



# City of Palo Alto

## Finance Committee Staff Report

(ID # 10392)

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**Report Type: Action Items**

**Meeting Date: 6/18/2019**

**Summary Title: Review, Comment, and Accept Preliminary Revenue Estimates for Consideration of a Ballot Measure**

**Title: Discuss and Accept Preliminary Revenue Estimates for Consideration of a Tax Generating Ballot Measure(s) in Support of the 2019 Fiscal Sustainability Council Priority, and Provide Feedback on Potential Tax Measures**

**From: City Manager**

**Lead Department: Administrative Services**

### **Recommendation**

Staff recommends that the Finance Committee review this report and provide comments on the potential ballot measures the City could pursue to generate additional revenue. Areas to consider commenting on include but are not limited to:

- A. Which potential tax measures, if any, staff should prioritize and focus analysis on;
- B. What potential baseline assumptions of annual revenue or bond financed proceeds should be transmitted to the Council Rail Committee of the Whole to be used in rail planning; and
- C. Direction to proceed with refinement of estimates and evaluation of potential tax measures, including stakeholder outreach, polling and further feasibility analysis by October/November.

### **Background**

The City of Palo Alto has explored a number of revenue generating measures historically and through adoption of the 2019 Fiscal Sustainability Council Priority workplan, the Council asked staff to continue these pursuits as part of the workplan.

Specifically, the 2019 Fiscal Sustainability workplan seeks to ensure providing ongoing services while maintaining finances at a credible and serviceable position with a long-term balance of resources and the cost of doing business. Within the ecosystem of day to day financial management, services provided to the community by the City's workforce, and the local (and broader) economy, the workplan identified many strategies to support either the resources or the cost of doing business to support services and individually they will not succeed, but together they strive to maintain a sustainable equilibrium in this ecosystem. Specifically, components approved by the City Council were elements M and N of the workplan:

- M. Analysis of revenue generating options,
- N. Develop a plan for a business tax proposal, including reform of the business registry through implementation of a business license program.

The full 2019 Fiscal Sustainability workplan can be found here:

<https://www.cityofpaloalto.org/civicax/filebank/documents/70506>

Staff subsequently provided a workplan specifically to address these components of the 2019 Fiscal Sustainability workplan specifically in regards to revenue generating measures and a potential business tax proposal. This workplan was approved by a majority of the City Council (6-1) and can be found here:

<https://www.cityofpaloalto.org/civicax/filebank/documents/70507>

This workplan identified the Finance Committee as the public body to review periodic progress reports, allow for structured public discussion, and provide feedback and recommendations on the review and development of a potential ballot measure or other revenue generating strategy. Ultimately, the Finance Committee would recommend a preferred revenue generating proposal(s) for City Council action. This is the first report as part of this workplan which outlines an iterative process.

### **Discussion**

Municipalities, specifically charter City municipalities such as the City of Palo Alto, have two primary mechanisms for generating revenue: charging fees for service and taxes. The City of Palo Alto has a robust municipal fee schedule which it reviews annually as part of the budget process. In addition, the City has service agreements with other entities in neighboring jurisdictions for services provided, including services at the regional water quality plant, to Stanford Fire and for communication services. These fees for services, governed by various state laws, help defray some of the cost of services. Cities also can impose taxes; however, adoption of or changes to those taxes must be approved by the voters in accordance with Proposition 218. A simple majority is required for approval of a general tax, and a 2/3 supermajority approval is required for a special tax. These potential measures must coincide with an election with established dates.

Below is a more detailed description of the various taxes the City of Palo Alto collects, some general information about the taxes and the drivers for them, and lastly potential revenue increases that could be seen if the tax rates were changed, or a new tax was imposed. In consultation with our current sales tax consultant a framework to help think through potential measures is as follows, E.A.S.E.:

<b>Equity:</b>	Who does the tax impact and how is that felt across all residents or businesses in the same industry?
<b>Administrability:</b>	How is the tax administered and what would be the cost of compliance on taxpayers and the City?
<b>Stability:</b>	What are the drivers of the tax and how does the tax type in question affect the volatility of the revenue over time (including potential recessionary or modernization scenarios)?
<b>Economic Benefits:</b>	Is the tax efficient, promote economic development objectives and minimize disruption on the taxpayer?

