File No. 110337

Committee Item No. 3
Board Item No.______________

COMMITTEE/BOARD OF SUPERVISORS

AGENDA PACKET CONTENTS LIST

Committee: Budget and Finance FULL-Committee **Date:** May 11, 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)**

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Completed by: Victor Young **Date:** May 6, 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.

FILE NO. 110337 Amendment of the whole in committee. 5/4/11 ORDINANCE NO.

[Business and Tax Regulations Code – Excluding Stock-Based Compensation from Payroll Expense, Tax Years 2011 through 201~~3~~7]

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 ~~p~~Payroll ~~e~~Expense that is attributable to ~~s~~Stock-Based ~~c~~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 201~~3~~7 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*-BASED *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*, or experiences a change in control prior to any such public offering, *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)~~(2) *"Stock*~~-~~Based *Compensation"* ~~shall mean any stock option granted prior to the person's date of initial public offering~~includes, but is 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.

(b) An Eligible Person may exclude from its ~~p~~P*ayroll* ~~e~~E*xpense*, as defined in Section 902.1, ~~all~~ *compensation related to Stock*~~-~~Based *Compensation for the tax years 2011*~~, 2012 and 2013~~ through 2017.

(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~~The amount of Stock-Based Compensation a person may exclude from its Payroll Expense is that amount of Stock-Based Compensation that exceeds an annual Payroll Expense Tax liability of $750,000.

(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-*Based *Compensation Exclusion in this Section may not be claimed concurrently with any other payroll expense tax exclusion.*

(j) The Tax Collector shall submit an annual report to the Board of Supervisors for each year for which the exclusion authorized under this Section is available that sets forth aggregate information on the dollar value of the exclusions taken each year, and the number of persons claiming the exclusion.

(k) Not later than six months prior to the expiration of this ordinance, the Controller shall perform an assessment and review of the effect of the Stock-Based Compensation Exclusion under this Section. Based on such assessment and review, the Controller shall prepare and submit an analysis to the Board of Supervisors. The analysis shall be based on criteria deemed relevant by the Controller, and may include but is not limited to, data contained in the annual report to the Board of Supervisors as required by subsection (j). In its analysis, the Controller shall recommend to the Board of Supervisors whether the exclusion should be extended for an additional period.

~~(j)~~(l) *This Section 906.4 shall expire by operation of law on December 31, 201~~3~~7, 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.

LEGISLATIVE DIGEST

[Business and Tax Regulations Code – Excluding Stock Compensation from Payroll Expense, Tax Years 2011 through 2017]

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-Based 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 Expense 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 six years. Under the exclusion, an Eligible Person is a person who undertakes an initial public offering on a public stock exchange or experiences a change in control prior to any such public offering. The exclusion cannot be claimed retroactively.

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 six year Payroll Expense Tax exclusion for the purpose of excluding stock compensation from the Payroll Expense Tax for companies that undergo an initial public offering or change in control prior to an initial public offering. The exclusion cannot be claimed retroactively.

Items 3 and 4 Files 11-0337 & 11-0462 *(Continued from May 4, 2011)*	Department(s): Office of Economic and Workforce Development 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 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[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 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

[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.

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[3] 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.

[3] 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[4]. 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.

[4] 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.[5] 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

[5] 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.

CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

May 3, 2011

RECEIVED
BOARD OF SUPERVISORS
SAN FRANCISCO
2011 MAY -3 PM 2:25
BY

The Honorable Board of Supervisors
City and County of San Francisco
Room 244, City Hall

Angela Calvillo
Clerk of the Board of Supervisors
Room 244, City Hall

Re: Office of Economic Analysis Impact Report for File Number 110337

Dear Madam Clerk and Members of the Board:

The Office of Economic Analysis is pleased to present you with its economic impact report on file number 110337, "Excluding Stock Options from the Payroll Tax: Economic Impact Report." If you have any questions about this report, please contact me at (415) 554-5268.

