TO: HONORABLE CITY COUNCIL

ATTENTION: FINANCE COMMITTEE

FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES

DATE: SEPTEMBER 20, 2005 CMR: 378:05

SUBJECT: REQUEST FOR COUNCIL DIRECTION REGARDING INSTITUTION OF A BUSINESS REGISTRY FEE OR A BUSINESS LICENSE TAX

RECOMMENDATION

Staff recommends that Council provide direction on whether to move forward with establishing a Business Registry Fee or a Business License Tax.

BACKGROUND

The City of Palo Alto is one of a few cities in California that does not have a Business License Tax (BLT). In the late 1980s, the City considered a Utility Users Tax (UUT) or a BLT. The electorate eventually passed a UUT to support the General Fund and the City’s commitments to the Palo Alto Unified School District under a Covenant not to Develop unused school sites.

During the late 1990s, when a funding plan for rehabilitating the City’s infrastructure was recommended, increased or new taxes were proposed. Although staff’s principal recommendation was to increase the Transient Occupancy Tax (TOT), discussions with the Chamber of Commerce’s Government Action Committee (GAC) touched upon extending the UUT and implementing a BLT. The GAC made clear its opposition to a significant increase in the TOT, changing the UUT, or establishing a BLT. The GAC did appear open, at that time, to discussing a nominal registry fee (a fee would capture administrative costs of program versus a tax which would raise General Fund revenues) for businesses within the City. Purposes for such a fee ranged from gathering data to promoting economic development within the City and developing a comprehensive database for public service and private sector needs.

Under one of its Top Five priorities, “City Finances,” Council tasked staff in early 2000-01 with exploring new funding sources for new infrastructure projects. In particular, Council was interested in exploring the levying of a BLT to fund General Fund needs such as new infrastructure. Several models with varying levels of a BLT were developed and readied for discussion with the business community and Council, but with the sharp economic downturn in 2000-01, the idea of a BLT was placed in abeyance. With a mild upturn in the economy, the
increasing need for new facilities, and to address a Council top priority, staff is responding to Council’s request for information on a Business Registry Fee (BRF) or a BLT.

Since Council directed staff to find new revenue sources specifically for new infrastructure, a number of additional and significant events have occurred that present a case for a new General Fund resource such as a BLT. These events, discussed in recent Long Range Financial Plans, include:

- The loss of key revenue generators such as Hyatt Rickey’s, Carlsen Porsche and Nissan auto dealerships, and Agilent Technology. The loss to the City’s revenue base of Agilent, Carlsen Porsche, Nissan, and Hyatt Rickey’s is well over $1.0 million annually. Three of these revenue generators appear to be lost permanently.
- Decline of City sales and transient occupancy taxes by $10.1 million since 2000-01 with no signs of returning to such levels.
- Inability to develop commercial sites such as the Alma and Edgewood plazas into better revenue generators.
- Inroads into sales and Utility Users Tax by technologies such as the Internet and emerging Voice Over Internet Protocols.
- Heightened shopping mall, supermarket, hotel, and big box store competition to City businesses.
- The transformation of the Stanford Research Park into a research and design complex that does not generate significant sales taxes as did prior technology company tenants.
- Rising City benefit expenses such as worker’s compensation, health care, and pension obligations.
- Disappearance of landfill rent to the General Fund beginning in 2013 that ultimately will reduce resources by $4.5 million annually.

DISCUSSION
This report will discuss the following:

- Purpose, pros and cons, and option(s) for a BRF.
- Purpose, pros and cons, and options for a BLT.
- GAC feedback on a BRF/BLT.
- Comparative data from surrounding cities with a BRF/BLT.
- Impact of a BRF or BLT on new and existing businesses given recent implementation of impact and other fees.

