File No. 110337

Committee Item No. 6
Board Item No. _____

# COMMITTEE/BOARD OF SUPERVISORS

## AGENDA PACKET CONTENTS LIST

**Committee:** Budget and Finance SUB-Committee **Date:** May 4, 2011

**Board of Supervisors Meeting** **Date** _____

| Cmte | Board | |
|---|---|---|
| ☐ | ☐ | **Motion** |
| ☐ | ☐ | **Resolution** |
| ☒ | ☐ | **Ordinance** |
| ☒ | ☐ | **Legislative Digest** |
| ☒ | ☐ | **Budget and Legislative Report** |
| ☐ | ☐ | **Ethics Form 126** |
| ☐ | ☐ | **Introduction Form (for hearings)** |
| ☐ | ☐ | **Department/Agency Cover Letter and/or Report** |
| ☐ | ☐ | **MOU** |
| ☐ | ☐ | **Grant Information Form** |
| ☐ | ☐ | **Grant Budget** |
| ☐ | ☐ | **Subcontract Budget** |
| ☐ | ☐ | **Contract/Agreement** |
| ☐ | ☐ | **Award Letter** |
| ☐ | ☐ | **Application** |

**OTHER** **(Use back side if additional space is needed)**

☐ ☐ _____
☐ ☐ _____
☐ ☐ _____
☐ ☐ _____
☐ ☐ _____

**Completed by:** Victor Young **Date:** April 29, 2011
**Completed by:** Victor Young **Date:** _____

An asterisked item represents the cover sheet to a document that exceeds 25 pages. The complete document is in the file.

[Business and Tax Regulations Code – Excluding Stock Compensation from Payroll Expense, Tax Years 2011 through 2013]

**Ordinance amending Article 12-A of the San Francisco Business and Tax Regulations Code by adding Section 906.4 to establish a payroll expense tax exclusion for that portion of an Eligible Person's payroll expense that is attributable to stock compensation.**

NOTE: Additions are *single-underline italics Times New Roman*; deletions are ~~*strike-through italics Times New Roman*~~. Board amendment additions are double-underlined; Board amendment deletions are ~~strikethrough normal~~.

Be it ordained by the People of the City and County of San Francisco:

Section 1. Findings. The Board of Supervisors hereby finds that:

(a) San Francisco is the only city in California to levy a payroll expense tax. The San Francisco Payroll Expense Tax is levied against businesses on its annual compensation expense, to which stock compensation can be subject.

(b) According to the California Employment Development Department, at the beginning of 2011 the City and County of San Francisco had an estimated 32,000 non-government technology jobs. Stated differently, about 17.4 percent of non-government office workers in San Francisco are employed in the technology sector.

(c) In a March 15, 2011 report issued by the Office of the Controller, its Office of Economic Analysis found that it is common practice in the technology industry to compensate employees with stock options. It also found that future payroll expense tax liability associated with stock options appears to be a significant incentive for successful technology companies to relocate outside of San Francisco. As a result, the report suggests that San Francisco consider modifying its payroll expense tax ordinance to reduce this incentive.

(d) It is widely believed that several local technology companies will undertake an initial public offering within the next few years. If so, shares of these companies will trade on a public stock exchange and potentially subject the companies to greater payroll expense tax liabilities. City leaders are concerned that faced with potentially greater payroll expense tax liabilities, these companies may move out of San Francisco as the Office of Economic Analysis suggested.

(e) San Francisco leaders currently are undertaking a comprehensive review of the San Francisco business tax code. Excluding stock compensation from the payroll expense tax through 2013 will allow the City time to complete its assessment. Also, it will provide a level of certainty regarding future tax liability for the technology companies who take their companies public so that such companies will not feel compelled to relocate outside San Francisco.

(f) Attracting and retaining growing businesses in San Francisco through thoughtful business tax reform is a key component to maintaining a strong local economy and tax base. Therefore,

Section 2. The San Francisco Business and Tax Regulations Code is hereby amended by adding Section 906.4, to read as follows:

***SEC. 906.4. STOCK COMPENSATION EXCLUSION.***

*(a) Definitions.*

*(1) "Eligible Person" shall mean a person who as of January 1, 2011: (i) is a Technology Business, (ii) employs at least 100 employees in San Francisco, (iii) was founded after 2001, and (iv) undertakes an initial public offering on a public stock exchange during the period this exclusion is in effect.*

(2) "Technology Business" shall mean a Web-based company whose core mission, business plan and revenues are developed through services or goods accessed by way of the Internet.

(3) "Stock Compensation" shall mean any stock option granted prior to the person's date of initial public offering.