Best Regards,

Ted Egan
Chief Economist

cc Victor Young, Committee Clerk, Budget & Finance Committee

City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Excluding Stock Options from the Payroll Tax:

Economic Impact Report

File #110337

May 3, 2011

City and County of San Francisco

Office of the Controller - Office of Economic Analysis

Excluding Stock Compensation from Payroll Expense: Economic Impact Report

May 3, 2011

Main Conclusions

San Francisco is unique among California cities in levying a tax on the payroll expense of businesses. This tax (the "payroll tax"), levied at a rate of 1.5%, applies to most companies doing business in the city whose payroll exceeds the payroll exemption for small businesses. This tax covers all forms of compensation paid to employees, including wages and salaries, bonuses, and any form of stock compensation. The tax on stock options has recently raised concerns that it could encourage successful companies to leave San Francisco.

On March 29th Board President David Chiu requested the Offices of Controller. Treasurer & Tax Collector, City Attorney, and Economic and Workforce Development research a solution that reduces the risk of growing technology companies leaving San Francisco, while minimizing the cost to the City's General Fund. Also on March 29, Supervisor Mirkarimi introduced an ordinance that would establish a two-year exclusion for the stock compensation of a privately-held company after its initial public offering. This report contains both the results of the Controller's research into President Chiu's inquiry, and the economic impact analysis of Supervisor Mirkarimi's legislation.

The City requires businesses that are subject to the payroll expense tax to report their total compensation to employees and pay tax on that. The City does not require companies to detail how much employee compensation comes from wages and salaries, stock compensation, or any other source. Thus, the City has no way to estimate precisely what any exclusion of stock compensation from the payroll expense tax will cost, or what, if any, job creation will result from it.

The impact of San Francisco's business tax is particularly disproportionate for a highly-valued company immediately after its initial public offering. An exclusion of stock options granted before an initial public offering—as opposed to some other form of payroll tax cut—would be effective in reducing the high tax burden facing such a company.

At the same time, of the 8,000 payroll expense tax-paying businesses in San Francisco, only perhaps 2-3 per year on average undertake an IPO, and would benefit from an exclusion for pre-IPO stock options. An efficiently-designed stock options exclusion can, therefore, have the policy advantage of providing a tangible benefit to a few successful companies, reducing their incentive to leave San Francisco, while leaving the majority of taxpayers—and the City's payroll tax revenue—unaffected.

The OEA's best estimates of the cost of such an exclusion are based on annual estimated payments of payroll tax associated with stock options, created for the 14 companies that have gone public in the city since 1997. The annual payments attributable to stock options ranged from $39,000 a year to $685,000, with an average of $140,000. Given that rate, an exclusion of stock options or other stock compensation that are granted before an IPO may cost the City between $500,000 and $750,000 a year in tax revenue annually.

An exclusion could be made even more efficient by capping the stock option tax instead of eliminating it completely. The evidence suggests that technology companies in San Francisco have paid tax on stock options up to $500k-$1M per year. Capping the tax on stock options at some ceiling within the $500k - $1M range would allow the City to retain the payroll expense tax associated with stock options from the less-valued IPOs, while protecting against a prohibitively-high payment for the most highly-valued companies, whose higher tax burden creates the greatest risk they will move out of the city.

In addition, the report recommends that the economic impact of Sup. Mirkarimi's legislation can be maximized by extending the exclusion to six years from the current three, as six years should cover every technology start-up now in existence, and give sufficient time to study the effect of the exclusion.

INTRODUCTION

Background

San Francisco is unique among California cities in levying a tax on the payroll expense of businesses. This tax (the "payroll tax"), levied at a rate of 1.5%, applies to most companies doing business in the city whose payroll exceeds the payroll exemption for small businesses. This tax covers all forms of compensation paid to employees, including wages and salaries, bonuses, and any form of stock compensation.

