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| <b>Items 3 and 4</b><br><b>Files 11-0337 &amp; 11-0462</b><br><i>(Continued from May 4, 2011)</i> | <b>Department(s):</b><br>Office of Economic and Workforce Development<br>Treasurer/Tax Collector |
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## EXECUTIVE SUMMARY

### Legislative Objectives

- File 11-0337 would amend the City's Business and Tax Regulation Code to establish a Payroll Expense Tax exclusion for the tax years 2011 through 2017 for that portion of an eligible business' payroll expense that is attributable to stock-based compensation.
- File 11-0462 would amend the City's Business and Tax Regulation Code to establish a Payroll Expense Tax exclusion for stock-based compensation.

### Key Points

- Businesses with an annual payroll of \$250,000 or more currently pay Payroll Expense Taxes to the City of 1.5 percent of the firm's payroll expenses, including stock options, for work or services performed in San Francisco. Certain biotechnology and clean energy technology businesses are currently exempt from the Payroll Expense Tax and recently Ordinance 64-11 (File 11-0155) established a Payroll Expense Tax exclusion for businesses in the Central Market and Tenderloin Area.
- The Controller's Office of Economic Analysis issued a report on March 15, 2011 stating that it is common practice for technology businesses to compensate employees with stock options and advising that City Payroll Expense Tax liability associated with stock options appears to be an incentive for technology businesses to relocate outside of San Francisco.
- The Controller's Office of Economic Analysis issued a report on May 3, 2011 stating that historically only two to three companies conduct an Initial Public Offering each year, with annual business' Payroll Expense Taxes for such stock-based compensation ranging from \$39,000 to \$685,000, or an average of \$140,000. However, the burden of taxing stock-based compensation is disproportionate for highly-valued companies immediately after their initial public offerings.
- File 11-0337 would only exclude the amount of stock-based compensation that exceeds an annual Payroll Expense Tax liability of \$750,000 from the Payroll Expense Tax to mitigate any potential loss of City General Fund monies received in previous years.
- File 11-0462 would only exclude the amount of stock-based compensation that exceeds the stock-based compensation portion of the business' 2010 or 2011 Payroll Expense to mitigate any potential loss of City General Fund monies received in previous years.

### Fiscal Impacts

- File 11-0337 would require one-time General Fund expenditures of approximately \$30,000 for professional services to amend reporting documents.
- File 11-0462 would create a separate tax base of stock-based compensation that the Treasurer/Tax Collector would need to treat differently than other compensation, requiring the Treasurer/Tax Collector to collect and verify a new set of data in order to administer this

tax exclusion and anticipates that annual administrative costs could be significant.

- Stock-based compensation information is not currently collected by the Treasurer/Tax Collector's Office and it is not possible to identify prospective companies that would benefit from the proposed Payroll Expense Tax exclusions for stock-based compensation.

### **Recommendations**

- Approval of the proposed ordinances are policy decisions for the Board of Supervisors.

## **MANDATE STATEMENT / BACKGROUND**

### **Mandate Statement**

In accordance with the City's Business and Tax Regulations Code Section 902.1<sup>1</sup>, currently, San Francisco businesses pay Payroll Expense Taxes to the City of 1.5 percent of the firm's payroll expenses for work or services performed in San Francisco. Each San Francisco businesses' tax liability is determined annually based on the payroll expenses of the entity. Business and Tax Regulations Code Section 905-A provides an exemption for businesses with a payroll of \$250,000 or less from the Payroll Expense Tax liability. Sections 906.1 and 906.2 of the Business and Tax Regulations Code provide exclusions for businesses engaged in certain biotechnology enterprises and clean energy technology, respectively. Section 906.3 also provides a Payroll Expense Tax exclusion for certain businesses that are located in or relocate to the Central Market Street and Tenderloin Area.

Charter Section 2.105 provides that all legislative acts in San Francisco be by ordinance, approved by a majority of the Board of Supervisors.

### **Background**

In 2004, the Board of Supervisors approved Ordinance 26-04 (File 03-1990) that amended the definition of "Payroll Expense" to clarify that the definition includes bonuses and property issued or transferred in exchange for the performance of services (including but not limited to stock options). As a result, companies received clarification that they are required to pay Payroll Taxes on gains from employee stock options when companies conduct an Initial Public Offering<sup>2</sup>.

On April 19, 2011, the Board of Supervisors approved Ordinance 64-11 (File 11-0155) establishing a Payroll Expense Tax exclusion for businesses in the Central Market and Tenderloin Area. The Controller's Office of Economic Analysis issued an economic impact

<sup>1</sup> Business and Tax Regulations Code Section 902.1(a) specifically defines Payroll Expense as compensation paid to individuals including shareholders of a professional corporation or a Limited Liability Company (LLC), for salaries, wages, bonuses, commissions, property issued or transferred in exchange for the performance of services (including but not limited to stock options), compensation for services to owners of pass-through entities, and any other form of compensation, who during any tax year, perform work or render services, in whole or in part in the City.

