

TO: HONORABLE CITY COUNCIL

ATTENTION: FINANCE COMMITTEE

FROM: CITY MANAGER

**DEPARTMENT: ADMINISTRATIVE
SERVICES**

DATE: MARCH 10, 2009

CMR: 156: 09

SUBJECT: BUSINESS LICENSE TAX ORDINANCE

REPORT IN BRIEF

The City of Palo Alto is a desirable and attractive environment for residents and the business community. To sustain the economic health and vitality of Palo Alto, as well as City services and programs, staff is proposing implementation of a business license tax program.

To assist with the development of the business license tax program, the City contracted with MuniServices, the City's current sales and use tax audit consultant. MuniServices prepared a Business License Tax Classification and Tax Rate Structure Report which provides three tax models for Council's consideration. The three different tax models are based on *number of employees*, a *flat tax* and *gross receipts*. Staff is recommending gross receipts as the methodology for the tax measure. The City asked for a fourth model based on square footage, however, due to the unavailability of adequate square footage data and the nature of the square footage tax rates, MuniServices did not prepare a tax model for this category. Staff tested MuniServices, assumptions, methodology, and forecasts for reasonableness, and modified the proposed tax structure to meet the specific needs and conditions of the Palo Alto Community. Based on MuniServices and staff's analysis, staff recommends a business tax structure based on gross receipts with a \$35 minimum tax and with a \$20,000 ceiling. As a result, the median tax payments for businesses in different sectors would range from \$35 to \$594. The estimated annual revenue to the City's General Fund is approximately \$4.4 million rather than the \$6 million referenced in MuniServices's report. The City's projection reflects an adjustment in the number of businesses, adjusted tax rates and a \$20,000 tax payment ceiling.

This report also provides information on tax rates for other local cities and provides guidance on the legislative and procedural requirements for Council to authorize a vote of the electorate in the November 3, 2009 general municipal election.

RECOMMENDATION

Staff recommends the Finance Committee:

- Provide feedback and direction on the proposed Business License Tax Program
- Approve gross receipts as the methodology for assessing taxes
- Approve staff's proposed tax rate structure
- Approve staff's proposed business classification system
- Approve a bi-annual increase in the business license tax minimum amount equal to the Bureau of Labor Consumer Price Index (CPI) for all urban consumers for the San Francisco-Oakland-San Jose, California Metropolitan Area
- Approve an annual increase in the business license tax ceiling amount equal to the Bureau of Labor Consumer Price Index (CPI) for all urban consumers for the San Francisco-Oakland-San Jose, California Metropolitan Area
- Recommend that the City Council authorize the placement of a ballot measure on the November 3, 2009 general municipal election to enact a Business License Tax Ordinance
- Approve staff's recommendation of implementing the tax effective July 1, 2010
- Late fees will be addressed in the Ordinance

BACKGROUND

Palo Alto is one of a few cities in California, and the only city in Santa Clara County, without a business license tax, a tax most businesses expect to pay as a cost of doing business. The matter of business license tax implementation has come before Council on several occasions over the last decade. In early 2001-02, as Council explored ways to fund the City's infrastructure backlog, a discussion of business license tax emerged as a potential funding source; however, business license tax discussions were never finalized.

On January 23, 2006, staff recommended that Council provide direction on whether to move forward with implementation of a Business Registry Fee or a Business License Tax; and on whether to pursue an increase in the Transient Occupancy Tax (CMR: 119:06). After a lengthy discussion, Council elected to proceed with a Business Registry at a nominal cost to businesses rather than a business license tax program. On March 20, 2007, staff presented a Business Registry Implementation Plan to the Finance Committee with a request that the Finance Committee make an implementation recommendation to the full Council. After a lengthy debate on the business registry proposal, the Finance Committee directed staff to return in September 2007, with options for a comprehensive business license tax program. Consistent with Council's direction, staff began the development of a business license tax program. This work was placed on hold, however, while an infrastructure funding plan was developed to address the General Fund's infrastructure backlog.

With completion of the infrastructure backlog analysis, the City Council directed staff to explore a business license tax to supplement the General Fund. The objective of the tax structure is to maintain a sustainable city budget that can continue to provide the level of services provided to the community.