The Controller's Office of Economic Analysis issued a report on March 15, 2011 on the economic impact of the proposed Central Market and Tenderloin payroll expense tax exclusion. That report highlighted the fact that Twitter, a privately-held technology company, could face a payroll tax liability in the tens of millions of dollars because of the City's practice of taxing stock options. The report recommended that the City consider modifying the payroll expense tax to address the stock options issue, and reduce the incentive for the most successful technology companies to relocate outside of San Francisco.

In response to that recommendation, on March 29th Board President David Chiu requested the Offices of the Controller. Treasurer & Tax Collector, City Attorney, and Economic and Workforce Development research a solution that reduces the risk of growing technology companies leaving San Francisco, while minimizing the cost to the City's General Fund.

Also on March 29, Supervisor Mirkarimi introduced item #110337, an ordinance that would establish a two-year exclusion for the stock compensation of a privately-held company after its initial public offering.

Proceeding from these actions, the Controller's Office and the Treasurer's Office began to research the tax history of San Francisco-based companies that undertook an initial public offering (IPO) in the past 15 years. This research attempted to determine if, in fact, companies paid higher payroll taxes during the year of their IPO and the following year, and, if so, how much of that tax could be attributable to stock-based compensation.

On April 19th, Supervisor Farrell introduced a different stock compensation exclusion (item #110432), which would permanently exclude all stock compensation from the payroll tax.

Since President Chiu's request and Supervisor Mirkarimi's legislation occurred at the same time, and addressed the same policy issue, this report contains both the results of the Controller's research into President Chiu's inquiry, and the economic impact analysis of Supervisor Mirkarimi's legislation. Supervisor Farrell's legislation was introduced less than two weeks before the issuance of this report. A separate report will be prepared for Supervisor Farrell's legislation by

May 19, if it is not acted on by a Board committee before that time.

How the City Taxes Stock Options

The City considers a company's grant of stock to an employee to be a form of compensation that is subject to the payroll expense tax. If a company grants an employee 1,000 shares of stock worth $10/share during the course of year, that $10,000 in stock value is considered compensation, and is taxed exactly the way $10,000 in wages would be, at 1.5% of the value.

Stock options—which are a right to purchase company stock in the future at a price determined in advance—are also considered compensation and are also taxed, but are treated differently. If an employee is granted an option to buy 1,000 shares of stock, the grant is not considered compensation until the options are exercised, and the actual shares are passed from the company to the recipient. At that point, the recipient pays the company a strike price per-share, and the difference between the aggregate value of the shares received, and the recipient's aggregate payment for the shares, is subject to the City's payroll expense tax.

There is one exception to this. Some options—called Incentive Stock Options or ISOs—may not be subject to the payroll expense tax, even after they are exercised. These are options that can only be granted to employees, and receive preferential tax treatment from the Federal government. If an employee exercises an ISO, and holds the shares for sufficiently long periods of time, when they are sold any gain is treated by the IRS as a capital gain, not as income. Under this situation, the gain on stock is *not* considered compensation by the City and is not covered by the payroll expense tax.

Based on discussions with technology and legal experts, the OEA believes ISOs represent a fairly small share of total stock options granted by a typical technology company. Moreover, even if a employee receives ISOs, if he or she exercises the options or sells the stock too quickly, the options would lose their preferential federal tax treatment, and be considered income for federal purposes. In that case the City would consider the gain compensation and it would be subject to the payroll expense tax.

Stock Options and the Initial Public Offering

Many companies that grant stock options place a time limitation on their vesting, to create an incentive for corporate officers and employees to remain with the company. In addition, employees have a limited incentive to exercise their stock options, until a public market exists where they can exchange their shares.

This happens when a company undertakes an initial public offering. In this process, a company raises money by selling shares to outside investors. It also lists the company on a public exchange in which any shareholder, including employees, can sell shares to other investors independent of the company. In many cases, employees and other stock option recipients may be prohibited from selling their shares until the company goes public. For these reasons, most companies will not experience significant payroll expense tax liability associated with stock options until their IPO.

Successful public companies will likely continue to see their stock rise, in general, over time. To the extent that stock options are part of their employee compensation, these companies will continue to experience a payroll expense tax liability associated with the exercised options.

