



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Paul Krutko

SUBJECT: See Below

DATE: August 3, 2009

Approved

Date:

8/11/09

COUNCIL DISTRICT: City-Wide

SUBJECT: Ordinance establishing the eligibility for a use tax allocation incentive under the Business Cooperation Program.

RECOMMENDATION

- Approve an ordinance amending Title 4 of the San Jose Municipal Code to add a new Chapter 4.86 to create a use tax allocation incentive program for the period of five years.

OUTCOME

The desired outcome is the adoption of an ordinance establishing the rebate terms under the Business Cooperation Program (BCP). The rebate terms will be followed in accordance with the rebate process as outlined in this memorandum.

The primary benefit of a Business Cooperation Program is that the City receives its full 1% share of sales & use tax revenue instead of having sales & use tax revenue leak into statewide and county pools. This results from firms proactively allocating use tax to the State of California which has a positive impact on the City's tax revenue base used to fund critical City Services.

BACKGROUND

Approximately twenty percent of the City's General Fund tax revenue comes from sales and use tax. When a taxable transaction occurs in California, sales tax is applied. When taxable purchases occur out-of-state for consumption in California, use tax is applied. Use Tax is collected when entities in California make purchases of fixtures (elevators, escalators, etc), tools, machinery and materials (steel, wood, etc) from out-of-state companies. Often, out-of-state retailers do not have reasonable means to determine which California jurisdiction the goods are shipped to and where the first functional use occurs. As a result, the State of California allocates use tax into county or statewide pools rather than to the City. These "pools" are pots of tax money that are eventually allocated to local jurisdictions, unlike a traditional retail sale in California where the point of sale is easily

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determined and the local portion of the tax revenue is able to flow back to the local jurisdiction. In order for the State Board of Equalization (SBOE) to distribute the money from these pools, they use a pro-rata formula to determine how much each jurisdiction gets from each of the pools. The allocation to San Jose from the statewide pool is, on average, 2-3% and from the countywide pool, 43%. This translates to 2 cents on the dollar and 43 cents on the dollar, respectively. The following represents how this calculation works for a hypothetical \$5 million purchase.

Example of Use Tax Allocation From Countywide Pool

Purchase Price of Widget	\$5,000,000
Santa Clara County Tax Rate	9.25%
<i>Total Tax Collected by Seller</i>	\$462,500
Use Tax Received by CA SBOE	\$462,500
State of California Portion	\$362,500
County/VTA Portion	\$50,000
City of San Jose Portion (43% of 1%)	\$21,500
Other Santa Clara Cities (dispersed on a pro-rate formula)	\$28,500

Normal Retail Sale Process (City Receives 100% of its 1%)

Purchase Price of Widget	\$5,000,000
Santa Clara County Tax Rate	9.25%
<i>Total Tax Collected by Reseller</i>	\$462,500
State of California Portion 7.25%	\$362,500
County/VTA Portion 1%	\$50,000
San Jose Portion 1%	\$50,000

As a way to help ensure the City receives its full 1% share (\$.01 cent per \$1 dollar) of Use Tax, the Office of Economic Development (OED) brought forward to the Community and Economic Development (CED) Committee on May 21, 2007 the concept of a use tax strategy known as a Business Cooperation Program (BCP). This program relies on the California State Board of Equalization (SBOE) regulations that allow firms, under limited circumstances, to allocate use tax to local jurisdictions.

The CED committee approved the initial workplan and OED issued an RFP on July 2, 2007 seeking consultants with an expertise in Use Tax allocation within the State of California. Based upon the content of the two proposals received and the complex nature of allocating Use Tax dollars, OED had to issue a subsequent clarifying document to the two proposers. On September 14th, responses to the clarifying document were received and evaluated. An RFP review panel evaluated the proposals and determined that Muniservices LLC was the firm that most closely met the RFPs evaluation criteria. Muniservices was one of the innovators in creating Business Cooperation programs throughout the State.

After a lengthy negotiation process, the City finalized a consultant agreement with Muniservices in April 2008. Muniservices has begun providing technical assistance to firms that are currently in the process of making purchases that qualify for use tax allocation. The City has also identified a handful of companies that meet the conditions to allocate use tax and have been building relationships with these companies.