The modeling of the potential implications of changes in current tax rates is purely staff's estimate based on discrete basic assumptions and math. It is anticipated that these figures will only be reduced based on additional variables, exemptions, or changes in the base and more refined estimates will be provided later this year.

### Property Taxes

Property Taxes are the largest revenue generator for the City of Palo Alto with estimated receipts of \$48.6 million in FY 2020. Under current law, all taxable real and personal property is subject to a basic tax rate of one (1) percent of assessed value collected by local jurisdictions and school districts for general service purposes. There are other taxes and levies on a typical property tax bill such as a parcel tax, General Obligation (GO) bond, and special assessments. In Santa Clara County, four (4) countywide levies totaling 1.5 per 100 dollars of valuation and one GO bond specifically for Palo Alto 0.01106 per 100 dollars of valuation are levied in addition to the 1 percent. Below is some information about the City's Property Tax for the 2018/2019 taxable year which had a taxable assessed value of \$36.7 billion:

- The City has a little over 20,000 parcels (not including exempt parcels) of which approximately 19,000 or 95 percent are residential land use. Residential land use represents 68.57 percent of the total taxable assessed value.
- Approximately 35 percent of the parcels in Palo Alto have an assessed value less than \$600,000
- Based on property transactions in calendar year 2018, it is estimated that approximately 50 percent of the City of Palo Alto's growth in assessed value is due to parcel turnover and the assessed value was adjusted based on the sale price.

Of the 1 percent property tax that is assessed on the property owner, the City of Palo Alto receives only 9.4 percent, or 9.4 cents for every property tax dollar a property owner pays to the county. The majority of the tax dollar paid or 56.6 percent goes to the school district,

community college, and county school service, 15.9 percent goes to the county and the remaining goes to special districts and to the State.

#### *Potential Tax Rate Change*

Property taxes are regulated by state laws, including voter-approved constitutional provisions such as Proposition 13, therefore, changing the rate itself is not within a municipality's authority. However, cities can use mechanisms such as parcel taxes which are levies on parcels of property, which are assessed based on property or parcels. Typically, these are set at some fixed amount per parcel and cannot be based on the value of a property. These levies can be based on lot square footage and or land use designation. Parcel taxes are usually special taxes requiring a 2/3 voter approval and these are levied on the property owner. Additional information on this type of tax and the potential revenue generation is discussed under the "Business Tax" section later in this report.

#### Sales and Use Taxes

Sales and Use Taxes are the second largest revenue generator for the City of Palo Alto with estimated receipts of \$34.3 million in FY 2020. Sales Tax rates are comprised of state, regional, and local assessments and typically vary slightly by city because of this. Administered by the State of California and the newly established California Department of Tax and Fee Administration (CDTFA), cities are apportioned their receipts based on the point of sale or for internet sales based on County pools. Currently the City of Palo Alto has a tax rate of 9.0 percent paid for goods sold within Palo Alto. The City receives 1.0 percent point of the purchase price or 11.1 percent for each tax dollar paid. The remaining sales tax dollars are distributed as follows: State of California (5.75 percentage points), Santa Clara County (0.125 percentage point), Santa Clara Valley Transportation Districts (1.625 percentage points), and the Public Safety Fund (0.5 percentage point).

#### *Potential Tax Rate Change*

An increase in the Sales Tax rate of ¼ cent, or 0.25 percentage points district tax, would generate approximately \$4.5 million in additional revenue annually. This tax would be equitable across businesses of the same industry, however, it does not apply to industries that are not subject to sales tax. Sales tax is widely considered to be an outdated tax structure and according to the City's consultants only applies to up to 40 percent of the economic base. This structure and the driver for it, disposable income being a significant portion this tax, is subject to economic fluctuations as well as longer term fluctuations and the consumption of goods changes in society.