A Hypothetical Example

The City requires businesses that are subject to the payroll expense tax to report their total compensation to employees and pay tax on that. The City does not require companies to detail how much employee compensation comes from wages and salaries, stock compensation, or any other source. Thus, the City has no way to estimate precisely what any exclusion of stock compensation from the payroll expense tax will cost. While rough estimates can be made, as described in a later section, the fiscal and economic impacts of changes to the tax treatment of stock options are subject to unusual levels of uncertainty.

The City has no way to estimate precisely what any exclusion of stock compensation from the payroll expense tax will cost.

Nevertheless, a simple example of a hypothetical company's growth trajectory can illustrate how stock option compensation can affect a payroll expense tax liability as a company grows and goes public. Figure 1 below indicates what a hypothetical company would pay in payroll expense tax in each year of first ten years of its existence, with the tax associated with employee wages and salaries indicated with one line, and the tax associated with exercised stock options on another. This chart is only an example and is not based on the tax payments of any particular company.

The company grows from 0 employees to 1,000 in year 5, at which point it goes public and receives a valuation of $5 billion. Before the IPO, 20% of the company's shares have been committed for stock options, and 80% of those options are the non-qualified variety that create a payroll expense tax liability for the company regardless of how long the shares are held by the recipient. The other 20% are assumed to be ISOs, and are not considered payroll expense.

These pre-IPO options are assumed to all be exercised in a three-year period after the IPO, at ten times their strike price, on average. None of them are exercised before the IPO. No assumption about when stock option recipients actually sell their shares needs to be made, simply that employees will begin to exercise their options after the IPO.

In year 6, after the IPO, the company doubles its employee headcount to 2,000, after which it more slowly rises to 3,000 by Year 10. Also after the IPO, the company's valuation rises, but again more slowly, to a $9 billion market capitalization by Year 10. Newer, post-IPO employees are assumed to receive post-IPO options, but these options (unlike the pre-IPO options) are valued based on the public valuation in the year the employee is hired. Consequently, the percentage gain on these options will be less than on the pre-IPO options, and the company's payroll expense tax liability will be less as well. In addition, these shares are more likely to be the qualified ISOs that may not be taxed as payroll expense.

This hypothetical company can be thought of as a prototypical technology start-up that becomes very successful in its early stages, and is worth several billion dollars at the time of its IPO. San Francisco has recently become a Bay Area center for technology start-ups, and in the future potentially several San Francisco companies could have a valuation of that amount at IPO.

Payroll Expense Tax History of a Hypothetical Successful IPO Company in San Francisco

