COUNCIL AGENDA: 12-13-11
ITEM: 4.3

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Dennis Hawkins, CMC
City Clerk

SUBJECT: SEE BELOW

DATE: 11-30-11

SUBJECT: DEVELOPMENT TAXES, FEES AND COSTS

RECOMMENDATION

As recommended by the Community and Economic Development Committee on November 28, 2011 and outlined in the attached memo previously submitted to the Community and Economic Development Committee, accept staff's analysis of development taxes, fees and costs, and:

(a) Direct the City Attorney to draft an ordinance to implement an interim incentive program to encourage absorption of vacant space by driving industry companies by partially suspending for a limited period the City's the Building and Structures Tax (SJMC 4.46), and the Construction Excise Tax (SJMC 4.47) on the following uses: (1) Solar Photovoltaic Systems; (2) Office, Research and Development as defined in Section 20.200.818; and (3) Data Centers as defined in Section 20.200.265, and funding anticipated revenue losses to the City's Traffic Capital Improvement Program with the Economic Development Enhancement Fund.

(b) Direct staff to propose a plan for a modernization of the City's construction taxes to better align the taxation policies with the job goals of the City's Economic Strategy and Envision 2040 Plan.

(c) Direct staff to explore and bring back for Council consideration in January 2012, a program that provides a reduction in the North San José Traffic Impact Fee for new development projects to improve competitiveness of North San José for near-term development.

CED AGENDA: 11/28/11
ITEM: D (3)

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: COMMUNITY & ECONOMIC DEVELOPMENT COMMITTEE

FROM: Kim Walesh
Joseph Horwedel

SUBJECT: DEVELOPMENT TAXES, FEES AND COSTS

DATE: November 10, 2011

Approved [signature] Date 11/21/11

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

Accept staff's analysis of development taxes, fees, and costs and recommend that staff bring forward the following recommendations for full Council consideration:

a Direct the City Attorney to draft an ordinance to implement an interim incentive program to encourage absorption of vacant space by driving industry companies by partially suspending for a limited period the City's the Building and Structures Tax (SJMC 4.46), and the Construction Excise Tax (SJMC 4.47) on the following uses:
   i *Solar Photovoltaic Systems*
   ii *Office, Research and Development as defined in Section 20.200.818*
   iii *Data Centers as defined in Section 20.200.265*

   and funding anticipated revenue losses to the City's Traffic Capital Improvement Program with up to $450,000 from the Economic Development Enhancement Fund.

b Direct staff to propose a plan for a modernization of the City's construction taxes to better align the taxation policies with the job goals of the City's Economic Strategy and Envision 2040 Plan.

c Direct staff to explore and bring back for Council consideration in January 2012, a program that provides a reduction in the North San Jose Traffic Impact Fee for new industrial development projects to improve competitiveness of North San Jose for near-term development.

OUTCOME

Staff has analyzed the City's development-related taxes, fees and costs to address the issues raised in the Mayor's March Budget message. This memorandum provides a detailed account of this analysis, clarifies the economic development reason for assessing these costs, identifies underlying issues with the current structure, assesses the cost of development in San Jose for driving industries, analyzes the competitive nature of the local real estate market and San Jose's competitive position, reviews the budget and transportation consequences resulting from possible actions to modify these taxes and provides recommendations to address policy imbalances related to driving industries.

BACKGROUND

In March 2011, the Mayor's Budget message directed staff to review costs assigned to private development and develop a structure that makes San Jose more competitive with surrounding communities. In addition, staff was directed to explore a short term incentive program for R&D, office, retail, and light industrial/manufacturing uses. Following further consultation with the Mayor's office, the incentive program was deferred until it could be considered as part of a more complete review of the costs of development. Staff from multiple departments have reviewed some of the City's development taxes and fees to assess whether they create an uncompetitive environment for development in San Jose and to determine how these taxes could better align with the City's goals related to economic development, the recently adopted Envision 2040 General Plan, and the City's transportation investments.