### Transient Occupancy Tax

Transient Occupancy Tax (TOT) is the third largest tax revenue generator for the City of Palo Alto with estimated receipts of \$29.3 million in FY 2020. The rate in Palo Alto is 15.5 percent and is applied to the daily rate charged by a hotel, motel, and lodging establishment. Most recently City voters approved two ballot measures, one in November 2014 (and November 2018 increasing the rate from 12 percent to 15.5 percent.

#### *Potential Tax Rate Change*

An increase in the TOT rate would primarily impact the visitor population. A 0.5 percentage point increase in the rate from 15.5 percent to 16 percent would generate approximately \$900,000 additional revenue annually.

### Documentary Transfer Tax

Documentary Transfer Taxes are one of the most volatile tax revenues and in FY 2020 are anticipated to generate \$8.4 million in receipts for the City of Palo Alto. These receipts have reached peak levels of \$10.1 million (in FY 2015) or lows of \$3.1 million (in FY 2009) during recession periods. This tax is applied to the sale of real property within Palo Alto at the time property ownership is transferred. The State of California has a standard base rate of \$1.10 per \$1,000 of sale price of which the City and the County split these proceeds 50/50, each receiving \$0.55 per \$1,000 of the sale price. The City of Palo Alto has a non-conforming rate, and the current rate is \$3.30 per thousand dollars of sale value. A house that sells for \$1.5 million, for example, would result in the City collecting \$4,950. This tax is collected by Santa Clara County and then remitted to the City.

#### *Potential Tax Rate Change*

Property owners who sell their property would be impacted by an increase in the rate and would pay this tax once per sale of a parcel. Assuming approximately \$9 million in annual proceeds, a \$1.10 increase in the rate to \$4.40 per \$1,000 of the sale price would result in additional revenue of approximately \$2.8 million.

### Utility User Tax

Utility User Taxes (UUT) generate an estimated \$17.6 million in receipts in FY 2020. The Utility Users Tax is charged to all users of electricity, gas, water, and telephone services. Each utility has a slightly different user base and this tax is based on consumption by respective utility. With the City of Palo Alto as the provider for utility services - electric, gas, and water – some metrics are available based on annual rate payer revenues in these utilities. The electric utility revenues reflect approximately 70 to 75 percent commercial usage and 25 to 30 percent residential usage. The gas utility revenues reflect approximately 45 to 50 percent commercial usage and 50 to 55 percent residential usage. The water utility revenues reflect approximately 30 to 35 percent commercial usage with 65 to 70 percent residential usage. These rates not only impact the utility user tax, but in addition have some correlation to the annual equity transfers to the General Fund from the electric and gas utilities totaling nearly \$20 million annually.

The current tax rate is for electricity, gas, and water is 5.0 percent and for telephone is 4.8 percent. In November 2014, Palo Alto voters approved decreasing the telephone utility user tax rate from 5.0 percent to 4.75 percent. This tax decrease became effective on April 1, 2015 due to Public Utility Commission advance noticing requirements. This ballot change modernized the ordinance, providing better stability and the ability for it to adapt to the changing customer environment and new technologies. These taxes are charged directly on the monthly billing, therefore receipts are not transferred or submitted via any separate tax return except from the utility providers.

### *Potential Tax Rate Change*

Assuming a 1 percentage point increase in the current UUT rates, bringing the electricity, gas, and water rate from 5 percent to 6 percent, and the telephone rate from 4.8 percent to 5.8 percent, \$2.3 million in additional revenues are estimated annually. As a consumption-based tax, high volume customers bear more of the cost.

### Business Tax

The City of Palo Alto does not currently have a business license tax. In 2014, the City approved a Business Registration Certificate (BRC) Program which currently has a \$54 annual registry fee per business. This annual fee is in addition to specific area assessments such as the Downtown Business Improvement District (BID) or Downtown Parking Assessment District. Through the BRC Program, the City has collected some demographic data for businesses that participate in the Program, however, staff recognizes this data is incomplete and is working to bolster the integrity and thoroughness of the data. Business License Taxes are typically assessed based on a baseline variable, examples include but are not limited to, a flat fee, head count, square footage, gross receipts or a payroll tax. With incomplete data, modeling tax receipts based on these variables is challenging. Staff is working to onboard a consultant to assist in defining these variables and build a profile of our business community to help model more refined revenue estimates later this year.