DISCUSSION

Business License Tax Overview

Under California law cities have the ability to impose business license taxes subject only to requirements in the state and federal constitutions and their own charters.

A revenue raising ordinance can apply to all businesses operating within the City unless specifically exempted by the ordinance, or by provisions in the state or federal constitution. Rates for a revenue raising ordinance are determined based on the City's financial need. However, a City may only apply the tax to that portion of business activity which is attributable to the City. In addition, like other taxes, a business license tax, requires a vote of the electorate. Constitutional amendments such as Propositions 13, 62 and 218 have limited the taxing authority of cities and make distinctions between types of revenue raising measures and the voter approvals required to enact them. Each measure (e.g. tax, fee, assessment) determines when elections are held, how revenue can be used, and what percent of the vote is required for passage. The proposed business license tax is considered a general tax measure. Revenue from the tax will be used for General Fund purposes such as ensuring public safety and health, providing general infrastructure improvements, and park and recreation services. As a general tax, a simple majority vote of the electorate will be required. This vote must occur at a regularly scheduled general election at which members of the Council will be elected, unless by unanimous vote, the Council finds that there is an emergency that justifies placing the proposed tax before the voters at a special election.

PROGRAM DEVELOPMENT

To understand business license tax programs and ordinances, staff spoke with and visited business license tax professionals in several local cities including: Santa Clara, Benicia, Sunnyvale, Mountain View, Fremont, Menlo Park, Oakland, Cupertino, Hayward and Monterey. In addition, staff reviewed on-line posting of other California municipal business license tax programs and ordinances. Staff also held roundtable discussions with business license tax professionals from some of these cities to discuss business license tax software systems, administration, enforcement and State of California reporting requirements. During the evaluation process various methodologies and options on how the tax can be levied were explored and particular attention was paid to anticipating the needs of the business community. The advantages and disadvantages of various rate structures and a tax ceiling were discussed in detail.

A recurring theme throughout the interviews with other cities was the need for an ordinance that provides for ease of administration. The insights gained have benefited staff planning efforts in several areas. One of the lessons staff learned is that a well drafted ordinance has four distinct

features: a simple, uncomplicated tax structure; ease of administration and compliance; a uniform method of calculating the tax; and the ability to generate sufficient revenues in changing economic conditions. Staff's business license tax proposal has sought to incorporate these features.

To assist with development of a business license tax program, the City issued a Request for Proposal for a qualified firm to provide professional guidance on a Business License Tax Classification and Tax Rate Structure Program. MuniServices, the City's current sales and use tax audit consultant, was awarded the contract. MuniServices produced a comprehensive business license tax report which contained tax models and revenue estimates. Staff concurs with the base model of MuniServices' proposal; however, to evaluate the consultant's conclusions, staff analyzed various raw data elements from the report to conduct sampling test and reasonableness studies to determine the validity of the reports' assumptions. After conducting internal tests and analysis staff concurs with most of MuniServices' conclusions and recommendations. Based on staff's installation of a maximum tax payment of \$20,000 and business inventory sampling, the most likely revenue amount will be approximately \$4.4 million.

METHODOLOGY

Business Inventory Analysis

The names and addresses of businesses in Palo Alto were compiled with the assistance of MuniServices, who developed the inventory list from a variety of public and private databases, including property tax information, sales tax permits and doing business as (DBA) business listings. The business inventory generated for the City utilized more than 35,000 business data records which resulted in more than 21,000 business listings. The initial inventory of more than 21,000 entries was corrected to eliminate businesses that no longer existed, statutorily exempt businesses, duplicates, and non-profit organizations, which resulted in a final inventory population of approximately 9,800 businesses. Staff excluded the category of single family rentals (1,500 businesses) from the inventory list to make the City's proposed ordinance comparable with other cities. Research and comparison confirms this is standard practice as most cities only license residential rental properties with three or more units. The exclusion of the single family rentals resulted in a "final" inventory of 8,300 businesses. Development of the business inventory presented a huge challenge to staff because the City did not have a comprehensive and complete listing of all businesses in Palo Alto. The business inventory will require continual updating and maintenance to remain current. As the business license tax program is implemented, further refinements to the inventory list will be made. MuniServices states that due to compliance issues, it could take three years or more for the City to compile an accurate list of businesses.

