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CITY COUNCIL STAFF REPORT

Meeting: June 19, 2018

Subject

Proposed restructuring of Cupertino's business license tax

Recommendation

Provide staff direction on a proposed restructuring of the Cupertino's business license tax.

Background

The City's business license tax was enacted in 1992 with minor amendment. Rates have been increased periodically based on inflation and are estimated to generate about \$800,000 in FY 2017-18.

As part of the City's Work Program, staff presented background information on restructuring the City's business license tax at a study session on June 5, 2018, including the City's current business license structure, business profile, and preliminary public opinion polling data. The polling data indicated that a majority of likely November voters would support an employee-based business license tax with large business paying more than small businesses (see Attachment A).

At the study session, Council directed staff to return on June 19, 2018 with information and several draft models for restructuring the business license tax. Information requests included a list of potential projects that could be funded with revenue generated from a restricted business license tax, feedback from the business community, Council's ability to refund tax revenues in exchange for community benefits or partnership agreements, and information on other key parameters.

Discussion

Business Tax Models

Below is information regarding several types of business tax models as requested by Council at the June 19 study session. These models were developed using examples from

structures used by other cities and feedback from meetings with individual Council members.

Employee-Count Business Tax Models

Based on individual feedback from Council Members, staff developed five models tied to employee counts (see Attachment B). The models are based on data from our business license database and the California Employment Development Department (EDD) and the US Census Bureau's 2016 Zip Business Patterns. Unfortunately, our current business license application does not ask applicants to self-report their employee count. EDD provides employee count ranges, which are not ideal. Therefore, the data in the model is based on rough estimates. It's also important to note that nonprofit organizations were excluded as they are currently exempt from the City's business license tax.

Like Mountain View's proposed measure, under the five employee count models in Attachment B, employers would pay a flat base fee plus a progressive per-employee rate that increases in increments as the employee count increases. Businesses with less than 99 employees would not be subject to a per-employee rate in any of the five models. Larger businesses would not pay an employee rate for the first 99 employees. From a policy perspective, this ensures that small businesses will not be negatively impacted. Most cities take a similar approach to protecting small businesses.

Cupertino has very few large businesses and a relatively small number of medium size businesses compared to other cities. Therefore, the per-employee rate is estimated to impact only about 30 businesses in the City. However, those 30 businesses are estimated to employ 75% of the total workforce in Cupertino.

The models generate between \$4.1 million and \$32.7 million with per-employee rates of \$150 to \$1,500 for the largest employer. The base business license rate is \$140 in Cupertino, which increases annually based on inflation. For this reason, the models start at a base rate of \$150.

Model 4 and Model 5 have the most aggressive rates for the largest employers. Staff would not recommend moving forward with either of these proposals without carefully weighing the potential negative impacts on future employment in the City and conducting additional polling to determine resident support.

Payroll Tax Models

Payroll taxes can either be paid by the employee or the employer and are often a percentage of salaries or wages. The table below shows examples of agencies that levy a

payroll tax on employers based on wages earned within the jurisdiction's boundaries, and in the case of Newark, wages earned while supervised from within city limits.

Very few cities structure their business tax as a payroll tax. Before San Francisco made efforts to move away from the payroll tax structure in 2014, they were the only major city in California to levy its entire business tax on payroll expense. During that time, San Francisco found that the exclusive payroll-based tax discouraged job creation and economic growth, lowered wages, and provided an unstable revenue stream. To address this issue, a tiered gross receipts tax was introduced in 2014 with the intent to replace the payroll tax which was amended to be phased out by 2018. However, the gross receipts tax revenue has been less than expected so the payroll tax will continue in San Francisco to ensure revenue remains steady, although at a much lower rate estimated to be between 0.4% and 0.6%.

Agency	Payroll Expense Threshold	Payroll Tax Rate	Notes
San Francisco, CA	>\$300,000	0.711%	Prior to the introduction of the Gross Receipts Tax, the payroll tax rate was 1.5%
Newark, NJ	>\$2,500	1%	If more than 50% of an employer's workforce is Newark residents, there is an exemption for Newark-resident employees over the 50% threshold
Jersey City, NJ (Proposed)	TBD	1% (Proposed)	S-2581 is under consideration by the State of New Jersey; Tax revenue would go towards the school districts
Tri-Met Transportation District (Oregon)	All wages	0.7537%	
Lane County Mass Transit District (Oregon)	All wages	0.73%	
New York City Metropolitan Transportation Authority (MTA)	>\$312,500 to \$375,000 >\$375,000 to \$437,500 >\$437,500	0.11% 0.23% 0.34%	

Staff consulted with outside counsel to confirm that the City may propose a payroll tax measure. While Council can pursue this type of business license tax structure, staff currently does not have the adequate data or information on the desired parameters to develop credible models. Data on wages of Cupertino employees is very limited. While we know that Cupertino employees on average earn \$120,000 per year, developing a model under this assumption could be misleading.

