

REPORT FROM

## OFFICE OF THE CITY ADMINISTRATIVE OFFICER

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Date: August 22, 2014

CAO File No. 0160-00323-0050

Council File No. 14-0945

Council District: All

To: The Mayor  
The Council

From: Miguel A. Santana, City Administrative Officer



Reference: July 2, 2014 Motion (Blumenfield-Cedillo)

Subject: Analysis and Extension of the Internet-Based Business Tax Subclassification  
(Ordinance 181127)

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### SUMMARY

In March 2010, Council approved Ordinance No. 181127 reducing the business tax rate for Internet-based businesses (C.F. No. 09-1914). The ordinance established new classifications for businesses providing online electronic applications or online search engines, which would then be assessed the lowest business tax rate of \$1.01 per \$1,000 of gross receipts. The lower rate would be in effect for the tax years from 2010 to 2014.

On July 2 2014, the Council referred a motion (Blumenfield-Cedillo) to the Budget and Finance Committee seeking a comprehensive analysis from the Office of Finance and the Department of Economic and Workforce Development of the impact and effectiveness of the lower tax rate for Internet-based businesses to include details on the number and type of businesses, the number of employees, and the gross receipts and related tax revenue of Internet-based businesses, as well as the broad impact of the tax policy (C.F.No. 14-0945). This report summarizes data provided by the Office of Finance for the number of businesses, gross receipts and tax revenue. However as reported at the August 4, 2014 Budget and Finance Committee meeting, the additional analysis requested cannot be conducted using available City data.

During discussion at the August 4, 2014 Budget and Finance Committee, the Committee directed the City Attorney to prepare a draft ordinance to extend the current classification and corresponding rate for one year, through the 2015 tax period, to allow for further analysis on the effectiveness of the lower tax rate. In accordance with the Committee's direction, it is recommended that the City Attorney's report to amend the ordinance for the one-year extension be approved. Additionally, it is recommended that the pending analysis be conducted by subject-matter experts through the Office of Economic Analysis upon the identification of contract funding.

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## FINDINGS

Prior to the 2010 tax year, businesses providing Internet-based services were categorized as professions and occupations with the highest business tax rate of \$5.07 per \$1,000 of gross receipts. In April 2009, Council adopted a motion (Garcetti-Greuel, et al) directing the Office of Finance to report on a business tax classification that recognizes the use of a computer and the internet as the primary means to provide services and to make a recommendation on an appropriate tax rate (C.F. No. 09-0836). The motion also requested the City Attorney to prepare and present an ordinance to implement the new tax classification and tax rate. The subsequent Office of Finance report recommended implementing two new classifications subject to the same tax rate as the multimedia business classification—\$1.01 per \$1,000 of gross receipts. The two new classifications were Internet-based Application Service Provider (ASP) and Internet-based Data Manipulation Business (DM).

The new classification of Internet-based ASP was defined for businesses providing access, exclusively through the Internet, to electronic applications via information systems operated by or on behalf of the ASP, such as an on-line tax preparation service. The second new classification of Internet-based DM was defined for businesses that exclusively provide access to Internet-based applications that allow a user to search, compile or otherwise manipulate data, such as a search engine application. The classifications and the corresponding tax rate were implemented for the 2010 tax period and will expire at the conclusion of the 2014 tax period.

At the direction of the Budget and Finance Committee during its discussion of motion (Blumenfield-Cedillo) at its August 4, 2014 meeting, the City Attorney has prepared an amendment to extend the tax classifications by one year (C.F.No. 14-0945). With regards to the motion's request for a broad economic analysis of the effectiveness of the internet-based business policy, available data is insufficient to draw meaningful conclusions. Impediments to analysis include: the lack of sufficient data to compare business formation and revenue before and after policy adoption; the inability to control for external factors of business formation and revenue such as local economic conditions and market demand; and the inability to determine offsetting benefits, such as job growth or other tax revenue. The Office of Finance has provided data on the number of new and reclassified Internet-based businesses and the resulting business tax revenue for the three years following the ordinance's implementation, which is summarized below without conclusions on policy effectiveness.