(b) An Eligible Person may exclude from its payroll expense all compensation related to Stock Compensation for the tax years 2011, 2012 and 2013.

(c) No exclusion shall be allowed under this Section to the extent that such exclusion reduces an Eligible Person's payroll expense tax liability below $1,500 for any individual employee. In such case, the Eligible Person's payroll expense tax liability shall be fixed for such individual employees at $1,500.

(d) In order to be eligible for the payroll expense tax exclusion authorized under this Section, persons wishing to claim the exclusion must:

(1) File with the Tax Collector, on a form prescribed by the Tax Collector, an affidavit attesting to the facts establishing entitlement to the tax exclusion. The affidavit shall be supported by such other documentation as the Tax Collector shall prescribe.

(2) Maintain records and documents in a manner acceptable to the Tax Collector. Such records and documents must objectively substantiate any exclusion claimed under this Section and be provided to the Tax Collector upon request.

(3) File an annual payroll expense tax return with the Tax Collector regardless of the amount of tax liability shown on the return after claiming the exclusion provided for in this Section.

(e) A person may not use or claim any unused portion of the exclusion available under this Section after the expiration date of this Section.

*(f) The Office of the Treasurer and Tax Collector may adopt rules and regulations regarding the exclusion provided under this Section.*

*(g) The Tax Collector shall verify that any exclusion claimed pursuant to this Section is appropriate.*

*(h) A misrepresentation or misstatement by any person regarding eligibility for the exclusion authorized by this Section that results in the underpayment or underreporting of the payroll expense tax shall be subject to penalties.*

*(i) The Stock Compensation Exclusion in this Section may not be claimed concurrently with any other payroll expense tax exclusion.*

*(j) This Section 906.4 shall expire by operation of law on December 31, 2013, unless extended by the Board of Supervisors or the voters, and the City Attorney shall cause it to be removed from future editions of the Business and Tax Regulations Code.*

APPROVED AS TO FORM:
DENNIS J. HERRERA, City Attorney

By: _____
STEPHANIE PROFITT
Deputy City Attorney

FILE NO.110337

# LEGISLATIVE DIGEST

[Business and Tax Regulations Code – Excluding Stock Compensation from Payroll Expense, Tax Years 2011 through 2013]

**Ordinance amending Article 12-A of the San Francisco Business and Tax Regulations Code by adding Section 906.4 to establish a payroll expense tax exclusion for that portion of an Eligible Person's payroll expense that is attributable to stock compensation.**

## Existing Law

San Francisco imposes a payroll expense tax on business entities based on the compensation they pay to employees and others for work or services performed in San Francisco. (Business and Tax Regulations Code Section 901 et seq.) The tax rate is 1.5% of taxable payroll expense. This tax is determined each year based on the payroll expenses of the entity. Stock compensation is subject to the payroll expense tax.

## Amendments to Current Law

The proposed amendment would amend Section 906 to establish an exclusion from the payroll expense tax for stock compensation of Eligible Persons for the next three years. Under the exclusion, an Eligible Person is a person who as of January 1, 2011 is a Technology Business that employees at least 100 people in San Francisco, was founded after 2001 and undertakes an initial public offering during the next three years.

## Background Information

Under Business and Tax Regulations Code Section 901 et seq., businesses pay a payroll expense tax based on the compensation paid to employees and others for work or services rendered in San Francisco. (Section 901.1) This proposed amendment would amend Section 906 to establish a three year payroll expense tax exclusion for the purpose of excluding stock compensation from the payroll expense tax for certain technology companies that undergo an initial public offering within that same time period.

| Items 6 and 7<br>Files 11-0337 & 11-0462 | Department(s):<br>Office of Economic and Workforce Development<br>Treasurer/Tax Collector |
|---|---|

## 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, 2012, and 2013 for that portion of an eligible business' payroll expense that is attributable to stock 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 and would permanently remove stock options from the definition of Payroll Expense.

### 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.

### Fiscal Impacts

- File 11-0337 would require one-time General Fund expenditures of approximately $30,000 for professional services to amend reporting documents, noting that additional costs may be necessary to further amend reporting documents in order to validate a $1,500 tax minimum for any given employee.
- File 11-0462 would require one-time General Fund expenditures of approximately $30,000 for professional services to amend reporting documents.
- Stock 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 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[1], 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 also 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[2].

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 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.

---

[1] 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.

[2] 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.

## 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 compensation[3] for tax years 2011, 2012, and 2013. The proposed ordinance would become effective at least 30 days after the Board of Supervisors approves the proposed ordinance, estimated to be approximately June 16, 2011. Section 906.4 would expire on December 31, 2013.