Construction-Related Taxes

San Jose has four construction-related taxes, but for the purposes of this discussion only two are pertinent: the Building and Structures Tax (SJMC 4.46), and the Construction Excise Tax found at SJMC 4.47, (also known as the CRMP Tax). These two taxes have been the primary focus of this analysis as they make up approximately two-thirds of the cost of many building permits issued by the City and fund the majority of the Traffic Capital Improvement Program. Due to the fact that the Construction Excise Tax is a general purpose tax, this tax has also been used for General Fund budget balancing purposes. The remaining costs can be attributed to plan check and inspection fees, which are 100% cost-recovery, and other charges, such as the City's refundable Construction & Demolition Diversion Deposit. In addition, key development areas like North San Jose, Edenvale and Evergreen have impact fees to mitigate the impacts of new development on City infrastructure.

San Jose's Building and Structure Construction Tax and Construction Excise Tax are applicable to all building permits including both new construction and tenant improvements. For the purposes of collecting these taxes, permit applications are deemed by a permit technician to be Residential, Commercial or Industrial. The Building and Structures Tax is a special tax, the revenues from which must be used for the construction of arterials and major collector streets in the City. The Construction Excise Tax is a general tax with no restrictions on expenditure, but has historically been used for a number of programs in support of the City's General Plan and Green Vision goals to develop a pedestrian, bicycle, and transit environment.

Rates for these taxes vary based on the intended use of the building or structure being permitted. Construction taxes are collected against the valuation of the project derived from the higher of either the International Code Council's building valuation data table or the submitted valuation estimate by the project proponent.

Use	Building & Structures Tax	Construction Excise Tax	Total

	Rate / % of Valuation	Rate / % of Valuation	**Rate / % of Valuation**
Residential	1.75% / 88%	2.75% / 88%	**4.5% / 88%**
Commercial	1.5% / 100%	3% / 100%	**4.5% / 100%**
Industrial	1% / 100%	N/A	**1% / 100%**

Residential and Commercial uses are broadly defined for both taxes based on the provisions of the Zoning Ordinance. Residential is considered in terms of one-family dwellings, two-family dwellings or multiple dwellings, while Commercial uses are those allowed in the General Commercial Zoning District per the Zoning Ordinance.

"Industrial" uses are defined differently in that twelve specific uses are explicitly called out as eligible for the lower tax rate. Based on uses that were considered industrial in the Zoning Ordinance in effect at the time, September 1987, these uses are:

- Laboratories devoted exclusively to research, product development and testing, engineering development, and sales development
- Manufacturing facilities
- Photographic processing and developing
- Mini-warehouses
- 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

In practice, when a non-residential permit application doesn't align with these 12 uses above, they were classified as a Commercial use and taxed at the higher rate of 4.5% of valuation instead of 1%, regardless of whether they are enumerated in the General Commercial Zoning District. For a period following the adoption of the City's first Economic Strategy in 2003, the City Council approved an ordinance in June 2004 amending Title 4 to expand the list of industrial uses to include additional uses that help drive job and revenue growth that were taxed at the lower rate of 1%. These uses were:

- 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, mobile homes, construction equipment.
- Software development.
- Internet applications
- Server farms and co-location facilities
- Telephone switching gears, telecommunication facilities, wireless communication facilities, antenna, and equipment

The ordinance included a sunset provision of five years or until June 30, 2009 to allow the City Council the flexibility to review the uses included and verify that these sectors represented those businesses the Council desired to continue incenting. The memorandum recommending the ordinance specifically noted that the sunset provision would provide the City Council with the "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." The amendment sunsetted in June, 2009. The effect of the five years of the suspension followed by the two years of no suspension has caused confusion in the development community and directly impacted a number of driving industry projects in process or under consideration.