*Potential New Tax*

A number of cities have recently updated or instituted business tax modernization efforts. In the absence of this more refined data, staff has modeled what these measures potentially generate if applied in the City of Palo Alto based on the current data available (sources cities as appropriate). These assumptions do not factor any programmatic considerations the Council may wish to consider such as exemptions based on size or hardship, nor does it assume cost of administration. This would be a new tax, which does not have existing business processes in place, not only collections but also enforcement. In order to pursue a new type of tax, a number of variables and definition of those variables will be necessary.

City of Mountain View: In 2018, the City of Mountain View citizens approved a per-employee business tax which is tiered based on the number of employees. A table of the tiers is below. In total it is estimated to generate approximately \$6 million in annual revenues. Per the American Community Survey (ACS), there are approximately 97,000 jobs in Palo Alto<sup>1</sup>. Assuming the highest per employee count of \$150/ employee (highest employee count per Mountain View’s tax table and excluding the \$584,195 base), a flat rate would generate \$14.55 million in annual revenues.

Number of Employees	Business License Tax
1	\$75
2-25	\$75 + \$5/per employee over 1
26-50	\$195 + \$10/per employee over 25
51-500	\$445 + \$75/per employee over 50
501-1,000	\$34,195 + \$100/per employee over 500
1,001-5,000	\$84,195 + \$125/per employee over 1,000
5,001 +	\$584,195 + \$150/per employee over 5,000

The City only has the data by company in the BRC Program. If this tiered fee structure is modeled with the Business Registry Program annual revenues only generate between \$2.5 and \$5 million annually.

East Palo Alto: The City of East Palo Alto recently approved a parcel tax of \$2.50/square foot for commercial development over 25,000 square feet. Currently based on CoStar Realty Information, the Palo Alto has approximately 12 million square feet of office space<sup>2</sup>. This includes Class A through C space. If assessed a \$2.5/square foot tax, \$31 million in annual revenues are anticipated to be generated. This figure does not include any exemptions, nor does it adjust to exclude facilities 24,999 square feet or less like East Palo Alto’s at this time. Based on the data from CoStar, average rental costs are \$6.24/square foot per month<sup>3</sup> for that 12 million in office space in the city which has a vacancy rate of 6.5 percent. This square footage does not include industrial or retail spaces.

<sup>1</sup> ACS 2013-2017 5-year estimates table B08501: means of transportation to work by age by workplace geography

<sup>2</sup> CoStar Realty Information Inc.: Fourth Quarter report 2018, [www.costar.com](http://www.costar.com)

<sup>3</sup> <sup>15</sup>CoStar Realty Information Inc.: Fourth Quarter report 2018, [www.costar.com](http://www.costar.com)

**Timeline**

As outlined in the original workplan, staff anticipated to return to the Finance Committee in late August with more refined revenues estimates for potential ballot measures. At that meeting, staff will ask the Finance Committee to discuss polling and make a recommendation on next steps to forward to the full City Council in September. Ultimately, the current workplan outlines a Council decision by October/November on what type of measure to pursue including the major variables for it to be based on.

**Resource Impacts**

No funding or staff are currently assumed in the budget to support these efforts, therefore, a budget amendment for the consultant costs will be necessary in the General Fund. Known cost estimates are outlined below.

Consultant assistance for the research and analysis, especially of a potential Business Tax will be necessary. Work through August to develop more refined estimates for tax measures is anticipated to cost \$50,000 to \$80,000. Costs beyond this would depend on the additional research and support necessary. In addition to the cost of consultant work through August, if Council were to continue to pursue a ballot measure, consultant support to define and refine through an iterative process will be necessary. Polling costs are anticipated to cost \$35,000 per poll, however this is dependent on the length and quantity of the poll. Outreach costs to assist in communication strategy will be necessary as well. Staff is working to obtain early estimates of this cost, however, staff does not have them at this time. Lastly, there will be election costs associated with any ballot measure to establish or increase a tax.

**Environmental Review**

This report is not a project for the purposes of the California Environmental Quality Act (CEQA). Environmental review is not required.