the auction program does impose a tax because it is a mandatory cost of doing business in California. He pointed to an uncontroverted declaration stating that the plaintiff Morning Star must purchase allowances to cover its emissions. Because Morning Star must bear increased costs to continue doing business in California, purchasing allowances is essentially compulsory and should be considered a tax. Hull also noted that auction proceeds are used in ways that go far beyond covering the costs of administering the program, which also supports the contention that the program is a tax.

At least one of the plaintiffs has reportedly already signaled its intent to appeal the decision to the California Supreme Court. Review by the Supreme Court is discretionary—so we won't know if the case will be taken up for six months to a year. In the meantime, California businesses will need to continue to raise their virtual paddles to obtain the allowances they need to comply. •

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