Business Registry Fee
It appears that no other California cities have such a fee. If cities levy a business tax, they do so primarily to raise revenue and then to gather the data that is necessary to collect the tax and help City departments to fulfill their regulatory functions whether it be economic development, land use planning or managing sewer discharge. For Palo Alto, the purposes and benefits of having a registry fee could include:
Pros

- Gather data needed to support economic development planning between businesses and the City and for the City to regulate such development.
- Assess whether the appropriate level and type of public safety, emergency, utility and other services are being delivered.
- Provide data to develop recommendations on land use trends and to better coordinate transportation programs such as commute coordination and transportation demand management.
- Provide Water Quality Control Plant with updated information to identify all facilities that must comply with the Sewer Use Ordinance.
- Valuable business profile information (see below) would be available to City and businesses via a centralized database on the City’s Web site.
- Allow the City to integrate sales tax information with other measures of business activity (e.g., transient occupancy tax generators) in the city.
- Save time and expense of multiple City departments requesting information from businesses and landowners as they try to keep up with tenant and owner turnover.
- Better statistics on businesses leaving and entering the city.
- The City would have information on contractors and other businesses that are in Palo Alto on a temporary basis and using its services.

Unlike other cities in California, the City lacks comprehensive, up-to-date, and centralized information on businesses within its boundaries. The City and business community would benefit from centralized data such as the number of employees businesses have, the square footage of commercial buildings, the tenant and owner of a building, and the types of businesses that operate within city limits. Existing databases such as Reference USA are helpful, but they do not provide current information, are not comprehensive, and are not necessarily tailored to the City’s information needs. Moreover, data to these publications is provided on a voluntary basis.

Cons

There is downside to implementing a fee. Although the fee is expected to be nominal, it will have an impact on businesses, especially on those with narrow profit margins. This impact will depend on the methodology used to allocate collection costs. The BRF will be viewed as “one more tax” that, when added to other costs, further erodes profit margins. Small businesses, professional offices, professionals visiting Palo Alto, and home businesses would probably view the fee as burdensome. As discussed below, the Chamber’s Government Action Committee is concerned about mounting fees particularly given recent implementation of a number of impact fees and the Business Improvement District.

A second potential argument against a BRF is that it may appear intrusive. Currently, the comprehensive list of businesses envisioned by staff would include residential businesses. Unaccustomed to the regulatory oversight and requirements that more traditional businesses face, residential enterprises may object to being identified and to paying a fee not previously paid. The practice of home businesses and visiting contractors paying a tax is common, however, in cities having a BLT. As required by law, neither a BRF nor a BLT would be charged to exempt businesses (e.g., banks), non-profits, or other businesses Council exempts.
BRF Option
The BRF is anticipated to be at a nominal cost to businesses. Since the primary purpose is to obtain information for regulatory and other purposes, the fee would be calculated solely to recoup the administrative costs of the program. Based on a flat fee per business, the estimated fee would roughly equate to $35 - $50 per business. Should Council emphasize a BRF, staff would investigate potential fee options other than a flat fee that are legal.

Business License Tax
The chief purpose of a BLT is to raise revenue to support General Fund activities. Methods for taxing businesses and the amount raised vary considerably from jurisdiction to jurisdiction, but the common thread is to generate resources for public use, be it capital or operating programs.

Pros
New revenue sources are needed to build new facilities in the City. With adoption of the Infrastructure Management Plan in 1997, Council also approved a policy of requiring new resources to build new General Fund infrastructure. Council has applied this principle to proposed major new facilities such as the Mitchell Park Library and other community center and library renovations by placing a General Obligation Bond (GO) measure on the ballot. With its considerable facilities and recent revenue constraints, the City is hard-pressed to rehabilitate and maintain existing infrastructure and has been unable to meet expanding or new needs. The recent four-year economic slump forced the City to reduce its operating expenditures by over 10 percent since 2001, so resources for new programs and facilities are limited.

Another reason for a BLT is to backfill for actual and potential revenue losses. Unless sales and transient occupancy taxes rebound dramatically, the City is facing increasing challenges in terms of rising expenses and potential revenue losses.

Since all but two jurisdictions in California have a BLT, businesses are familiar with and expect a BLT when they move to Palo Alto. Anecdotally, businesses relocating to the City always inquire about a BLT and are taken aback when they hear the City does not have one.

Cons
While there are solid reasons, both short and long-term, for a new tax, there are arguments against it. A major initiative on the part of Council and City staff has been to maintain and encourage new businesses in Palo Alto. A new tax will be perceived as contrary to this effort and potentially send a mixed message.