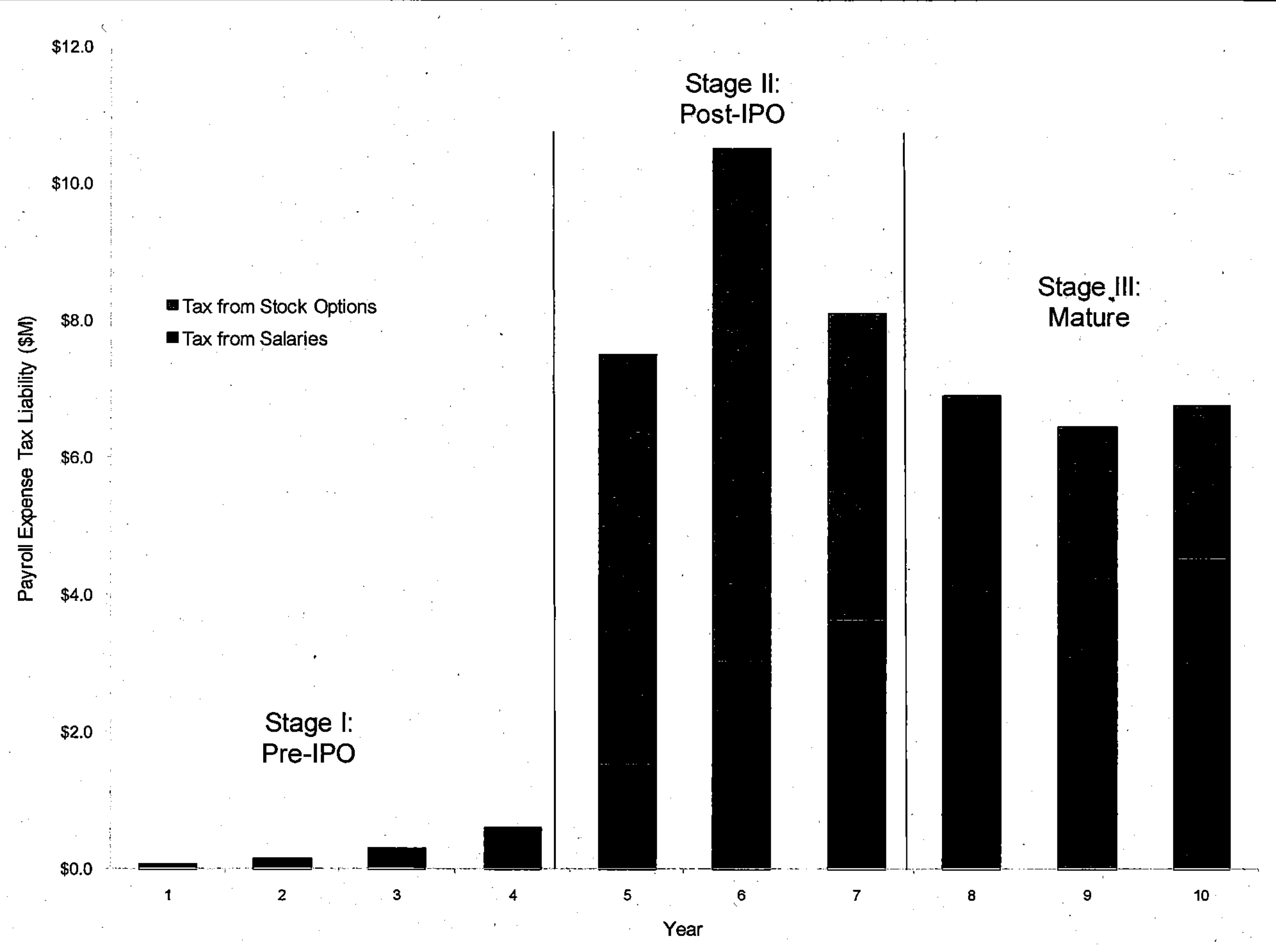

Figure 1 highlights the three payroll tax "stages" that a technology start-up may pass through as it goes public and matures. In the first, "Pre-IPO" stage, the company has no payroll expense tax associated with stock options. In this stage, none of the options are exercised, and its only payroll expense is associated with employee wages and salaries.

In most cases a company's payroll tax payment from stock options would be at its highest in the immediate post-IPO stage.

After the IPO, the company enters a 3-year "Post-IPO" phase. During this phase, its payroll expense tax payment rises dramatically, and the payroll tax associated with its stock options far exceeds the tax associated with its salaries. This is because during this period, all of the pre-IPO stock options that were granted are exercised, and the average gain on these shares is high.

Finally, in the third. "Mature" stage, the company's payroll expense tax actually declines, even though its employee head-count continues to rise. The reason its tax liability declines is because the new, post-IPO options will not be as valuable as the pre-IPO options, and hence they will not, on average, generate as big a tax liability for the company when they are exercised.

This decline in payroll tax payment in the Mature phase will not always occur; it happens in this hypothetical case only because the company's stock is assumed to be so valuable at the time of its IPO. If the company were significantly less valuable than the $5 billion assumed here—and every San Francisco IPO identified in the past 13 years falls into that category—then the drop-off in taxation from stock options might not be enough to offset the growth in taxation of employee salaries, and total payroll tax would still rise.

A payroll tax exclusion for stock options would be particularly effective in reducing the incentive for such a company to move out of San Francisco.