If Council wishes to pursue this model, more time would be needed to develop credible estimates and develop a proposal for Council consideration.

Neutral and Progressive Square-Foot-Based Business Tax

Information on restructuring our current square footage to be neutral or progressive was also requested. The chart below shows the rates and ranges of cost by business size. Currently, about 870 business licenses are charged per square foot. Home businesses, sublessees, and businesses without a physical location within Cupertino are not charged based on square footage. Based on our business license database, a neutral model with a flat rate of 0.038 cents per square foot would generate an additional \$4,000 to \$11,000 per year. A progressive rate starting at 0.038 cents per square foot and increasing to 0.25 cents per square foot would generate an additional \$56,000 to \$64,000 per year. It is important to note that the business license tax is applied per location. Therefore, larger businesses with multiple buildings may not reach the higher square footage tiers as the separate buildings are not considered in aggregate.

Cupertino Business License Fee Structure						
Square Footage Range	Regressive Structure (Current)		Neutral Rate Structure		Progressive Structure	
	Rate (\$/sq ft)	Total Tax	Rate (\$/sq ft)	Total Tax	Rate (\$/sq ft)	Total Tax
Base	\$ -	\$140	\$ -	\$140	\$ -	\$140
1-5,000	\$ 0.0380	\$140-\$330	\$ 0.0380	\$140-\$330	\$ 0.0380	\$140-\$330
5,001-25,000	\$ 0.0331	\$330-\$992	\$ 0.0380	\$330-\$1,090	\$ 0.0500	\$330-\$1,330
25,001-75,000	\$ 0.0287	\$992-\$2,427	\$ 0.0380	\$1,090-\$2,990	\$ 0.0750	\$1,330-\$5,080
75,001-100,000	\$ 0.0237	\$2,427-\$3,020	\$ 0.0380	\$2,990-\$3,940	\$ 0.1000	\$5,080-\$7,580
100,001-150,000	\$ 0.0189	\$3,024-\$3,965	\$ 0.0380	\$3,940-\$5,840	\$ 0.1500	\$7,580-\$15,080
150,001+	\$ 0.0048	\$3,965+	\$ 0.0380	\$5,840+	\$ 0.2500	\$15,080+

Other Key Parameters

Council must consider other key parameters of a potential business license tax ballot measure, including whether the revenue would be used for general or specific purposes,

General and Specific Tax Measures

Currently, general taxes need to be approved by 50% of voters. These revenues are expended annually as part of the budget process.

Special taxes used for a specific purpose requires 67% voter approval. Based on our poll, likely November voters are slightly more likely to support a specific tax but the difference is not statistically significant. Additionally, Cupertino would need to develop a spending plan to include as part of a specific tax measure, which would take several months.

Cupertino could take Mountain View's approach of passing a resolution prioritizing projects that would be funded with the additional revenue, should the measure be successful. The resolution could be passed by Council at a later date.

Methodology for Part-Time Employees

Models for per-employee business license taxes are based on full-time employees. However, many businesses employ part-time employees. Council will need to consider how to treat part-time employees for purposes of the business license tax. San Jose and Redwood City both charge half of the employee rate for part-time employees.

Methodology for Employers Located Outside of Cupertino

Over 2,000 (or 52%) of business license holders in Cupertino are located outside of city limits. Currently, these businesses pay a flat rate fee. Council will need to consider how these businesses who are located outside of the city but have employees who work in Cupertino are treated under the restructured measure. Under Mountain View's proposal, out of town pay a prorated base rate based on the average number of days working in City in calendar year plus incremental tax based on number of employees. This structure is also similar to San Jose.

Methodology for Other Types of Businesses

As seen in Attachment C, Cupertino currently has distinct business license tax rates for the businesses, including apartment houses and complexes, lodging-related businesses, entertainment-related businesses, coin operated devices, auctioneers, care homes and centers, seasonal lot sales, taxicabs and other miscellaneous businesses. Council should provide direction on consolidating these into the new structure or continue to charge them separate rates.

Inflation

The City's current business license tax includes an inflationary index. Since 1992, this index has allowed the City to increase business license tax rates by an average rate of 1.8% per year. Counsel should consider adding a similar inflationary factor to any new business license tax structure.

Implementation Timeline and Phasing

Council should direct staff on the effective date and phasing of any proposed measure. Mountain View is setting an effective date of 2020 for smaller businesses subject to a registration fee. Larger companies would be phased in to new rates over two years starting in 2020.