<sup>2</sup> An Initial Public Offering is when a company issues common stock or shares to the public for the first time. Typically the companies conducting an Initial Public Offering are smaller, younger companies seeking capital to expand, but also large privately owned companies may conduct an Initial Public Offering to become publicly traded.

report to accompany the legislation on March 15, 2011. The report stated that it is common practice for technology businesses to compensate employees with stock options and found that future Payroll Expense Tax liability associated with stock options appears to be a significant incentive for technology businesses to relocate outside of San Francisco.

## DETAILS OF PROPOSED LEGISLATION

### *File 11-0337*

File 11-0337 would amend Article 12-A of the City's Business and Tax Regulation Code by adding Section 906.4 to establish a Payroll Expense Tax exclusion for that portion of an eligible business' payroll expense that is attributable to stock-based compensation<sup>3</sup> for tax years 2011 through 2017. The proposed ordinance would become effective at least 30 days after the Board of Supervisors approves the proposed ordinance, estimated to be approximately June 30, 2011. Section 906.4 would expire on December 31, 2017.

Under the proposed ordinance, an eligible business' Payroll Expense Tax attributable to stock-based compensation would be excluded if the business undertakes an Initial Public Offering on a public stock exchange or experiences a change in control prior to any such public offering, during the period of the exclusion.

In order to be eligible for the Payroll Expense Tax exclusion for stock-based compensation, businesses must (a) file with the Tax Collector's Office an affidavit to establish entitlement to the tax exclusion, including supporting documentation prescribed by the Tax Collector; (b) maintain records and documentation in a manner acceptable to the Tax Collector that objectively substantiates the claimed tax exclusion; (c) provide the records and documentation to the Tax Collector's Office upon request; and (d) file an annual Payroll Expense Tax Return with the Tax Collector's Office regardless of the amount of tax liability shown on the return after claiming the exclusion.

Under the proposed ordinance of File 11-0337, the Office of the Treasurer/Tax Collector would be responsible for adopting rules and regulations for implementing the proposed Payroll Expense Tax exclusion for stock-based compensation and the Tax Collector would be responsible for (a) verifying all exclusion claims and (b) submitting an annual report to the Board of Supervisors for each year of the exclusion that includes both the (i) number of exclusions claimed and (ii) aggregate dollar value of such exclusions.

Under the proposed ordinance of File 11-0337, at least six months prior to the expiration of the proposed Payroll Expense Tax exclusion for stock-based compensation, or no later than July 1, 2017, the Controller would (a) assess and review the effect of the exclusion, and (b) provide an analysis to the Board of Supervisors, including recommendation(s) on whether the exclusion should be extended for an additional period.

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<sup>3</sup> Stock-based compensation is defined in the proposed ordinance (File 11-0337) as including but not limited to, all incentive and non-statutory stock options, including all underlying stock relating to such options, restricted stock, restricted stock units, and stock acquired as a result of employee stock purchase plans.

Under the proposed ordinance of File 11-0337, the Payroll Expense Tax exclusion for stock-based compensation would only exclude the amount of stock-based compensation that exceeds each business' annual Payroll Expense Tax liability of \$750,000. In addition, the proposed Payroll Expense Tax exclusion for stock-based compensation could not be concurrently claimed by a business that claims any other Payroll Expense Tax exclusion, such as the existing biotechnology, clean energy, or Central Market Street and Tenderloin Area Payroll Expense Tax exclusions.

*File 11-0462*

File 11-0462 would amend Article 12-A of the City's Business and Tax Regulation Code by adding Section 906.5 to establish a Payroll Expense Tax exclusion for that portion of an eligible business' payroll expense that is attributable to stock-based compensation<sup>4</sup>. The proposed ordinance would become effective January 1, 2012 and would have no expiration date.

Under the proposed ordinance, Payroll Expense Tax attributable to stock-based compensation would be excluded only in the amount that exceeds the stock-based compensation portion of an individual business' Base Year Payroll Expense, which is defined as the greater of the business' 2010 or 2011 stock-based compensation portion of their Payroll Expense Tax liability.

Similar to the above noted provisions in File 11-0337, in the proposed ordinance of File 11-0462, in order to be eligible for the Payroll Expense Tax exclusion for stock-based compensation, businesses must (a) file with the Tax Collector's Office an affidavit to establish entitlement to the tax exclusion; (b) maintain records and documentation in a manner acceptable to the Tax Collector that objectively substantiates the claimed tax exclusion; (c) provide the records and documentation to the Tax Collector's Office upon request; and (d) file an annual Payroll Expense Tax Return with the Tax Collector's Office regardless of the amount of tax liability shown on the return after claiming the exclusion. Similarly, under the proposed ordinance, the Office of the Treasurer/Tax Collector would be responsible for adopting rules and regulations for implementing the proposed Payroll Expense Tax exclusion for stock-based compensation and the Tax Collector would be responsible for verifying all exclusion claims.