It is nevertheless likely, however, that in most cases a public company's payroll tax from stock options would be at its highest in the immediate post-IPO stage, unless it did not become very successful until well after its IPO. Moreover, if the company was highly-valued at the time of its IPO, the tax it paid on exercised stock options could easily exceed what it paid for employee wages and salaries, during the post-IPO period.

San Francisco is the only city in California that charges a payroll expense tax, and for this reason it is also the only city that taxes stock options. In many Bay Area cities that are home to technology companies, the business tax is relatively low, whether it is a tax on gross receipts, employee headcount, a fixed per-company fee, or some other basis. For this reason, the difference between a company's business tax liability in San Francisco and another Bay Area city is primarily driven by the size of their payroll tax in the city.

These points suggest that the impact of San Francisco's business tax is particularly disproportionate for a highly-valued publicly-traded company in the post-IPO phase. It further suggests that an exclusion of stock options—as opposed to some other form of payroll expense exclusion—would be particularly effective in reducing the incentive for such a company to move out of San Francisco. Stock options comprise a large share of its payroll expense during this period, so excluding them would greatly reduce the business tax disadvantages of a San Francisco location.

At the same time, of the 8,000 payroll expense tax-paying businesses in San Francisco, perhaps 2-3 per year on average undertake an IPO. An efficiently-designed stock options exclusion can, therefore, have the policy advantage of providing a tangible benefit to a few successful companies, reducing their incentive to leave San Francisco, while leaving the majority of taxpayers—and the City's payroll tax revenue—unaffected.

FISCAL AND ECONOMIC IMPACTS

Potential Costs of a Stock Options Exclusion

As stated in the previous section, there is no way for the City to directly measure the amount of payroll tax revenue associated with stock options or stock compensation more generally. The only way to indirectly estimate it is to examine the actual payroll tax payment history of companies that have undertaken an IPO in San Francisco, and compare tax payments before and after the event. Using Dun & Bradstreet data, the OEA was able to identify 21 companies that are located in San Francisco and had an IPO since 1997. These companies are listed in Table 1 below.

Current San Francisco Companies Having an IPO Since 1997

Company	Industry	IPO Year
AMB Property Corporation	Real Estate	1997
Autonomy	Internet/Information Technology	2007
Bare Escentuals, Inc.	Consumer Products	2006
Design Within Reach, Inc.	Media	2004
Digital Realty Trust, Inc.	Real Estate	2004
Dolby Laboratories, Inc.	Internet/Information Technology	2005
Embarcadero Technologies, Inc.	Internet/Information Technology	2000
Genesys Telecommunications Laboratories Inc.	Internet/Information Technology	1997
IA Global, Inc.	Financial Services	1999
JMP Group Inc.	Financial Services	2007
KKR Financial Holdings LLC	Financial Services	2005
LookSmart, Ltd.	Internet/Information Technology	1999
MarketWatch, Inc.	Internet/Information Technology	1999
Mediaplex, Inc.	Internet/Information Technology	1999
MyPoints.com, Inc.	Internet/Information Technology	1999
OpenTable, Inc.	Internet/Information Technology	2009
OpenTV Corp.	Internet/Information Technology	1999
Organic, Inc.	Internet/Information Technology	2000
Riverbed Technology, Inc.	Internet/Information Technology	2006
Salesforce.com	Internet/Information Technology	2004
Thomas Weisel Partners Group, Inc.	Financial Services	2006

Source: D&B Million Dollar Database / San Francisco Public Library

This list of companies was provided to the Treasurer and Tax Collector's Office, who identified payroll tax payment, and employment, information for 14 of the 21 companies. Three years of information was requested for each company: the year preceding the IPO, the year of the IPO, and the year following the IPO.

In some cases complete information was available for the pre-IPO, year of IPO, and one year following. In other cases, information was available for only two of those three years. In either event, however, the trend information can be used to estimate the company's tax payment from stock options.

Annual payments attributable to stock options ranged from $39,000 a year to $685,000, with an average of $140,000.