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On October 28, 2008 the City Council adopted the workplan and outreach strategy for the Business Cooperation Program. In addition to the workplan adoption, Council also accepted the recommendation for the City Attorney's Office to draft an ordinance establishing the rebate terms for the Business Cooperation Program.

ANALYSIS

Overview of Program

OED is proposing a work plan for a Business Cooperation Program (BCP) that would aid in capturing the full 1% (\$.01 cent per \$1 dollar) of Use Tax revenue on select projects.

- The most common form of the use tax program implemented is encouraging companies to obtain Direct Pay Permits. This Permit allows the buyer to accrue the use tax instead of the seller and report it to the SBOE making an allocation to the local jurisdiction. The SBOE will provide a Direct Pay Permit to any business that has more than \$500,000 in use tax revenue in the immediately preceding calendar year. This permit is revocable at any time. For example, a firm could register for a direct pay permit when they purchase \$5 million in computers or turbines for a new power generation facility.
- A second avenue exists for the allocation of use tax. The SBOE has a provision that allows for use tax to be allocated to local jurisdictions in the case of construction contracting. Through the construction company's sellers permit, construction purchases of equipment and fixtures of \$5 million or more residing at the job site can have use tax from those purchases allocated to the job site. Through tax forms issued by the SBOE a firm can assume the tax liability, self-accrue the tax, and then report the collection of the tax to the state, thereby allocating the use tax back to the jurisdiction where the equipment and fixtures will reside. (Sales and Use Tax Regulation 1521). For example, a firm might use the construction contracting allocation with the acquisition of steel for the Airport Expansion.

As encouragement to businesses that use Direct Pay Permits or Construction contracting, the City, consistent with Long Beach and San Diego, is offering businesses a rebate of up to 30% of the additional net new Use Tax collected by the SBOE. Because the City receives consideration, in the form of increased use tax revenue, for actions undertaken by a business that it is not required to do, staff believes such an incentive is appropriate. Firms undertaking use tax allocation need extensive review of invoices to determine applicability of the use tax. Given the complexity and time of these tasks, staff will be providing consultant services through Muniservices to firms to aid in the reporting process.

Rebate Process

Interested Participants

Any firms that are interested in participating in the Business Cooperation Program (BCP) need to contact the Office of Economic Development (OED) ninety days prior to making a claim for a use tax rebate and before the payment of use tax to the State. Additionally, the City along with Muniservices has identified several outreach strategies to market to firms the potential benefits of participating in the BCP. Areas of focus include:

- City staff conducts a personal property tax analysis of firms operating in San Jose. Undertaking this analysis shows firms that have substantive amounts of personal property which is traditionally subject to the collection of use tax.
- Firms participating in the Special Tenant Improvement/Industrial Tool Installation Programs. These firms are in the process of acquiring building materials, machinery and other fixtures that could be subject to use tax.
- Corporate Outreach/Business Appreciation meetings. This will help staff identify companies long term plans in the San Jose area and market the BCP.
- Construction Projects seeking City permits (housing, commercial, industrial). Acquisition of construction materials may be subject to use tax.

Once a firm notifies OED of their interest in BCP, the City along with Muniservices will conduct a preliminary analysis of the firms' future purchases to determine the likelihood of a use tax allocation. If after the preliminary review, it is determined that none of the purchases qualify under the direct pay permit or construction contract allocation, the BCP process ends. Should the analysis determine the potential for use tax allocation, the City and Muniservices will work with the firm on the allocation process.

Work with Firm on Allocation Process

Prior to the allocation of use tax, the City and Muniservices will need to determine an average baseline sales and use tax for each participating firm or specific job site. This is accomplished through reviewing tax returns submitted to the SBOE for each firm. Determining the baseline sales and use tax revenue to the City is important because it will be used in the calculation of net new tax revenue that would be generated by the Program. Firms with on-going participation in the Business Cooperation Program will have their baseline sales and use tax reviewed every five years. Based upon the terms proposed for the ordinance (Table A), the proposed Business Cooperation Program would provide firms a minimum of 20% of the net new use tax revenue in exchange for their participation. Muniservices and the City can assist the firm determining which process is most appropriate for use tax allocation, Direct Pay Permit or Construction contracting.