North San Jose Impact Fee
The North San Jose area plays a vital role in the achievement of San José's economic goals. In 2005, the City adopted the North San Jose Area Development Policy which established a policy framework to guide the ongoing development of the area as an important employment center for San Jose. The Policy provides for development of 26 million square feet of new industrial development and brings additional consistency and predictability to the development process by standardizing mitigation responsibilities within the Policy boundaries. In order to provide certainty to Developers with regard to the public infrastructure requirements, the City adopted a Traffic Impact Fee, based on a nexus study analyzing, among other things, expected trip generation for categories of development. When implemented, this fee was set at $10.44 per square foot of industrial development. Due to a 3% escalator included in the Policy, the current fee for industrial development is $12.69 per square foot and is set to rise again in 2013 to $13.54 per square foot.

ANALYSIS

Staff's intent in addressing concerns related to construction taxes is to create a predictable and competitive environment that supports the City's economic development goals of filling vacant industrial buildings and encouraging new workplace development.

Conflicting Definitions of Industrial Use
As companies and developers come to the city to obtain building permits, they are deemed to be either Commercial or Industrial based on Title 4 of the municipal code. The definitions used by staff to make this determination create considerable ambiguity about which category best captures many of our driving industry companies. Since this determination can have significant implications on the cost of permitting, resulting in four and a half times the construction taxes

due on a project, the predictability and consistency of costs are important considerations in promoting economic development.

Economic Development Definition of Driving Industry. For the purposes of economic development, the term "industry" is used in the context of driving industries, the sectors which make up the economic engines of the San Jose economy. Industries such as information and communication technologies, software, networking, biomedical and clean technology are abundant in our industrial lands and provide many of the jobs and revenues that our Economic Strategy aims to attract.

Land Use Definition of Industrial. The economic development definition of driving industries differs significantly from use of the term "Industrial" when used in the context of allowable land uses in industrial zoning districts. Here, the definition of Industrial is related to the physical nature of how a property or facility is used, which is then translated into a broader classification that captures the nature of the use, such as a processing laboratory, a manufacturing or assembly plant, a warehouse or a general business office. When considering land use entitlements, the difference between the definition of Commercial and Industrial can also have implications on the traffic analysis performed on new development proposals. In this context, uses are defined by their likely vehicular trip generation, and fall into categories such as headquarters, manufacturing, research and development center or business park.

Use Definition Related to Traffic Trips. Unlike a developer fee, there is no requirement that there be a strict nexus between the rate and method of collecting a tax, and the use of the proceeds of the tax. However, the traditional distinction in the rate of tax applied to construction between Industrial and Commercial uses was grounded in the demand placed upon the City's infrastructure network by the different types of use. Uses consistent with the Title 4 definition of Industrial, such as research and development laboratories and manufacturing facilities, generate lower amounts of vehicular trips, between four and eight trips per thousand square feet of building space. A Commercial use, such as a general business office for real estate, insurance, property management, or other professional services, generates a higher amount of trips, around seventeen per thousand square feet. The challenges related to the City's construction tax rates center on those driving industry companies that are performing research and development activities in an office environment.

With the development of the North San Jose Area Development Policy, staff needed to address this disparity regarding traffic trips in order to show the required nexus to impose the Traffic Impact Fee. Since the Policy was explicitly focused on increasing the intensity of the City's primary industrial core to accommodate the future growth of technology companies, the analysis of demand on the road infrastructure in the area needed to reflect a broader definition that was better aligned with the types of uses expected to occur. This was achieved through the creation of a new use definition, "Office, Research and Development." This use is defined in the Zoning Ordinance as establishments engaged in industrial or scientific research and product design that involves the use of computers and other related office equipment in an office setting. In the North San Jose Policy, trip generation rates for this use were calculated at a blended rate of twelve trips per thousand square feet. This hybrid approach to the changing nature of the San

Jose economy has yet to be used as a basis of revising the Building and Structures and the Construction Excise Tax, as a tool to incentivize desirable driving industries.

The differing use and understanding of the term "Industrial" within the City's policies and practices makes it difficult to align economic development objectives within existing land use and permitting procedures without significant modernization and realignment of certain provisions within the municipal code. In reality, regardless of the particular lens applied to the term, San Jose's driving industries and industrial lands include a broad range of companies and uses but are dominated by technology companies like Cisco Systems, Brocade, IBM, Ericsson, Super Micro Computer, and Maxim Integrated Products. While these types of driving industry companies are located in Industrial Park Zoning Districts, their facilities today are in many ways similar to an office environment with employees working on computers at desks, which for reasons described in more detail below, would be otherwise considered Commercial. While the nature of industrial space has evolved, our treatment of these facilities for the purpose of collecting construction taxes has not.