If companies pay no tax on stock options before their IPO, then the company's payroll per employee in the pre-IPO year represents its average salary payments to employees. If this average salary does not change significantly from one year to the next, and there is no reason to expect that it would, then this average can be multiplied by the reported employment in a later year, to estimate the total payroll for wages and salaries in that year. If this amount is then subtracted from the actual amount paid—which reflects stock compensation as well as wages and salaries—then the result should approximate the payment the company made for its stock compensation.

Using this method, annual estimated payments of payroll tax associated with stock options were created for the 14 companies for which information was provided. The annual payments attributable to stock options ranged from $39,000 a year to $685,000, with an average of $140,000. On average, the average was higher in the year following the IPO than the year of the IPO.

An exclusion of stock options that are granted before an IPO may cost the City an average of between $500,000 and $750,000 a year in tax revenue annually.

To put these findings in context, it is likely that there are no more than 2 to 3 initial public offerings among San Francisco companies each year. Given that rate, an exclusion of stock options or other stock compensation that are granted before an IPO may cost the City an average of between $500,000 and $750,000 a year in tax revenue annually. Most companies that have had an IPO in San Francisco had a relatively modest market capitalization at the time, in comparison to the current valuation of Twitter, for example.

Technology Companies That Have Left San Francisco

In order to investigate the question of whether San Francisco's taxation of stock options contributes to successful companies moving out of the city, the OEA also acquired data on companies that have left. As detailed in the OEA report on the Central Market tax exclusion, San Francisco companies have historically shown a greater tendency to move out of the city than have companies based in other Bay Area counties.

We acquired a subset of companies from the National Establishment Time Series (NETS), a longitudinal database of public and private companies that allows for the analysis of business expansions, contractions, and moves over time. The database is increasingly used in economic research, and is well-regarded for its comprehensiveness and accuracy.

The data shows that, since 1990, 43 publicly-traded headquarters or standalone establishments in the technology industry have left San Francisco. The OEA individually researched the history of each of these forty-three companies, investigating when they filed their IPO, when they moved out of San Francisco, and what circumstances surrounded their leaving. In 11 cases, the move from San Francisco was associated with an acquisition of the privately-held company by a publicly-traded corporation, and a consolidation of facilities outside of San Francisco. It is impossible to know what role San Francisco's payroll tax played in the decision by the companies to consolidate operations outside of the city.

There is no evidence that the publicly-traded technology companies that have moved out of San Francisco were any larger, more valuable, or faced a higher payroll expense than the companies that have remained.

In 14 cases, the company underwent an IPO as an independent company. Eight of these companies went public while headquartered in San Francisco, and then subsequently moved out, in each case within 3 years of the IPO. In the other six cases, the company moved out of San Francisco and then went public. Four of those six companies went public within 3 years of leaving San Francisco, with the others waiting longer.

There is no evidence that the these technology companies that were once located in San Francisco are, on average, any larger, more valuable, or would have faced a higher payroll expense than the companies that have remained. On the contrary, with the notable exception of Southern Pacific Telecom, which moved to Denver and became Qwest, a multi-billion dollar telecommunications company, and URS Consultants, few of the companies that have departed are significant in their industry. Six of the 14 companies that left San Francisco shortly before or after having an IPO were defunct within three years of their move, for example. This suggests that while San Francisco's practice of taxing stock options does create a higher risk of companies leaving, there is no systematic pattern of companies leaving who have the most to lose from the tax.

RECOMMENDATIONS

Details of Sup. Mirkarimi's Legislation

Supervisor Mirkarimi's legislation, item #110337, would allow certain businesses to exclude stock compensation from their taxable payroll expense, for a limited period of time.

In order to eligible for the exclusion, a business must:

1. be a "web-based company whose core mission, business plan, and revenues are developed through services and goods accessed by way of the Internet."
2. employ at least 100 people in San Francisco as of January 1, 2011.
3. have been founded after the year 2001.
4. undertake an IPO within the effective period of the legislation.

