CITY OF CUPERTINO

ADMINISTRATIVE SERVICES DEPARTMENT

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CITY COUNCIL STAFF REPORT

Meeting: December 5, 2023

Subject

Receive presentation regarding revenue tax measure options for the City's General Fund and provide direction to staff on which revenue tax measure(s), if any, to explore for feasibility through opinion research for the November 2024 election.

Recommended Action

Provide direction to staff regarding exploring the feasibility of one or more potential revenue tax measures—Transaction and Use Tax, Transient Occupancy Tax, Parcel Tax, and/or Business Operations Tax—through opinion research for the November 2024 election.

Reasons for Recommendation

The City Council's current work program includes research on potential revenue tax measures. This research has become important as the City faces a structural budget deficit, with ongoing revenues below ongoing expenditures. In addition to the identified revenue measures, budget-balancing strategies can include expense reductions and service fee increases.

To assist with this work, the City re-engaged Urban Futures, Inc. ("UFI") to provide an update on the following revenue tax measures: Transaction and Use Tax ("TUT"), Transient Occupancy Tax ("TOT"), Parcel Tax, and Business Operations Tax. UFI has evaluated and ranked each revenue option, considering each tax's adequacy and certainty of generated revenue, equity and fairness for Cupertino residents and businesses, transparency of the tax structure, and simplicity of implementing and administering the tax.

UFI has ranked TUT as the top option, followed by TOT, Parcel Tax, and Business Operations Tax.

Transaction and Use Tax (TUT)

TUT is the local equivalent of sales tax. A State cap of 9.25% limits the total amount of combined sales tax and TUT in a jurisdiction, subject to special state legislation that raises the cap for a particular region or county. In Santa Clara County, special legislation has raised the cap to 9.375%. The current rate in Cupertino is 9.125%, leaving a 0.25% TUT available. A general TUT requires a ballot initiative approved by a majority vote (50% plus 1 vote) for enactment. Generally, this type of initiative is more likely to be approved by voters than other initiatives. TUT is ranked as the top option because using the remaining 0.25% TUT rate keeps the City aligned with surrounding communities, spreads the tax burden across residents, businesses, and visitors (daytime work force), and generates meaningful annual revenue (estimated at $5.4 million). Additionally, there is a potential for the County or a regional agency to propose a ballot measure that would take up the remaining 0.25% TUT capacity.

City/Area	Rate*
Santa Clara Countywide	**9.125%**
Campbell	9.375%
Los Gatos	9.25%
Milpitas	9.375%
San Jose	9.375%

*Effective rates as of April 2023

Transient Occupancy Tax (TOT)

TOT is a tax on short-term stay room rentals, commonly known as a hotel tax. This tax requires a ballot initiative approved by a majority vote for enactment. This option is ranked second because of its higher likelihood of voter approval and because the tax is paid by non-residents. This item is disfavored relative to the TUT due to the lower overall revenue potential. For example, if the City increased its current 12% TOT rate to 15% (which would place it as one of the highest TOT rates in Santa Clara, San Mateo, and San Francisco Counties), the estimated additional annual revenue generated is $1.9 million.

City/Area	Rate*
Gilroy	9%
Mountain View, San Jose, Saratoga	10%
Morgan Hill	11%
Campbell, Los Gatos, Sunnyvale	12-12.5%
Los Altos, Milpitas, Santa Clara	13.5-14%
Palo Alto	15.50%
Cupertino	12%

*Rates as of November 2022

Parcel Tax

A parcel tax is a non-ad valorem (non-value based) tax on parcels of property. A parcel tax requires a ballot initiative approved by a two-thirds vote for adoption. This option is ranked third primarily because of the challenging supermajority voter requirement and because a flat parcel tax is generally considered regressive. While the regressive nature of the flat parcel tax can be mitigated by using a per square foot parcel tax rate, the increased equity comes at the cost of eroding the benefits of the parcel tax's efficiency, simplicity, and transparency. A rate equivalent to the recently expired local school district parcel tax ($250/parcel or $0.020 per SF) is significantly higher than most parcel taxes in surrounding communities but generates significantly less revenue than a TUT.

City/Area	Rate/yr.
Santa Clara - Libraries	$34 parcel
Santa Clara – Open Space	$24 parcel
San Jose – Libraries	$30 parcel
North County - Libraries	$76 parcel
Santa Clara Water Dist.	$0.006 per sf
El Matador - Roads	$350-$750 parcel

Business Operations Tax

A business operations tax is a tax on businesses for the privilege of conducting business within the City. This tax requires a ballot initiative approved by a majority vote for enactment. A business operations tax can be either a fixed/flat rate per business (often varies by type of business) or a variable rate based on some measurable aspect of the business operations, such as gross receipts/payroll, number of employees (headcount), square footage of business, etc. Cities have wide discretion in determining methodology, rates, and applicability (cannot be discriminatory or confiscatory, and state/federal law exempts certain activities).