Policy Alignment with the Economic Strategy and Envision 2040

The City's Economic Strategy and Envision 2040 Plan focus on economic development as a means of ensuring the community's long-term fiscal sustainability. Strategic Goal #1 of the City's Economic Development Strategy, aimed at "encouraging companies and growth sectors that can drive the local economy and generate revenue for City services and infrastructure," emphasizes the importance of attracting and sustaining a growing concentration of "driving industry" companies. These companies, which stimulate and sustain the other support sectors of the regional economy, typically have many choices about where to locate. As such, the City needs to be aggressive in its practices to capture an increasing share of driving industry jobs in Santa Clara County and the Bay Area. Goal #6 of the Economic Strategy specifically calls out improvement in "the speed, consistency, and predictability of the development review process, and cost" as important to San Jose companies. Time-to-market and cost-competitiveness are always crucial—even more so in a very slow, uncertain development environment.

With the Envision 2040 General Plan, the City has taken a "jobs first" approach to the long-term physical development of the City. The Plan's Major Strategy #4 – to become a regional employment center – includes planning for an additional 470,000 new jobs in San Jose, providing greater flexibility for commercial activity, and supporting job growth within existing job centers. Both the General Plan and the North San Jose Area Development Policy focus on intensification of the City's major employment areas in order to accommodate a wide variety of industry types and development forms. These include high-rise and mid-rise office, research and development uses, heavy and light industrial uses and supporting commercial uses.

Combined, the Economic Development Strategy and the General Plan call for aggressive actions related to the pursuit of driving industry companies and greater flexibility to support company location and job growth in San Jose. As the economy recovers, San Jose has a great opportunity for new job growth by filling vacant industrial real estate and encouraging renovation and redevelopment of older buildings.

Cost of Development Related to Other Cities

When developers and facility managers make expansion or development plans, they often work closely with the City to anticipate the costs of obtaining permits. In San Jose, this figure can be dramatically affected by construction-related taxes since the rate varies significantly depending on the type of use or the nature of the project. The City of San Jose in collaboration with neighboring Santa Clara County cities has been conducting an annual survey over the last six fiscal years to benchmark San Jose's cost of development against neighboring jurisdictions. The survey uses five prototype projects: residential addition/alteration, single-family residential development, multi-family residential development, commercial tenant improvement and industrial/R&D building development. Responding cities calculate the appropriate fees and taxes associated with each prototype. San Jose staff then compile the results for the cost of development report.

Prototype number five of the cost of development survey is based on new construction of a 100,000 square foot shell R&D building. When considered as an Industrial use for the collection of construction-related taxes, San Jose's cost of development is lower than the other jurisdictions (County of Santa Clara, Morgan Hill, Palo Alto, San Mateo, and Sunnyvale). This is based on the industrial definition, wherein construction taxes are assessed as 1% of the project valuation. This makes the total cost of permitting 3.5% of the total project cost. With the ambiguity surrounding the difference in the use of the industrial and commercial definition, the building could alternatively be assessed based on a commercial definition, and therefore subject to 4.5% tax on the value of the project. If this were the case then the cost of permitting would account for 7% of the total cost of the project, making San Jose second highest only to Palo Alto in the cost of development survey.