Inventory Assessment

In order to begin assessing the impacts of possible tax structures on the business community in Palo Alto, staff examined in detail the 2,500 businesses in the inventory for which gross sales data was available. This data was reviewed in great detail. Errors and omissions were corrected by contacting the business directly or by reviewing business information on-line. After

completing the review process the final list contained 2,250 businesses which were categorized into seven (7) sectors: professional, miscellaneous, retail, services, wholesale/manufacturing/construction, commercial properties and multi-unit rentals. The total gross sales from these 2,250 businesses were \$3.88 billion, and thus represent a significant portion of the City's business community. Summary information on this dataset is presented below in Table 1. Staff would have preferred to directly contact all the businesses in the inventory, however; due to time constraints and expense this was not feasible.

Table 1

Summary of Business Sample Gross Sales Results					
Category	No. of Business in Sample	Business Percentage In Sample	Gross Sales	Average Gross Sales	Standard Deviation of Gross Sales
Professional	103	4.58%	\$ 221,019,057	\$ 2,145,816	\$ 3,471,074
Retail	884	39.29%	2,069,368,914	2,340,915	8,528,028
Services	1,049	46.62%	1,149,799,732	1,096,091	18,790,858
Wholesale/Manufacturing/Constr.	115	5.11%	415,920,666	3,616,701	19,688,145
Miscellaneous	99	4.40%	31,340,166	316,567	814,425
Total	2,250	100.00%	\$ 3,887,448,535	\$ 9,516,091	

* Gross Sales Data for Commercial Property and Mult-Unit Rentals were not available

A number of conclusions can be drawn about the business sample. First, the retail and services sectors represent a significant number of businesses with gross sales. Second, manufacturing and service industries show a wide dispersion, as shown in the standard deviation. This is the result of the manufacturing sector being comprised of a small number of very large businesses, and the services sector, having a large number of both very small and very large businesses. Finally, because of the high dispersion within the sample, staff is using the median value in its analysis, as opposed to the mean.

Classification System

A well-drafted business license tax classification system addresses equity by permitting the application of different taxing measures or tax rates to a given class of businesses. For example, a classification could be based on the profitability or nature of a particular type or class of business. Particular attention was given to the development of a classification system that ensures similar businesses are classified together and taxed similarly which allows for a balance between administrative ease and equity. The City's proposed classification system is broad enough to ensure that all types of business activities are subject to the provisions of the ordinance while being taxed equitably. Staff's proposed classification system is as follows:

- Retail-includes any business activities where the goods, wares, merchandise are sold as retail (e.g., department stores, drug stores, auto dealers)
- Wholesale-typically is business to business activity where the goods, merchandise and wares are intended for resale (e.g., technology firms)
- Service-covers all service related businesses (e.g., landscape architecture, etc.)

- Professional-typically includes any business where a professional license is issued or businesses that are regulated by the state (e.g. dentist, attorney)
- Manufacturer-businesses that manufacture, produce or package goods
- Construction – (e.g., home builders)
- Transportation – (e.g., limousine service)
- Miscellaneous-a “catch all” classification for unique or non-classified businesses

Home based businesses are assigned to the above classifications based on the business activity.