This might be especially true for businesses building new or expanded facilities (i.e., adding new net square footage) that will now be affected by new development impact fees such as the community facilities, parks, and transportation fees. Although it is important to recognize that existing businesses do not have to pay impact fees, a BLT would increase their costs as well. While the extent of this cost is dependent on the level of fees adopted by Council, businesses could expect their taxes to rise by several hundred of dollars. In addition to the quantitative impact, businesses will experience the intrusion cited in the BRF discussion. Businesses relatively untouched by City taxes such as service and home businesses would be impacted.
Recent analyses of the Peninsula economy show a modest upturn. Corporate profits have turned in solid results, but job growth has been especially slow and is not expected to rise sharply over the next few years. Companies have been reluctant to rehire employees in face of economic uncertainties. The slow revival of City sales and occupancy taxes supports this view. Levying a BLT at this juncture in the local economy can be viewed as negatively timed.

**BLT Options**
Council has numerous options both in how a BLT is levied and in determining revenue levels. Methodologies for applying the tax include gross receipts, number of employees, square footage, or a mix and match of the aforementioned. Exemptions, caps and other techniques are typically incorporated in the taxing system as well. The amount to be collected depends on revenue needs and what is acceptable to the overall community. If Council decides to move ahead with a BLT, staff would return with a recommended tax methodology and a variety of revenue ranges. Staff’s tentatively preferred methodology is to tax according to the number of employees in each business. This method is straightforward and relatively easy to administer.

**Estimated Administrative Costs of a BRF/BLT Program**
Staff estimates the initial or first year costs of starting and implementing a BRF or BLT program at $232,000. Second year costs are estimated at $152,000. These costs include a permanent 1.0 FTE, temporary staffing, software and hardware, overhead, and other supply and material costs.

It is important to note that these estimates do not include a rigorous BLT enforcement effort. Some cities hire an additional full-time staff person to monitor, enforce and audit their BLT programs. This is especially true in programs whose tax is based on the gross receipts of businesses and where business tax revenues are a major budget resource. If a strict enforcement program is implemented, an additional 1.0 FTE or approximately $80,000 in costs would be required.

**Chamber of Commerce’s Government Action Committee Comments**
On September 1, 2005, staff met with the Chamber’s Government Action Committee (GAC) to discuss the BRF/BLT. The GAC was vocal with questions and comments.

**GAC Questions and Staff Responses**
1) Question: What are the legal requirements for implementing a fee or tax?

   Response: A registry or regulatory fee is not covered by Proposition 218 and does not require a vote. Staff believes a registry fee would serve a number of regulatory purposes including but not limited to economic development planning and assessing the adequacy of City service levels to businesses. A business license tax is covered by Proposition 218 and would require approval by a simple majority of City voters. As a general tax, a measure would be brought to voters during a general municipal election.

2) Question: Why does the City seek another fee when it is already costly, especially given the “Palo Alto Process,” to establish or maintain a business in Palo Alto. What value or return will businesses see for paying the fee or tax?
Response: The GAC is correct that a BRF/BLT will add to a business’ operational costs. Staff believes, however, that a BRF will be nominal (approximately $35 - $50 annually) and would not impose a considerable burden. As cited in earlier pages, there are numerous benefits of having a database that can synergistically enhance cooperation among businesses and between business and the City. A BLT would add more significant costs depending upon desired revenue levels and the allocation methodology used.

It is generally acknowledged that the City’s process for approval of business projects is lengthy and costly. Several efforts to streamline the process and to support businesses (e.g., red team) have occurred. Mayoral and staff committees have been established to understand and troubleshoot issues businesses face. This activity recognizes the leakage of businesses from the City and the need to retain those businesses. Nevertheless, economic forces beyond the City’s control (e.g., dot com bust and consequent weak economy) have been more instrumental in challenging businesses than have City taxes and fees. Staff believes the departure of Hyatt Rickey’s and Agilent has less to do with fees and more to do with conditions within their respective industries.

3) Question: Will the City eventually turn the BRF into a BLT and will the City propose increasing the Transient Occupancy or Utility Users Tax if a BRF is implemented?

Response: There is no plan to turn a registry fee (if implemented) into a tax now or in the future. Council does, however, retain the prerogative to submit tax increases or new taxes to voters under Proposition 218 and other applicable State laws. As stated at the GAC meeting, there is no proposal to increase the Transient Occupancy Tax, especially given heightened competition from surrounding cities, nor is there any intent to extend the Utility Users Tax.