The exclusion would apply to tax years 2011, 2012, and 2013. Effectively, this means that a company that went public during the three year period would only be able to exclude stock options that were exercised during the remainder of the period.

In addition, the company would be required to make payroll expense tax payments of no less than $1,500 per employee, which is apparently intended to ensure that companies continue to pay an industry-average level of payroll tax despite the exclusion. The average annual salary for Internet companies is approximately $100,000 per year, which translates into a $1,500 per employee average payment.

For the purposes of the legislation, stock compensation is defined as "any stock option granted prior to the date of the [company's] initial public offering". Other types of stock compensation, such as the granting of restricted stock units, or stock purchased through employee stock purchase plans, would not be included.

Recommendations

Each of these three aspects of the policy: the types of businesses that are covered, the definition of stock compensation which may be excluded, and the length of time the exclusion is in effect, shapes the impact of the legislation.

Based on the discussion in the previous section, companies in a range of industries have gone public in San Francisco over the past 13 years. There is no *a priori* reason to believe that a web-based company would have any greater likelihood of leaving San Francisco because of a high payroll tax than a company in any other industry.

The same point can be made to the legislation's requirements that a company must have a 100 employees or be founded after 2001 in order to qualify; there is no reason to believe such a company is a greater risk of leaving San Francisco than a smaller or older company.

The legislation's definition of stock compensation may be too narrow, given the wide variety of ways that companies use stock compensation. Supervisor Farrell's legislation offers a broader definition of stock compensation, which includes restricted stock, restricted stock units, and stock acquired through employee purchase plans. That broader definition may be more appropriate for the exclusion.

The legislation's restriction of the exclusion to stock compensation that is granted before an IPO greatly restricts the applicability of the exclusion. While, as stated earlier, 2-3 IPOs per year is reasonable estimate of the San Francisco average, there are over 200 publicly-traded companies in the city at the moment, likely most of whom grant some form of stock compensation.

Limiting the stock compensation to only that stock compensation that was granted before an IPO greatly reduces the tax liability of a young company in the post-IPO phase. At the same time, because few companies would be eligible to take advantage of it, it would also reduce the impact to the General Fund. While of course there are hundreds of young, "pre-IPO" companies that grant stock compensation, few of these companies will survive in an independent form to the point where they actually go public and that stock compensation becomes valuable, and taxable. The exclusion is unlikely to be significant to, or reduce the tax payment of, technology start-ups that never go public.

As discussed in the previous section, it is reasonable to believe the cost to the General Fund of the proposed legislation during an average year would be less than $1 million. In the event of an IPO of a highly-valued technology company, such as Twitter, the exclusion would be considerably more valuable. However, counting the value of that exclusion as a cost to the General Fund assumes that such a company would elect to remain in San Francisco in the event it owed several million dollars in tax on stock options. The OEA's best estimates is that no technology company in San Francisco has paid more than $685,000 in a single year in stock option taxation in the past thirteen years.

The legislation's limitation of the exclusion to three years may do relatively little to reduce the tax burden on a newly-public company, particularly one that has an IPO in 2012 or 2013. Employees may be restricted from exercising options immediately after the IPO, and there is no reason to believe that all pre-IPO stock options would be exercised before expiration of the exclusion. Thus, the exclusion might not mitigate the tax burden facing companies that are currently facing an IPO decision. It might be preferable to extend the exclusion to six years, and require a study of its effectiveness after five years before the Board considers its extension.

Finally, the research conducted in this report suggests that while Supervisor Mirkarimi's legislation will have a relatively small cost to the General Fund, it could be made more efficient by capping the stock option tax instead of eliminating it completely. The evidence suggests that technology companies in San Francisco have paid tax on stock options up to $500k-$1M per year. It is unlikely, therefore, that requiring such a payment would cause companies to move out of the city. Capping the tax on stock options at some ceiling within the $500k - $1M range would allow the City to retain some payroll expense tax associated with stock options, while still maintaining protection for the most highly-valued companies, whose tax burden from stock options is disproportionately higher.

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