In San Jose, construction taxes are unilaterally applied to all building permits whether for tenant improvements or new construction. Due to the research and development nature of many of San Jose's technology companies, repeated modification of processes and/or equipment is a common occurrence. To the extent that these modifications affect utility or structural connections, or the reconfiguration of internal space, construction taxes are applied to the value of the project - regardless of whether it creates additional demand on the City's road infrastructure. This situation is legally acceptable because, unlike a developer fee, there does not need to be a strict nexus between the use of the tax proceeds and the application of the tax. However, from an economic policy perspective, this approach should be reconsidered.
A recent example of how construction taxes continue to be collected over the life of a building was illustrated by an incoming technology company who leased 50,000 square feet in North San Jose. The company came through the City's Special Tenant Improvement Program and received their permits in a little under an hour and a half. The project, valued at approximately $1,100,000, was for interior renovations on an existing office/industrial building that were largely cosmetic and did not constitute a major change in use or function of the building. For the purposes of this permit, the use was considered Commercial and the company was required to pay $49,500 for construction taxes. These taxes represented 81% of the company's non-refundable permitting costs. Constructed in 1998, this six-story building was originally taxed at a commercial rate and had paid almost $500,000 in Building and Structures and Construction Excise taxes when built. Over 100 building permits have since been issued for modifications to

the building since 1998 - ranging from major remodels to sink replacements - resulting in $310,000 in additional construction taxes paid.

North San Jose Traffic Impact Fee
In addition to the conventional costs associated with obtaining building permits, larger mitigations to support specific development play an important part in the costs associated with new development. In addition to creating new employment-generating development capacity, the creation of the North San Jose Area Development Policy was intended to bring additional consistency and predictability to development process by standardizing mitigation responsibilities within the Policy boundaries through the adoption of a Traffic Impact Fee.

Unintentionally, this Policy has created a near term competitive disadvantage for North San Jose during a period of economic contraction. This stems from the distribution of the fee evenly across all four phases. This, in addition to other financial obligations resulting from the law suit filed by neighboring jurisdictions has meant that near term development within the Policy area must equally bear the burden of mitigation resulting from all development in the area over the next 20 to 30 years, where other competing jurisdictions need only mitigate traffic impacts within the scope of individual projects. Long term, North San Jose will benefit from the approach created in the Policy as the cost of mitigating development in surrounding communities becomes prohibitive; however, considerable development must take place before then. In the meantime San Jose is not-well positioned to receive near-term development with existing traffic impact fees.

Competitive Nature of the Commercial Real Estate Market
San Jose has over 47 million square feet of industrial real estate, almost one-third of Silicon Valley's total R&D space. Currently, San Jose's Research and Development vacancy rate is 17.75%, and while San Jose appears to be well positioned to accommodate a wide range of users and space needs given the large amount of available real estate, a number of different factors go into the location decisions made by technology companies.

Geography
Cities along the Peninsula have less industrial space than San Jose which, combined with attractive proximity to academic base at Stanford and the venture capital base on Sand Hill Road, has put many of these areas at a premium. The attractiveness of the Peninsula to new and emerging companies and has driven much of the new Class A lease and development activity occurring over the last ten years to occur in these communities and has put potential corporate locations further south at a significant disadvantage. Currently, over 60% of San Jose's R&D vacant properties are less than 30,000 square feet and much of this capacity is considered to be Class B and C space. This is a direct reflection of San Jose's aging building stock which has seen less re-investment than other communities in recent years and doesn't reflect the types of properties currently desired by many growth companies.

Cost
Cost of business operations continues to be a significant factor as companies look to relocate facilities. While this includes the cost of construction-related fees and taxes, it also considers a much broader set of costs. Traditionally, because of the geographical factors described above,

lease rates in San Jose have been lower than neighboring cities. These lower lease costs are considered against the higher costs of upgrading building infrastructure, higher tenant improvement permitting costs, lower utility rates in those communities with municipally owned utilities, and lower business taxes imposed by neighboring cities.

Access to Workforce
Despite its concentration of housing, San Jose has generally been at a disadvantage as far as perceived access to talent. There is an ongoing perception that young professional talent and senior executives are easier to attract from locations on the Peninsula.

At first look, it may seem that broad range of site selection factors would mitigate the subtle differences between the different costs associated with different cities. As companies and their consultants become more aware of the costs, programs and advantages associated with different locations, the margins between different lease rates, utility rates and fees and taxes are under increasing pressure. When applied to larger facilities where costs are analyzed on a per square foot basis, these differences can result in dramatic implications in the long term.