Tax Rates

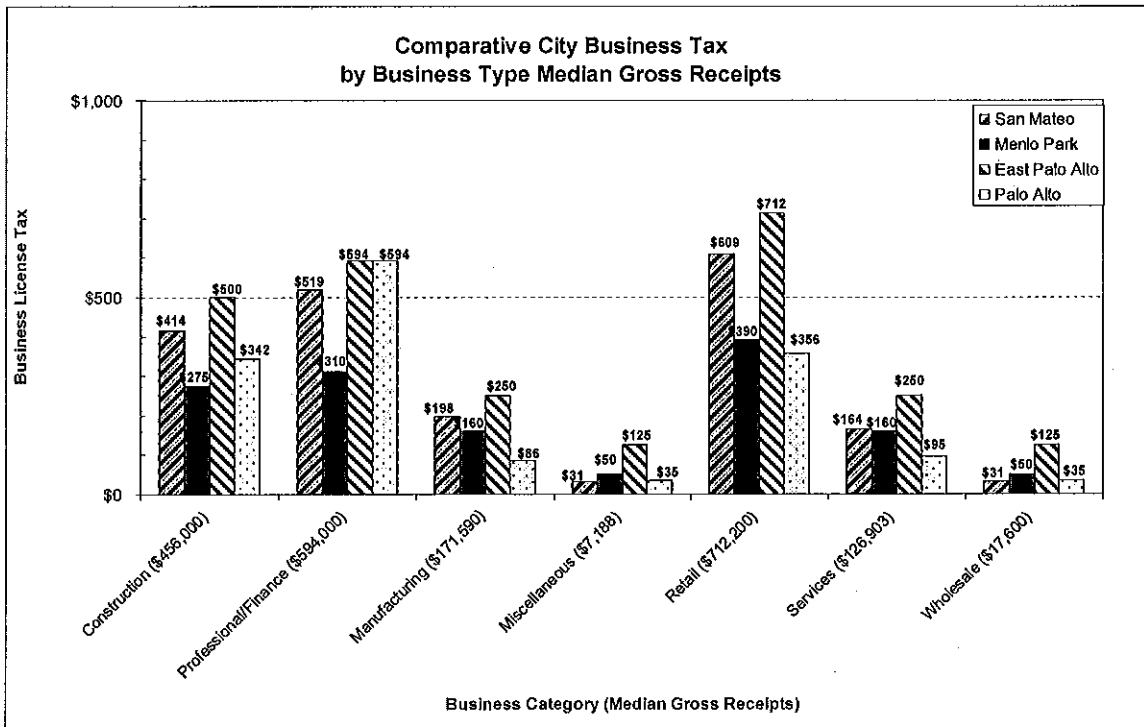
To determine appropriate gross sales tax rates, business license tax ordinances of local cities were analyzed. Cities within close proximity to Palo Alto (Menlo Park, San Mateo and East Palo Alto) and those with a similar economic base and business license tax structure were examined. In addition, staff and the consultants evaluated the ordinances of Mountain View, Sunnyvale, and Santa Clara. Mountain View and Sunnyvale generate nominal revenues of approximately \$200,000, while Santa Clara generates approximately \$800,000 annually. As MuniServices states in its report, “The taxes and fees collected in Santa Clara are for regulatory purposes and not for revenue generating.” These cities do not use gross receipts as the basis for their tax measures; instead they use number of employees, flat fee, and number of units, or a combination of these tax measures, which are all regressive taxes. For these reasons, the business license tax programs of these cities are not comparable to Palo Alto’s proposed revenue raising tax program. To retain and encourage new high revenue businesses, Palo Alto’s proposed business license tax program will have a ceiling. This ensures that under the proposed rate structure the largest gross-receipts companies will pay no more than \$20,000 annually - a tax burden that should be affordable to the largest businesses.

Palo Alto’s proposed rates are as follows:

CLASSIFICATION	TAX RATE
Retail	\$0.50 per \$1,000 of gross receipts
Service	\$0.75 per \$1,000of gross receipts
Professionals	\$1.00 per \$1,000 of gross receipts
Manufacturing, Wholesale & Construction	\$0.50 per \$1,000 of gross receipts
Commercial Property Rentals	\$1.50 per \$1,000 of gross receipts
Miscellaneous	\$1.00 per \$1,000 of gross receipts
Multi-Unit Rentals	\$0.75 per \$1,000 of gross receipts
Home based businesses will be charged business license tax based on the classification claimed.	\$0.50 per \$1,000 of gross receipts

* A retail business with gross receipts of \$75,000 would pay a tax of \$.50 per \$1,000 in gross receipts (75,000÷1,000 x.50= \$37.50)

As illustrated in the graph below Palo Alto's business license tax payments will be comparable to or lower than surrounding cities that use gross receipts as a tax measure.