Under the proposed ordinance, an eligible business' Payroll Expense Tax would be excluded if the business is (a) a technology business[4], (b) employs at least 100 employees in San Francisco, (c) was founded after 2001, and (d) undertakes an Initial Public Offering on a public stock exchange during the period of the exclusion.

In order to be eligible for the Payroll Expense Tax exclusion for stock 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 compensation and the Tax Collector would be responsible for verifying all exclusion claims.

Under the proposed ordinance of File 11-0337, the Payroll Expense Tax exclusion for stock compensation would not reduce an eligible business' Payroll Expense Tax liability below $1,500 for any individual employee. In addition, the proposed Payroll Expense Tax exclusion for stock 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 removing stock options from the definition of Payroll Expense in Section 902.1 and 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 compensation.

---

[3] The proposed ordinance defines stock compensation as any stock option granted prior to the date of initial public offering.

[4] The proposed ordinance defines a technology business as a Web-based company whose core mission business plan and revenues are developed through services or goods accessed by the way of the Internet.

Similar to the above noted provisions in File 11-0337, in the proposed ordinance in File 11-0462, in order to be eligible for the Payroll Expense Tax exclusion for stock 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 compensation and the Tax Collector would be responsible for verifying all exclusion claims.

The proposed Payroll Expense Tax exclusion for stock 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 compensation could not be claimed retroactively.

## 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 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 compensation information is not currently collected by the Treasurer/Tax Collector's Office.

The Controller's Office of Economic Analysis will be issuing an economic impact report on Payroll Expense Tax exclusions for stock compensation prior to the Budget and Finance Committee Meeting on May 4, 2011.

## Administrative Impacts and Costs

*File 11-0337*

Mr. Kato, with the Treasurer/Tax Collector's Office, reports that it is not known how many businesses will conduct an Initial Public Offering within the June 2011 through December 2013 timeframe specified in the proposed ordinance 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 11-0337, 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 initial one-time General Fund expenditures of approximately $162,000 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 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 compensation into the Tax Collector's administration of the Payroll Expense Tax.

Under the proposed amended Section 906.4(c) of File 11-0337, the Payroll Expense Tax exclusion for stock compensation would not reduce an eligible business' Payroll Expense Tax liability below $1,500 for any individual employee; as such eligible businesses' Payroll Tax Liability would be fixed at a minimum of $1,500 for each individual employee. However, Mr. Kato advises that currently the Tax Collector does not track the tax liability associated with individual employees. Therefore, Mr. Kato reports that if the Tax Collector was required to validate a $1,500 tax minimum for any given employee there would be an additional administrative cost, as employee counts are currently a self-reported, un-validated data point on the Tax Collector's business tax form. However, Mr. Kato advises that if the Tax Collector's Office is able to make changes related to individual employees on the business tax forms at the same time as the Central Market and Tenderloin Area tax exclusion changes are implemented, such consolidation would greatly reduce the potential costs.

*File 11-0462*

As with the previously discussed proposed ordinance, Mr. Kato reports that it is not known how many businesses will conduct an Initial Public Offering 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.

Under the proposed ordinance of File 11-0462, each business would also 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 initial one-time General Fund expenditures of approximately $162,000 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 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 of File 11-0462 would be absorbed in the implementation of the Payroll Expense Tax exclusion for businesses in the Central Market and Tenderloin Area; 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 compensation into the Tax Collector's administration of the Payroll Expense Tax.

## POLICY CONSIDERATIONS

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

The Budget and Legislative Analyst notes that if either of the proposed Payroll Expense Tax exclusion for stock 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 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 compensation if eligible companies were to conduct an Initial Public Offering would be foregone

### Reported Possible Amendments to File 11-0337 Proposed Ordinance

The following may be introduced as amendments to the proposed ordinance of File 11-0337:

- Remove the technology company requirement;
- Remove the greater than 100 employee requirement;
- Remove the $1,500 per individual employee requirement and replace with a minimum amount of stock option Payroll Tax the companies would have to pay; and
- Extend the time limit to six years.

Depending on the extent of the amendments that are approved, the proposed ordinance may need to be continued.

## RECOMMENDATIONS

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

for Harvey M. Rose

cc: Supervisor Chu
Supervisor Mirkarimi
Supervisor Kim
President Chiu
Supervisor Avalos
Supervisor Campos
Supervisor Cohen
Supervisor Elsbernd
Supervisor Farrell
Supervisor Mar
Supervisor Wiener
Clerk of the Board
Cheryl Adams
Controller
Greg Wagner