A recent example of how these costs are considered by a large driving industry business was recently provided by IBM. Corporate staff from IBM global headquarters were analyzing the implications of consolidating a recently purchased company, Blade Network Technologies (a 200 person company located in Santa Clara), into one of the company's existing locations. Due to the nature of this relocation, the financial implications of the move were the primary consideration. IBM contacted the Office of Economic Development after analyzing the costs of locating the 200 staff in IBM's 4400 North First Street facility. Their analysis concluded that the difference between an Industrial and Commercial designation of the project would result in an almost $100,000 difference in construction taxes and that this was enough of a swing for them not to consolidate these employees in San Jose. After consulting with IBM about the nature of the use and confirming that under the provisions of Title 4 it could be considered industrial and taxed at the lower 1% rate, IBM decided to go ahead with the consolidation.

While in this instance IBM called OED staff directly to help identify the correct costs during the decision-making process, this is not always the norm. In fact, much analysis for major relocations is often performed by third-party site selection or real estate professionals who can be reluctant to engage with staff from different cities. The Office of Economic Development/Redevelopment Agency outreach team is actively addressing this issue, however, the perception of high or inconsistent costs in San Jose is still held by many based on their prior experience through this process.

Budget Consequences of Potential Change
The Building and Structures tax was enacted in the 1970's to develop and maintain the transportation system. The funds generated by these taxes are intended for acquisition of lands and for the construction, reconstruction, replacement, widening, modification and alteration (but not maintenance and repair) of existing and proposed City streets. The Construction Excise tax is a general tax, not legally earmarked for these purposes, but has been historically used in a similar manner.

San Jose is unique in its funding of the transportation system in this way. In other local jurisdictions, transportation improvements are funded through General Fund sources or Citywide Traffic Impact Fees. In effect, San Jose's construction taxes serve as a citywide impact fee and were initially scaled based on the transportation demands generated by residential, commercial, office, and industrial development. Due to statewide restrictions placed on the modification and increase of taxes the City is unable to address shifts in the changing nature of traffic trips as they relate to industrial or commercial uses in the way it could if these were impact fees.

An effective transportation system is critically important for the City's economic development. Given the scale of the costs associated with major transportation improvements, the revenues from these construction taxes alone do not cover the costs of the projects the City needs to implement. The City's Department of Transportation, however, has been successful in leveraging these funds as match for additional federal and state funds. Combined with these additional sources, these construction tax revenues support some of the major infrastructure projects facing the City. Revenues from the two taxes are used as follows:

- Building and Structure Construction Tax revenues are dedicated to the Traffic Capital Improvement Program and reserved for developing the General Plan Transportation System. As such, these revenues fund key transportation infrastructure in support of economic development. Some examples of the types of projects include the 101/Tully interchange reconstruction, the 101/Capitol/Yerba Buena interchange reconstruction, and the 280/880/Stevens Creek upgrade.

- The Construction Excise tax is a general purpose tax not restricted in its use. Per City Council Policy, the revenues are dedicated to the Traffic Capital Improvement Program. Revenue is used for a number of programs in support of the City's general plan and green vision goals to develop a pedestrian, bicycle, and transit environment. Examples of the type of projects that these revenues fund include traffic safety, required ADA curb ramps and sidewalk improvements, bicycle projects, and additional matching funds for future grant opportunities. In addition the revenue is also used in balancing the General Fund shortfall. In 2010-2011, $5.3 million was budgeted for General Fund balancing (40% of actual revenue), while in 2011-2012, $3.5 million (44% of expected revenue) was budgeted for General Fund balancing. It is anticipated that in 2012-2013, this funding source will again be required as a necessary General Fund balancing strategy.

Any alterations to the Building and Structure Tax or Construction Excise Tax revenues will have a direct impact on transportation programs and General Fund balancing solutions. Without adequate funds, the City's Department of Transportation will not be able to attract future grant opportunities to continue build out and upgrade of the City's capital infrastructure.