Tax Measures

Cities have a broad range of options available when selecting taxing measures. For example, a theater may be taxed on the number of seats for sale or a bowling alley may be taxed on number of lanes. However, as stated in the MuniServices report, the most common tax measure is gross receipts, with flat tax and number of employees being alternatives. Tax measures that are attached to a unit of measure such as number of employees are considered regressive and should be avoided. A regressive tax does not reflect a businesses' profitability. For example, a tax based on a flat rate or number of employees does not grow in proportion to business expansion as well as the gross receipts model. The most commonly used tax measures are illustrated in the chart below:

MEASURE	PRO	CON
Flat Tax-a tax of the same amount imposed on all engaged in the same business, regardless of the amount of business done or profit margin	<ul style="list-style-type: none"> • Administrative ease • No calculations • Revenue estimating 	<ul style="list-style-type: none"> • Does not reflect economic conditions • Limited growth • Regressive tax • Limited tax base
Number of employees-a tax on the number of persons employed in a business	<ul style="list-style-type: none"> • Administrative ease • Easy to compute • Limited tax apportionment concerns 	<ul style="list-style-type: none"> • Penalizes labor intensive businesses • Not a direct measure of ability to pay • Limited growth potential • Limited tax base
Gross Receipts-a tax on the total amount of the sale price of all sales and/or the total amount charged or received for performing any business activity or service	<ul style="list-style-type: none"> • Indicator of economic change • Broad tax base • Eliminates double taxation concerns • Can be calculated on a percentage or flat fee sliding scale 	<ul style="list-style-type: none"> • Administratively more complex than other tax measures • Some tax apportionment considerations • Calculation can be labor intensive • Enforcement more complex

Revenue Estimates

Staff developed modeling of various tax schedule impacts on estimated revenue to the City. Since MuniServices' inventory listing contained information gaps such as gross receipts for approximately two-thirds of the businesses, staff was unable to analyze the entire business inventory as discussed in the methodology section. To develop the models, staff first "normalized" the sample data so that the data fully reflected the distribution of businesses in each sector in the total population of the businesses inventory. For example, while professional businesses represented 4.6% of the sample population of 2,250 businesses for which gross receipts were identified, the sector represented 30.7% of businesses in the full population of 8,300 businesses.

The results from this analysis included a factor to take into account sampling error. Partial results of these analyses are presented in Table 2. The results indicate that the recommended tax, a \$35 minimum tax with a \$20,000 maximum will result in median payments ranging between \$35 and \$594. The total revenue for the City, under this scenario is estimated at \$4.4 million.

Table 2

Summary of Estimated Tax and Revenue				
Category	Proposed Business Tax Rate	Est. Average Tax Payment with \$35 minimum \$20K Ceiling	Est. Median Tax Payment with \$35 minimum \$20K Ceiling	Estimated Business License Tax Revenue
Professional	\$1.00 / \$1,000	\$ 2,148	\$ 594	\$ 1,984,903
Retail	\$0.50 / \$1,000	991	356	1,334,401
Services	\$0.75 / \$1,000	401	98	665,295
Wholesale/Manufacturing/Constr.	\$0.50 / \$1,000	911	64	122,222
Miscellaneous	\$1.25 / \$1,000	347	35	22,484
Sub-total				\$ 4,129,304
Commercial Property	\$1.50 / \$1,000	N/A	N/A	33,272
Multi-Unit Rentals	\$0.75 / \$1,000			210,600
Total				\$ 4,373,176

Timeline

If the business license tax ordinance is approved by the electorate in November 2009, staff estimates it will take several months for the program to implement technical and administrative capabilities. Therefore, staff recommends a July 1, 2010 implementation date. This delayed implementation also takes into account the current economic conditions.

Election Requirements

The business license tax ordinance must be approved by Palo Alto voters. The Palo Alto City Council's next opportunity to place a business license tax measure on the ballot is November 3, 2009. A general tax ballot measure must be submitted to the County of Santa Clara 88 days (August 7, 2009) before the scheduled regional general election. If this deadline is not met, the Council's next opportunity to place a measure before the voters will be November 2011. Staff has outlined the critical procedures and tentative timelines that must be met for the Business License Tax Ordinance ballot measure to qualify for the November 2009 general election.