Participating companies will request in writing 90 days after the close of the reporting quarter a claim for rebate to the City. City staff will verify the claim to ensure the SBOE has received the use tax allocation. Upon verification, the City will process the appropriate rebate for the participating company as outlined under the terms of the ordinance.

Ordinance (Rebate Terms)

The ordinance outlines the terms for eligibility for use tax rebates and the amount of each rebate under the Business Cooperation Program. The thresholds are as follows:

Table A: Net New Use Tax Received by the City of San Jose (Four Consecutive Quarters)	Rebate Percentage*
Tier 1: 0-\$200,000	20%
Tier 2: \$200,001-\$500,000	25%
Tier 3: \$500,001 and greater	30%

* Reimbursement is based upon the City's local 1% portion.

A participating firm, within 45 days after the close of the State's tax reporting quarter, submits a rebate claim to City's Finance Department, would be reimbursed at the Tier 1 level of 20%. If the total allocation for four consecutive quarters exceeds Tier one or Tier two, there will be a one time true up payment in the fourth quarter from the City at the next higher Tier. However, if a firm over four consecutive quarters does not exceed Tier one threshold, they receive the minimum 20%. Upon completion of the four consecutive quarters, the rebate term of four consecutive quarters starts over beginning with the 1st quarter.

Validation and Reporting

Muniservices and the City will work closely with the participating firm to provide technical assistance making sure that necessary tax forms are filled out correctly. In most cases, SBOE sales and use tax returns are remitted quarterly.

The Office of Economic Development will report out annually to the CED committee on the status of the Business Cooperation Program. Because sales tax records are confidential at the company level, the reporting to the CED committee will be on an aggregated basis for all participants of the BCP.

EVALUATION AND FOLLOW-UP

The ordinance is set to expire in five years, at which time, the merits of the program will be evaluated. If the program has demonstrated success, staff will recommend moving forward with an extension of the ordinance.

POLICY ALTERNATIVES

Alternative #1: The City could choose not to offer any incentives to businesses that are willing to participate undertaking the burden of allocating use tax in San Jose.

Pros: This policy alternative maintains the status quo.

Cons: Based upon direct conversations with firms, without compensation, companies are non-receptive to take on additional workloads to allocate use tax.

Reason for not recommending: The City desires to offer a Business Cooperation Program to maximize the allocation of use tax to the City.

PUBLIC OUTREACH/INTEREST

- Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- ✓ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This memorandum will be discussed at the August 25, 2009 City Council meeting.

COORDINATION

This memo has been coordinated with the City Attorney’s Office, Budget Office and Finance Department.

FISCAL/POLICY ALIGNMENT

These actions further the vision of San Jose as the world’s most livable city contained in the Economic Development Strategy to “Develop Retail to Full Potential, Maximizing Revenue Impact and Neighborhood Livability.” (Initiative 13).

COST SUMMARY/IMPLICATIONS

With the adoption of an ordinance, a portion of the City’s net new revenue associated with the Business Cooperation Program would be reimbursed to participating firms in the program. The magnitude of how much the City will need to reimburse would be positively correlated with how much new revenue the program can generate. Based upon the suggested ordinance threshold as discussed in the Analysis section, the following example demonstrates that a \$5 million purchase by a company results in \$40,000 new revenue to the City and \$10,000 to the participating firm.

Proposed Business Cooperation Scenario

Purchase Price of Widget	\$5,000,000
Santa Clara Co. Tax Rate	9.25%
<i>Total Tax Collected by Buyer</i>	\$462,500
Use Tax Rec'd by SBOE	\$462,500
State of CA Portion 7.25%	\$362,500
County/VTA Portion 1%	\$50,000
City of San Jose Portion 1%	\$50,000
→ Participating Firm Reimburse 20%	\$10,000
→ Resulting San Jose Share	\$40,000

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CEQA

CEQA: Not a project



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City Manager's Office

For questions please contact John Lang, Economic Development Officer at 408-535-8178.