4) Question: Why do we need a BRF for information when other business databases, phone directories and information sources exist?

Response: Staff agrees that a variety of databases from which to gather information on businesses exist. But these databases are often out of date, incomplete in terms of important information, and cumbersome to integrate. Once a City database is created, it will be updated annually and will be made available for businesses, residents, and staff on the City’s Web site.

Survey of Surrounding Cities with a BLT
The GAC was also interested in how taxes and fees paid by businesses in Palo Alto compare to surrounding cities and especially to cities of similar population size. Virtually all cities in California have a BLT. Considerable variations can be found, however, in the level of revenue raised, the methodology used to levy the tax, and in enforcement efforts. Attachment A shows that annual revenue levels range from a low of $0.13 million in Santa Paula to a high of $23 million in Santa Monica. As a percentage of total revenue, cities vary from a low of 0.6 percent to a high of 11.0 percent. Cities that are heavily reliant on the BLT for revenue tend to utilize the gross receipts methodology for levying the tax.
If Council wants to pursue a BLT, staff recommends a revenue target range of $1.0 million to $2.5 million annually. These revenue levels could, for example, pay debt service on a $10 - $30 million new facility (depending on interest rates and issuance costs) or backfill for lost revenues due to key revenue generators leaving Palo Alto (e.g., automobile dealerships generate around $2.0 million annually). The proposed revenue goals would place the City at the lower to mid level of revenue ranges in the attached survey. This level of BLT falls far below the steep revenue levels of Berkeley, Santa Monica or Modesto which are in the range of $10 million and higher.

Comparison of Palo Alto Fees/Taxes to Those in Other Cities
Comparative studies are difficult in that a true “apples to apples” comparison is elusive and subject to numerous qualifications. A major question of the Council and GAC is the impact of fees and taxes on businesses in Palo Alto compared to surrounding cities. The concern is that City-imposed “start-up” costs that are direct (fees and taxes) and indirect (time and financial costs of City approval process) are so burdensome that businesses will choose not to do business in Palo Alto or move away.

The only available source for comparing government-imposed costs of constructing new or expanded square footage for office, R & D, or retail purposes is the development impact fee comparison graphs in CMR:323:05 (Attachments B and C). These attachments compare the one-time fees charged to a developer in Palo Alto compared to those in surrounding communities. The conclusion drawn from these charts is that Palo Alto’s impact fees are high compared to other cities for non-residential development. By adding a registry fee, the City could be seen as raising the cost for those who want to develop new or expanded space. In Attachment C, the “Fee Comparison for Retail,” the addition of a fee would move Palo Alto’s potential fees higher and toward $27 per square foot, much higher than those in Menlo Park, Redwood City or Sunnyvale.

Combining the development impact fees with the BRF for comparative purposes is somewhat misleading, however, in that the former are one-time and the latter annual. Moreover, Attachments B and C do not include a business fee or higher business license tax that most of the comparative cities levy. Given the numerous permutations in fees, taxes, and assessments among cities as well as the intangible benefits of locating in particular communities, it is difficult to arrive at informative comparisons.

Request for Council Direction
Staff requests that Council discuss a potential BRF or BLT and give staff direction on which, if any, path to pursue. If Council chooses a BLT, its input on the revenue level desired from such a tax would be helpful. Additional feedback on fee or tax methodologies would be helpful but not necessary at this time. Once Council makes a decision, staff would return to the GAC to inform it of Council’s direction and to obtain their feedback.

POLICY IMPLICATIONS
This report is following Council direction to evaluate a new tax source to support new projects and programs. Examining a BRF or
BLT is a component of one of Council’s Top 5 Priorities “City Finances.”

TIMELINE
Should Council give direction to pursue a BRF or BLT, staff would return with an in-depth study of either option in January 2006. Preliminarily, a BRF could be implemented by the beginning of July 1, 2006. A BLT, however, would require a vote in the General Municipal Election of November 2006 with implementation to follow at a later date.

ENVIRONMENTAL ASSESSMENT
Implementing a fee or tax does not constitute a project for the purposes of the California Environmental Quality Act.

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ATTACHMENTS
Attachment A: Business License Tax – City Survey
Attachment B: Fee Comparison – Office/R&D
Attachment C: Fee Comparison -- Retail