RESPONSIBILITY	REQUIRED PROCEDURE	TIMELINE
Finance Committee	<ul style="list-style-type: none"> • Make a recommendation to the full Council regarding adoption of the Business License Tax program • Tentative Follow-up 	March 10, 2009 April 7, 2009
City Council	<ul style="list-style-type: none"> • Council input on Finance Committee recommendation • Review key elements of Business License Ordinance 	May 18, 2009
City Council	<ul style="list-style-type: none"> • Council recommendation to submit Business License Tax Ordinance to voters • Approve the resolution submitting ballot measure to voters, designate ballot argument authors and authorize the City Attorney to prepare an impartial analysis • Decide whether to accept rebuttals 	July 20, 2009
City Clerk	<ul style="list-style-type: none"> • Election Code Requirement – last day to submit ballot measure to Santa Clara County 	August 7, 2009
City Clerk	<ul style="list-style-type: none"> • Election Day 	Nov. 3, 2009

Business Community Outreach

In an effort to determine business community response to the proposed Business License Tax Ordinance, staff held a preliminary discussion with representatives from the Chamber’s Government Action Committee. Staff intends to continue involving the business community in future discussions and plans related to implementation of the tax. Staff will conduct outreach meetings to the general community and in particular the business community, regarding implementation of the business license tax program.

Resource Impact

Cost estimates are approximate and are based on staff’s cost models for implementation and renewal. The estimated resource impact is summarized in the table below:

	Implementation	Ongoing
Fixed Costs:		
Staffing:	\$290,000	\$290,000
Variable Costs:		
Forms, envelopes, software, hardware, etc.	\$90,500	\$40,500
Contingency:	\$10,000	
Total:	\$390,500	\$330,500

To cover the cost of the program and to generate the \$4.4 million in revenue, staff is proposing a minimum business license tax fee of \$35 and a maximum fee of \$20,000.

Costs are preliminary and will be refined as the program progresses. In addition, if approved by voters, staff will issue an RFP to select a qualified firm to implement and manage the City's business tax program. However, staff's recommendation is that the enforcement component of the business tax program should be administered in house.

Further, staff proposes an annual CPI adjustment to the business license tax minimum and ceiling amounts both rounded to the nearest dollar.

Policy Implications

The actions described in this report are consistent with Council's direction provided at its March 20, 2007 meeting. If approved by the electorate, the Business License Tax Ordinance will require that all businesses, except statutorily exempt businesses including non-profits, pay a tax to operate a business in the City of Palo Alto.

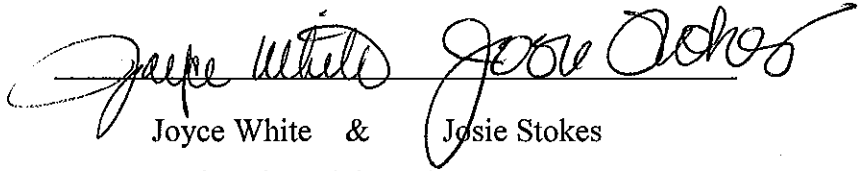
Environmental Review

The actions described in this report do not constitute a project under section 21065 of the California Environmental Quality Act.

Attachment

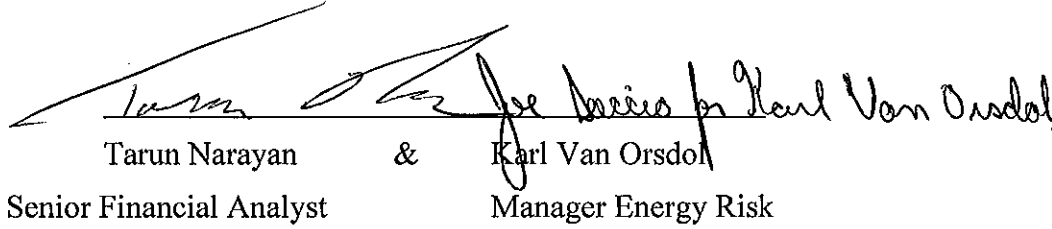
Attachment A: Business Tax Classification & Tax Rate Structure Report

PREPARED BY:



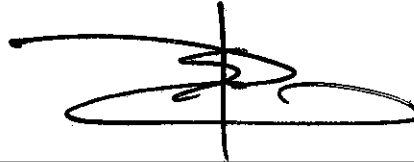
Joyce White & Josie Stokes

Senior Financial Analysts



Tarun Narayan & Karl Van Orsdol
Senior Financial Analyst Manager Energy Risk

DEPARTMENT HEAD APPROVAL:



LALO PEREZ
Director, Administrative Services

CITY MANAGER APPROVAL:



JAMES KEENE
City Manager