The proposed Payroll Expense Tax exclusion for stock-based compensation in File 11-0462 could also not be concurrently claimed by a business that claims any other Payroll Expense Tax exclusion, such as the existing biotechnology, clean energy, or Central Market Street and Tenderloin Area Payroll Expense Tax exclusions. Additionally, the proposed Payroll Expense Tax exclusion for stock-based compensation could not be claimed retroactively.

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<sup>4</sup> Similar to the definition in File 11-0337, stock-based compensation is defined in the proposed ordinance (File 11-0462) as including but not limited to, all incentive and non-statutory stock options, including all underlying stock relating to such options, restricted stock, restricted stock units, and stock acquired as a result of employee stock purchase plans.

**FISCAL ANALYSIS****Prospective Businesses and Payroll Tax Impacts**

In 2004, the Board of Supervisors approved Ordinance 26-04 (File 03-1990) amending the definition of “Payroll Expense” to clarify that the definition includes bonuses and property issued or transferred in exchange for the performance of services, including but not limited to stock options. As a result, San Francisco companies received clarification that they are currently required to pay Payroll Expense Taxes on gains from employee stock options when a company conducts an Initial Public Offering.

According to Ms. Jennifer Matz, Director of the Office of Economic and Workforce Development (OEWD), it is not possible to identify prospective companies in the City that would benefit from the proposed Payroll Expense Tax exclusion for stock-based compensation since companies do not tend to announce their intention to conduct an Initial Public Offering before the event occurs.

According to Mr. Greg Kato, Policy and Legislative Manager with the Treasurer/Tax Collector’s Office, stock-based compensation information is not currently collected by the Treasurer/Tax Collector’s Office. As a result, the amount of Payroll Expense Taxes previously paid to the City that were attributed to stock-based compensation cannot be determined.

The Controller’s Office of Economic Analysis issued a report on May 3, 2011 on Payroll Expense Tax exclusions for stock-based compensation.<sup>5</sup> The report notes that since the City requires businesses to report on their total compensation to employees and does not require businesses to detail what employee compensation is attributable to wages and salaries, stock compensation, or other sources, it is not possible to precisely estimate the cost or the benefit from a Payroll Expense Tax exclusion for stock-based compensation. The report found that the burden of taxing stock-based compensation is particularly disproportionate for a highly-valued company immediately after its initial public offering and that a Payroll Expense Tax exclusion for stock-based options granted prior to an initial public offering would be effective in reducing the significant tax burden. Additionally, the report stated that of the 8,000 businesses liable for the City’s Payroll Expense Tax, historically, only two to three companies conduct an Initial Public Offering each year. Based on the Initial Public Offerings in San Francisco over the past 14 years annual payments of Payroll Expense Tax for stock-based compensation range between \$39,000 to \$685,000 per business, with an average annual payment of \$140,000.

Under the proposed ordinance of File 11-0337, Payroll Expense Taxes attributable to stock-based compensation would be excluded in the amount that exceeds each business’ annual Payroll Expense Tax liability of \$750,000. For example, if following an Initial Public Offering a highly-valued business owes \$1,000,000 in Payroll Expense Taxes attributable to stock-based compensation in a given year during the period the exclusion is in effect, the company would

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<sup>5</sup> The Controller’s economic impact report was issued in response to Board of Supervisors President’s request to research a solution that reduces the risk of growing technology companies leaving San Francisco and minimizes the cost to the General Fund, in coordination with the introduction of File 11-0337.

only pay \$750,000 in taxes that year. By setting a cap on the Payroll Expense Tax exclusions for stock-based compensation with a ceiling of \$750,000 for each business, this provision may mitigate some of the loss of Payroll Expense Taxes attributable to stock-based compensation that the City historically has received and would be received by the City in the near future and provides protection for the most highly-valued companies. However, given that the Tax Collector's Office cannot identify the amount of Payroll Expense Taxes previously paid to the City that was attributed to stock-based compensation, the Budget and Legislative Analyst cannot estimate the actual amount of Payroll Expense Taxes from stock-based compensation that the City may continue to receive by establishing the \$750,000 threshold.

Under the proposed ordinance of File 11-0462, Payroll Expense Taxes attributable to stock-based compensation would be excluded in the amount that exceeds the greater of the business' 2010 or 2011 stock-based compensation portion of that business' Payroll Expense Tax liability. This provision may mitigate some of the loss of Payroll Expense Taxes attributable to stock-based compensation that would be received by the City in the near future. However, given that the Tax Collector's Office cannot identify the amount of Payroll Expense Taxes paid to the City in 2010 or 2011 that were attributed to stock-based compensation, the Budget and Legislative Analyst cannot estimate the actual amount of Payroll Expense Taxes from stock-based compensation that the City may continue to receive.