Potential Community Amenities and Infrastructure Opportunities

With revenues generated by any of the business tax models, the City Council would be able to later pursue a variety of community amenities or infrastructure investments. Poll respondents said their top funding priority would be transit improvements (25.6%), public infrastructure (24.4%), affordable housing (21.7%), parks and recreation (18.3%) and pedestrian/cyclist safety projects (10%).

Although there has been a significant amount of discussion regarding the need to reduce traffic congestion and provide viable transit alternatives, the magnitude of any of the ranges of revenue produced by the various business tax models would likely not be sufficient to accomplish the construction of any of the currently suggested transit concepts. However, the revenue would likely be able to support all or portions of the planning, design, and environmental clearance to prepare a transit project well for competitive federal or state funding.

Just to provide examples of the types of projects that have recently been discussed or have been part of recent master planning efforts such as the Bicycle Transportation Plan and the Citywide Parks Master Plan, the following sizable projects would likely be possible and are described in more detail in Attachment D:

- Automated Transit Guideway (Study, Design, Environmental) from Mountain View Transit Station to Highway 280/Wolfe Road
- East-West Transit (Study, Design, Environmental)—Stevens Creek Corridor to Downtown San Jose
- Library Story Room Expansion
- Electric Community Shuttle Service
- Stevens Creek Class IV Bike Lanes, Wolfe Road to Foothill Blvd
- Junipero Serra Trail
- Regnart Creek Trail
- Highway 85 Transit Guideway (Study, Design, Environmental)
- New City Hall
- Community Center (possible aquatic center, gym, performance space, incubator space, senior center, etc.)
- McClellan/De Anza Intersection Reconfiguration
- Carmen Road Bike/Ped Bridge
- UPRR Trail
- Bike/Ped Overcrossing of Highway 85 at the Oaks
- UPRR Bridge to Snyder-Hammond

Leveraging Revenue

The income stream produced by an annual business license tax can be leveraged to fund larger projects by using the income stream as security and debt service for Certificates of Participation or other forms of municipal debt. The amount of capital that can be raised is dependent upon a number of factors including the amount of revenue pledged for debt service, the length of time the security is outstanding before retirement, and the rate of interest required to successfully market the securities. As a rule of thumb for a longer

term issue (20-30 years) the amount of capital that can be raised can be expected to be roughly ten times the amount of annual revenue pledged.

Tax Agreements

Staff confirmed with outside Council that it may enter into a tax agreement, which allows for the refunding of business license tax under certain conditions established by Council. Council may wish to refund business license tax revenue in exchange for a community benefit or as part of a public-private partnership for an infrastructure or transit project.

Cupertino Business Outreach

Given the limited timeframe, staff targeted business outreach to the Chamber of Commerce and businesses that would be most impacted by the restructuring. Initial feedback includes concerns about how this measure would impact local businesses and in particular small businesses, businesses that employ low-wage workers, and businesses with small profit margins. Additionally, while there is a recognition that traffic is a significant issue affecting both residents and businesses, there is concern that the measure does not provide a spending plan that clearly articulates how it would provide a solution.

Staff is partnering with the Cupertino Chamber of Commerce to host a business forum on a proposed restructuring of the business license tax on Monday, June 18, 2018. This event is being promoted in the Economic Development “Business Buzz” electronic newsletter, through the Chamber’s network, and utilizing additional business contact lists.

Economic Development Manager Angela Tsui has reached out to schedule individual meetings with larger Cupertino employers including, Whole Foods, Seagate, Apple, Target, Safeway, Ranch 99, and the California Restaurant Association, as well as inviting them to attend the June 18 forum.

Feedback from the forum and individual meetings will be presented to Council at the June 19 Council meeting.

Next Steps

If directed, staff will bring an action item to Council on July 3, 2018 authorizing the placement of a ballot measure on the November 2018 ballot. However, staff needs direction on the specific model Council wishes to pursue to prepare ballot language for Council consideration by July 3. The easiest option is to generally structure the measure after Mountain View’s per-employee proposal. Council can make different recommendations on specific rates and other key parameters.

Any other proposed structure would require additional time and effort to gather better data, study all parameters, and develop adequate models for Council to consider. Under this scenario, staff will likely not have time to prepare a proposal for Council consideration in time to meet County deadlines for the November 2018 election.

Sustainability Impact

To the extent that revenue measures support transportation infrastructure that reduces single vehicle miles traveled in Cupertino, there would be a reduction in greenhouse gases.

Fiscal Impact

If approved by voters, these measures could increase revenues by millions of dollars.

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Approved for Submission by: David Brandt, City Manager

Attachments:

- A – Voter Poll Results
- B – Employee Count Business Tax Models
- C – Cupertino Business License Tax Rates (2018)
- D – Potential Projects