During the four and one-half tax years for which the Internet-based business policy has been in effect, thirty-two new Internet-based businesses have been established and fifty businesses have successfully sought reclassification (Table 1). Note that while data for tax years 2010 through 2014 show declining business formation, other factors besides business tax policy, such as local economic conditions or demand for internet services, may impact business creation. Additionally, it cannot be determined whether Internet-based business formation meets or exceeds that of prior years.

Table 1. Businesses Applying and Qualifying for New Classifications

	2010	2011	2012	2013	2014*	Total
Applications	145	86	48	32	10	321
Eligible new businesses	12	11	1	7	1	32
Eligible existing businesses	<u>7</u>	<u>16</u>	<u>16</u>	<u>7</u>	<u>4</u>	50
Eligible businesses	19	27	17	14	5	82

\*As of June 30, 2014

Business tax revenue from the Internet-based business policy will include growth from new business formation, offset by loss from the reclassification of existing business from higher tax rate classifications (Table 2).

Table 2. Previous Classifications and Tax Rates of Reclassified Businesses

Classification	Tax filers	Previous Tax Rate	New Tax Rate
Professions and Occupations	42	\$5.07/\$1,000	\$1.01/\$1,000
Miscellaneous Services	3	\$3.56/\$1,000	\$1.01/\$1,000
Commission Broker/Telemarketing	1	\$3.15/\$1,000	\$1.01/\$1,000
Retail	3	\$1.27/\$1,000	\$1.01/\$1,000
Wholesale	1	\$1.01/\$1,000	\$1.01/\$1,000

Over the four and one-half years for which the Internet-based business tax policy has been in effect, the City realized about \$355,000 less in business tax revenue (Table 3). In outgoing years this loss may decrease as new businesses, currently exempted under the New Business Exemption (NBE) policy, begin paying the gross receipts tax. Once new businesses are no longer eligible under the NBE, additional gross receipts revenue would be generated. However, this additional revenue would likely be insufficient to offset the estimated loss from reclassification. Furthermore, additional offsetting General Fund revenue (e.g., property tax, sales tax) or other positive benefits (e.g. job formation) resulting from new business formation cannot be quantified.

Table 3. Net Change in Gross Receipts Revenue from New/Reclassified Businesses

	2010	2011	2012	2013	2014	Total
Total Paid Under New Internet Business Classifications	\$2,510	\$40,644	\$74,361	\$2,647	\$3,225	\$123,387
Total Liability Under Prior Fund/Class	\$12,411	\$171,667	\$282,054	\$6,650	\$5,308	\$478,090
Net Difference In Business Tax Liability	(\$9,901)	(\$131,023)	(\$207,693)	(\$4,003)	(\$2,083)	(\$354,703)

The findings suggest that the impact of the Internet-based business category to overall business tax revenue is minimal due to the current low number of tax filers in the Internet-based business classification. Should the City wish to continue the Internet-based business classification, it is recommended that the one-year extension, through the 2015 tax period, be approved. This extension will allow the City to contract with subject-matter experts through the Office of Economic Analysis (OEA) for an analysis on the effectiveness of the ordinance to attract new Internet-based businesses,

promote job growth, and contribute to local economic growth. The amount of the study is pending, for which funding must be identified.

## **RECOMMENDATIONS**

It is recommended that the City Council, with the approval of the Mayor:

1. Adopt the City Attorney's report to amend Ordinance No. 181127 to extend the sunset provision for Internet-based businesses to the 2015 tax period; and,
2. Instruct the CAO with the assistance from the CLA to identify funding to allow the Office of Economic Analysis to complete a comprehensive analysis of the Internet-based business tax subclassification with regards to effectiveness of the ordinance to attract new Internet-based businesses, promote job growth, and contribute to local economic growth.

## **FISCAL IMPACT STATEMENT**

Extending the Internet-based business category to the 2015 tax period with the lower tax rate will result in the City continuing to forgo undetermined business tax revenue. This revenue loss may be offset by new Internet-based businesses becoming established in the City or by positive impacts to other General Fund revenues. However, the full fiscal impact cannot be determined at this time.

*MAS:BC/MCK: 01150013*