### **Administrative Impacts and Costs**

#### *File 11-0337*

Mr. Kato reports that it is not known how many businesses currently use or plan to use stock-based compensation, and/or will conduct an Initial Public Offering within the July 1, 2011 through December 31, 2017 timeframe specified in the proposed ordinance. Therefore, the Treasurer/Tax Collector's Office cannot estimate how many businesses would qualify for the proposed Payroll Expense Tax exclusion for stock-based compensation.

Under the proposed ordinance of File 11-0337, each business would be required to file an annual Payroll Expense Tax Return with the Tax Collector's Office regardless of the amount of the tax liability, after claiming the requested exclusion. Also, as previously mentioned, on April 19, 2011, the Board of Supervisors approved Ordinance 64-11 (File 11-0155) establishing a Payroll Expense Tax exclusion for businesses in the Central Market and Tenderloin Area. To implement the recently approved legislation, the Treasurer/Tax Collector's Office reported that initial one-time General Fund expenditures of approximately \$162,000 would be needed to create the necessary forms and establish procedures to verify each businesses employment and payroll data and provide refunds in the first year (2011), and approximately \$81,000 of General Fund expenditures would be needed in each of the following years to annually review and audit the Payroll Expense Tax exclusions for certain businesses in the Central Market and Tenderloin Area. Mr. Kato advises that the majority of the cost to implement the proposed ordinance would be absorbed in the implementation of the Payroll Expense Tax exclusion for businesses in the Central Market and Tenderloin Area that was recently approved by the Board of Supervisors; however, Mr. Kato notes that an additional one-time General Fund expenditure of approximately \$30,000 for professional services to make the necessary amendments to the revised reporting

documents would be needed to incorporate the Payroll Expense Tax exclusion for stock-based compensation into the Tax Collector's administration of the Payroll Expense Tax.

*File 11-0436*

Corresponding to the previously discussed proposed ordinance, Mr. Kato reports that it is not known how many businesses currently use stock-based compensation or plan to use stock-based compensation and therefore cannot estimate how many businesses would qualify for the proposed Payroll Expense Tax exclusion for stock compensation under the proposed ordinance of File 11-0462.

According to Mr. Kato, under the proposed ordinance of File 11-0462, a separate Payroll Expense Tax base of stock-based compensation would be created and would need to be administered differently than other compensation in the Payroll Expense Tax. Under the proposed ordinance of File 11-0462, Mr. Kato advises that the Treasurer/Tax Collector would be required to collect and verify a new set of data separate from the existing Payroll Expense Tax in order to initially administer this Payroll Expense Tax exclusion for stock-based compensation; and required to annually verify that stock-based compensation is handled appropriately in the following years. Mr. Kato reports that the Treasurer/Tax Collector anticipates the annual costs to administer the exclusion for stock-based compensation could be significant. However, as of the writing of this report, the Treasurer/Tax Collector could not estimate the cost to implement the proposed ordinance and was still reviewing this issue to consider strategies to achieve administrative efficiencies. Mr. Kato however advises that the Treasurer/Tax Collector staff will advise the Budget and Finance Committee by May 11, 2011 regarding the estimated costs to implement this ordinance.

## **POLICY CONSIDERATIONS**

### **Loss of Future City Payroll Expense Taxes Related to Businesses Conducting an Initial Public Offering versus Relocation of Companies out of the City**

The Budget and Legislative Analyst notes that if either of the proposed Payroll Expense Tax exclusion for stock-based compensation is not approved, companies that plan to conduct an Initial Public Offering may not stay and grow their business in San Francisco, such that San Francisco will lose the existing annual Payroll Expense Taxes that these companies currently pay to the City. On the other hand, if the proposed Payroll Expense Tax exclusion for stock-based compensation is approved and eligible companies stay in the City, the existing Payroll Expense Taxes currently paid by these companies would continue to accrue to the City's General Fund and possibly increase if the companies expand. However, if the proposed Payroll Expense Tax exclusion for stock options is approved, potentially a significant amount of revenue related to stock-based compensation if eligible companies were to conduct an Initial Public Offering would be foregone.

The Controller's report on Payroll Expense Tax exclusions for stock-based compensation concluded that an efficiently-designed stock option exclusion can provide a tangible benefit to a

few successful companies that could mitigate the risk of growing companies leaving San Francisco and the cost to the City's General Fund.

## **RECOMMENDATIONS**

Approval of the proposed ordinances are policy decisions for the Board of Supervisors.