Proposed Solutions

Implement Short-Term Incentive for Tenant Improvements

To ensure that San Jose remains competitive in the region for leasing of space by driving industry companies, staff proposes to implement an interim program that provides additional clarification to the definitions of industrial uses to ensure consistent and predictable permitting costs. For the interim period until a long term solution can be considered, staff is recommending the expansion of the Industrial use definitions included in Title 4 to include the zoning ordinance definitions of "Office/ Research and Development" and "Data Centers," and to include all Solar Photovoltaic Systems, which are those uses that most closely align with the City's economic and development policies. To limit the negative impact on revenues currently generated by both construction taxes, the benefit of these uses being classified as Industrial would only extend to tenant improvements. Based on staff's analysis of the last three years of construction taxes collected, staff estimates that these changes will amount to less than $300,000 per year in potentially foregone revenue. On the other hand, accelerated leasing of industrial space may increaser revenues above the base case. To reduce the impact on important transportation resources and the General Fund, staff is analyzing possible alternatives to fund this short fall prior to bringing the proposal forward to the full Council. This could include use of the Economic Development Enhancement Fund up to a capped amount at which point when funding is exhausted, staff will revisit the incentive program, being mindful of the fiscal environment at that time. The cap would ensure that the Traffic Capital Program and General Fund are protected in the short term.

Long Term Solution: Modernize Construction Taxes and Transportation Funding
Staff has concluded that the most sustainable solution for both the City and the business community is a full modernization of construction-related taxes to address the underlying twin challenges of encouraging job creation and funding major transportation infrastructure. Staff estimates that a program of this nature will take two years to develop and implement and would be subject to voter approval.

North San Jose Incentive Program for New Office/R&D Development
Staff intends in January to recommend a temporary reduction in the North San Jose Traffic Impact Fee for a limited time period, following further outreach and exploration. Staff's intent in limiting the scope of this incentive is to ensure that it is specifically targeted to meet the City's economic development goals by resulting in actual construction of new industrial buildings and the location, relocation or expansion of key driving industry tenants that will add jobs or provide additional revenues to the City. Encouraging key development projects within the policy area may help spur increased development activity throughout North San Jose which in turn will begin to drive additional revenues and fees. The City's mitigation obligations to neighboring jurisdictions related to the approval of the Policy are unlikely to be covered by Redevelopment Agency funds as hoped. Therefore it is important that the City begin generating revenues to make payments towards these obligations, and/or reevaluate the City's position regarding the Policy. The City's decision to offer a reduced traffic impact fee in North San Jose would by no means reduce the obligation to provide the necessary mitigations associated with these fees. As part of analyzing this proposal and bringing it forward to the full City Council in January, staff will need to identify necessary means to backfill this requirement.

<u>Alternate Incentive Structure</u>
As an alternative to the above proposals, staff has also considered a different approach to address the issues related to construction taxes. Rather than reducing construction taxes systematically for certain additional Industrial use classifications, the City could set aside funds from the General Fund to directly incent specific driving industry companies. This approach is not

recommended at this time, however, due to the current fiscal situation of the General Fund and historically low staffing levels.

COORDINATION

The memorandum has been coordinated with the City Attorney's Office, Department of Transportation, Public Works Department, Housing Department, Budget Office and Redevelopment Agency.

BUDGET IMPACT

The proposed temporary incentive program would result in funds currently allocated in the Economic Development Enhancement Fund being directed to the Traffic Capital Improvement Program, up to $450,000. A structural modernization of the City's development related taxes and fees would need to be analyzed to ensure that the Traffic Capital Improvement Program is adequately funded and transfers from the Construction Excise Tax Fund to the General Fund could continue, as needed for budget balancing purposes.

CEQA

CEQA: Not a Project, File No.PP10-066 (a), Staff Report

/s/
JOSEPH HORWEDEL, DIRECTOR
Planning, Building and Code Enforcement

/s/
KIM WALESH
Director of Economic Development
Chief Strategist

For questions please contact Chris Burton, Business Development Manager, at (408) 535-8114