This option is ranked last for the following reasons. First, the tax burden falls solely on local businesses, and while setting varying rates and caps can help distribute this burden differently across business sizes, it raises questions of equity. Secondly, the City currently maintains a notably low business license tax rate compared to neighboring cities on a per capita basis, and if an employee count tax is adopted that placed the City at the top of the region ($75 per capita), the resulting annual revenue still falls significantly short of the tax revenue generated by the 0.25% TUT. Additionally, this scenario would likely necessitate shifting the tax burden to a few large businesses, potentially impacting the locational choices of existing and future businesses, which could erode annual tax revenues.

City	Annual Revenue	Per Capita
Mountain View*	$6 million	$74
Sunnyvale	$2.1 million	$14
Los Gatos*	$1.1 million	$34
Santa Clara*	$6 million	$47
Los Altos	$490,000	$16
Palo Alto*	$9.6 million	$144
Campbell	$723,000	$17

* New or updated within last 5 years

Conclusion

The table below presents UFI's recommended ranking of revenue tax measures, along with estimated annual revenue figures, and a detailed breakdown of the pros and cons of each option.

Rank	Revenue Option	Est. Annual Revenue	Pros	Cons
1	Transaction and Use Tax (TUT)	$5.4 million	• 50% + 1 vote required with high voter approval in recent elections. • Generates most revenue with rate proportionate to surrounding cities. • Tax paid by residents, businesses and visitors/daytime workforce. • "Use it or lose it."	• TUT is more volatile and subject to annual revenue fluctuation than parcel tax but not TOT. • TUT not applicable to large portion of business-to-business sales in which purchaser located outside the City.
2	Transient Occupancy Tax (TOT)	$1.9 million	• 50% + 1 vote required with high voter approval in recent elections. • Tax paid by non-residents/visitors.	• TOT is more volatile and subject to annual revenue fluctuation than TUT and parcel tax. • Smallest overall revenue generation unless rate significantly higher than surrounding communities.
3	Parcel Tax	$3.7 million	• Parcel tax has lowest volatility and annual revenues are very stable.	• 2/3 vote required. • Tax paid by residents and businesses.

			• High voter approval but for restricted special purposes (not General Fund).	• Flat/fixed parcel tax often considered regressive tax (but can use variable rate to improve equity). • Rate equivalent to expired school parcel tax generates significantly less revenue than TUT and is higher than other parcel taxes in the area.
4	Business Operations Tax – Employee Count	$4.1 million	• 50% + 1 vote required with high voter approval over last decade. • Employee count tax has low volatility but could erode annual revenues if tax impacts business location decisions.	• Tax paid exclusively by local businesses, but varying rates/caps can allocate burden. • Setting rate at top of region generates significantly less tax revenue than TUT, and likely requires shifting tax burden to a few very large businesses.

If Council wishes to explore a revenue tax measure, UFI's analysis shows that a TUT revenue measure has the most upside given the meaningful annual revenue that can be generated by a 0.25% TUT increase, the high voter approval rate for TUT measures, the tax burden being shared by residents, businesses, and visitors, and the fact that a TUT rate of 9.375% (as opposed to the City's current rate of 9.125%) is proportionate to other Santa Clara County cities and lower than many San Mateo County cities. Additionally, Cupertino residents may ultimately pay the 9.375% rate, given the potential for the County or a regional agency placing a TUT measure on the ballot in future years for the remaining capacity. The City's adoption of a TUT would ensure these additional local sales tax revenues stay local.

Next Steps
If Council directs staff to explore the feasibility of a revenue tax measure, staff would work with its opinion research consultant to develop and conduct a survey based on the City's voter demographics. Survey results would then be presented to Council for further action.

<u>Sustainability Impact</u>
No sustainability impact.

<u>Fiscal Impact</u>
To proceed with an opinion research survey, the estimated cost is $13,000. This survey will be part of the Community Satisfaction survey, with costs divided between the City

Manager's Office and Administrative Services. There are sufficient savings in the revenue tax measure budget to cover an additional $38,000 in costs. If a revenue tax measure is placed on the ballot and approved, General Fund revenues could be augmented with an estimated $1.9 million to $5.4 million annually, depending on the revenue tax measure selected.

California Environmental Quality Act (CEQA)
Not applicable.

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Attachments:
A – Presentation