



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Stephen M. Haase
Paul Krutko

SUBJECT: See below

DATE: April 21, 2004

Approved

Date

COUNCIL DISTRICT: Citywide
SNI AREA: None

SUBJECT: CLARIFICATION OF INDUSTRIAL USE DESIGNATION

RECOMMENDATION

Approval of an Ordinance amending Section 4.46.050 of Chapter 4.46 of Title 4 and Section 4.47.040 of Chapter 4.47 of the San Jose Municipal Code:

1. to clarify the industrial use designation for buildings or structures subject to collection of Building and Structure Construction Taxes;
2. to add certain industrial uses to the expanded list for the purpose of collecting Building and Structure Construction Taxes and establish a sunset provision for the expanded list of industrial uses;
3. to clarify the procedures to collect taxes for building permits that are issued separately for building shell and the first tenant improvements.

The proposed Ordinance amendment implements the directives of both the Mayor's Getting Families Back to Work effort and the Economic Development Strategy - Strategic Initiative #6: "improve speed, consistency and predictability of the development review process, and reduce the costs of operating in San Jose."

BACKGROUND

The Building and Structures tax ordinance currently in place recognizes traditional manufacturing and research and development uses and imposes a lower construction tax burden on those uses. The City has a long-standing policy of providing a somewhat lower cost structure to industrial uses to attract and retain related jobs and tax revenues.

Over the last several decades, the definition of what is “industrial” has changed radically. Manufacturing and research and development activities once conducted in large manufacturing buildings now frequently take place in office environments on desktop computers. Production activities have become a diminishing share of the San Jose/Silicon Valley Driving Industry base. Some of San Jose’s Driving Industry businesses are penalized because the tax structure in effect classifies those businesses as “commercial” operations. Staff is seeking to update the Municipal Code to reflect current industry practices and updated technology.

The proposed changes are also consistent with the issues identified in the City Auditor’s report #00-08, An Audit of the City of San Jose’s Building-Related Fees and Taxes, in which the Auditor recommended a clarification of the types of uses that are included within the “industrial” designation to avoid inconsistent or subjective classification.

In his report, the Auditor also requested clarification of how taxes should be assessed on mixed commercial/industrial use projects. The staff recommends the following amendment to clarify the procedures for building permits that are issued separately for building shell and first tenant improvements on mixed commercial/industrial use projects.

ANALYSIS

Amendment of the Current Industrial Use Designation and Addition of New Eligible Uses

San Jose Municipal Code Sections 4.46 Building and Structure Construction Tax and 4.47 Commercial-Residential-Mobile Home Park Building Tax impose taxes on buildings or structures intended to be used as commercial and industrial purposes. The tax rate imposed on the commercial use designation is significantly higher than the tax rate imposed on the industrial use designation. Tax rates are set as follows:

In Section 4.46 of Title 4 BUILDING AND STRUCTURE CONSTRUCTION TAX

- Industrial tax rate is one percent of one hundred percent of the valuation.
- Commercial tax rate is one and one-half percent of one hundred percent of the valuation.

In Section 4.47 of Title 4 COMMERCIAL-RESIDENTIAL-MOBILEHOME PARK BUILDING TAX (CRMP)

- Commercial tax rate of three percent of one hundred percent of the valuation.

The industrial designation is an important factor in the calculation of construction taxes. Ordinance 22630, amending Chapter 4.46 and 4.47 of Title 4 of the San Jose Municipal Code defines eligible industrial uses based on the September 1987 Zoning Ordinance in effect at the time. Since then the Zoning Ordinance has been revised many times but the Municipal Code has not been updated accordingly. These subsequent changes have created confusion for the City staff and the inconsistent imposition of taxes to certain types of businesses.

Staff is seeking to clarify and add to the list of eligible industrial uses. Technically, the first step is to replace the current Municipal Code language which cross references a provision of the old Zoning Code with an actual list of each specific industrial use that is currently allowed by the Zoning Code:

- Laboratories devoted exclusively to research, product development and testing, engineering development, and sales development
- Manufacturing facilities
- Photographic processing and developing
- Miniwarehouses
- Production, preservation and preparation of food products for human consumption, excluding public dining
- Trade and business schools
- Repair, cleaning, and servicing of commercial or industrial equipment or products
- Storage, warehousing and distribution establishments
- Construction and corporation yards
- Repair and cleaning of vehicles, including boats, excluding gasoline service stations and repair shops installation of tire, battery, brake, muffler and shock absorber, and wheel aligning
- 9 and 18 hole golf courses
- Frozen food lockers

It is important to note, that during the review and amendment process, no land uses may be eliminated from the current list of eligible businesses, because this would result in the imposition of an increase in taxes on these uses that may require special voting requirements under Proposition 218.

The second step is to formally add the appropriate Driving Industry sectors to the list of eligible industrial uses.

Many new technologies and businesses have developed in San Jose and Silicon Valley. Some uses are similar to the uses listed above but are not specifically called out in the City's Municipal Code or Zoning Codes. The current situation can create confusion and inconsistency in the application of the appropriate construction taxes for certain buildings and uses. It is recommended that the industrial use list be expanded to include the following new technologies and businesses. Staff believes that adding these new sectors is consistent with the original intent of assessing a lower fee to industrial or Driving Industry jobs. The addition of the proposed sectors will encourage investment by high-multiplier Driving Industry facilities and jobs.

Staff recommends that the additional uses be subject to a sunset provision of five years or until June 30, 2009. The sunset provision will allow the City Council the flexibility to review the industries now included in order to verify that these sectors include businesses the Council continues to desire to incent.

- Industrial Services
- Retail or wholesale commercial entity, single occupant greater than 100,000 gross square feet
- Sales, office furniture, industrial equipment, machinery
- Printing and publishing
- Base Load Facility
- Photovoltaic
- Sale or lease of commercial trucks, buses, trailers, campers, boats, mobilehomes, construction equipment.
- Software development.
- Internet applications
- Server farms and co-location facilities
- Telephone switching gears, telecommunication facilities, wireless communication facilities, antenna, and equipment

Benefit Calculation and Cost

The costs associated with amending the Building and Structures Construction Tax Ordinance is estimated to be \$310,000 annually. This is a relatively low number in comparison with the potential benefits. Staff estimates that roughly 235,000 square feet of space will be assisted through this measure and that space will accommodate approximately 750 employees. Adding jobs will also increase other City taxes and revenues such as property tax, utility tax, and ultimately sales tax.

Staff is recommending that the proposed changes sunset after a period of five years. The sunset provision will retain the City Council's flexibility to determine if the sectors included continue to generate a significant number of middle and high paying jobs and thus merit assistance from the City. If no sunset is included on the suspension of taxes, then as long as Proposition 218 is in effect, any future City Council would have difficulty reinstating the tax. Five years is deemed to be a reasonable period for Council to review industry and economic trends to determine if the proposed driving industry sectors are still major engines within the economy.

It should be noted that companies that enter into a Development Agreement that provides for a use that City Council determines to have an economic impact similar to an industrial use can also be taxed as industrial use for the duration of the development agreement, generally twenty years. In cases where there is a new use that is not provided for in a development agreement, the Ordinance provides that City Council can by special ordinance determine that use to be taxed as an industrial use.

Application of Taxes to Mixed Use Commercial/Industrial Buildings

The current code language determining which tax rate applies to a mixed-use commercial/industrial building or structure in Section 4.46.050 of the Municipal Code states that "... the purpose for which the rate is highest shall control and such highest rate shall apply...." This language fails to address how to collect proper taxes in those instances where building permits are issued separately for building shell and the first tenant improvement to a portion of the building. This has resulted in inconsistent assessment of the taxes by staff when the use of the first tenant improvement is not consistent with the use declared in the application for the building shell permit.

It is recommended that Section 4.46.050(B)(1) be amended to read as follows:

1. If the building or structure or portion thereof is designed or intended to be used for more than one purpose, ~~the purpose for which the rate is highest shall control and such highest rate shall apply~~ *the rate of tax shall be applied in accordance with the following rules:*
 - a. *In the case where a building permit is issued for improvements to construct a building shell only for an industrial use and no tenant improvements have been determined for uses within the building, the rate of tax for industrial use may be applied for the entire structure, subject to reassessment in accordance with subsections b and c below.*
 - b. *For each portion of a building or structure for which a building permit for the first tenant improvements for that portion of the building is issued, the rate of tax for the use designated for those tenant improvements shall be applied.*
 - c. *In the case where the rate of tax for an industrial uses was paid at the time of issuance of the building shell and a building permit for tenant improvements for a use other than an industrial use is being issued, then the rate of tax for the non-industrial use shall also include a reassessment of the rate of tax applicable to a portion of the assessment of the building shell which is proportional to the square footage of the tenant improvements for the non-industrial use to the total square footage of the building or structure.*
 - d. *In the case where there are secondary non-industrial uses which directly support the industrial uses designated for a parcel (campus) containing more than one building and there is a single business which directly operates both uses in conjunction with each other, then such secondary non-industrial uses shall be assessed at the rate of tax for industrial uses.*

It should be noted that the current code language provides that if there is a mixed-use project with both an industrial use and a commercial use, then the entire project should be



charged the commercial tax rate. The proposed amendment would change this assessment to allow for collection of the commercial rate only on those portions of the project that are commercial uses. It would also allow for the recapture of commercial rate taxes on those portions of the building shell proportionally attributable to the commercial uses, when the taxes paid on the shell had been based on the industrial use designation.

PUBLIC OUTREACH

Extensive public comment was given in support of the recommendations suggested above in August 2003 during the Mayor's Getting Families Back to Work Initiative study sessions and through the public outreach efforts conducted during the development of the San Jose's Economic Development Strategy.

CEQA:

Not a Project

COORDINATION

The recommendation has been coordinated with Office of Economic Development, The Redevelopment Agency and City Attorney's Offices, City Auditor's Office, and City Manager's Budget Office.

STEPHEN M. HAASE, Director
Planning Building and Code Enforcement

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