OFFICE OF THE CONTROLLER
CITY AND COUNTY OF SAN FRANCISCO

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MEMORANDUM

TO: Mayor London Breed
Members of the Board of Supervisors

FROM: Ben Rosenfield, Controller
Ted Egan, Chief Economist

DATE: February 4, 2019

SUBJECT: **Stock-based Compensation Payroll Expense Tax Exclusion**

Background

In 2011, the City adopted Ordinance 87-11, "Excluding Stock-Based Compensation from Payroll Expense, Tax Years 2011 through 2017" ("the Exclusion"). This memo was written because of a code requirement that the Controller's Office report on its impact. The Exclusion provided certain businesses that were subject to the City's Payroll Expense Tax (PET) with the option to exclude a portion of their taxable payroll expense, and thus reduce their tax liability. Specifically, it allowed a business to exclude the value of stock options and other stock-based compensation granted to its employees from its PET liability.

The Exclusion became effective approximately 6 months after the Central Market Payroll Expense Tax Exclusion, a separate PET exclusion adopted by the City in 2011. The legislative debate surrounding both ordinances focused on the potential impact of the PET on a start-up business that undertakes an initial public offering (IPO) of its stock, and that granted its employees options to purchase that stock at a discounted price. This practice of granting stock options, as a part of an employee's compensation package, is particularly common in the technology industry. Such compensation is normally taxable under the City's PET.

Because of this, in cases where an IPO significantly raises the value of this compensation, it would also significantly raise the business's PET liability. Reflecting the debate at the time, the legislation stated, "City leaders are concerned that faced with potentially greater Payroll Expense Tax liabilities, these companies may move out of San Francisco".

Accordingly, the Exclusion permitted businesses that undertook an IPO, or experienced a change in control prior to an IPO, to exclude stock-based compensation from its taxable payroll expense, for tax years 2011 through 2017. An eligible business could exclude stock-based compensation above $750,000 from its payroll expense, unless the business had paid $750,000 in PET from stock-based compensation in 2010, in which case all additional stock-based compensation in that year was excludable.

Based on information from the Office of the Treasurer and Tax Collector, reproduced below in Table 1, the Exclusion was not widely used. Two businesses used the Exclusion in 2012; no businesses used it in 2014. In each of the other years of its existence, one business used it. The identity of the businesses using the Exclusion is confidential information. Table 1 also indicates the number of employees at the affected businesses, and the PET which was foregone because of the Exclusion.

Table 1

Summary of Stock-Based Compensation Payroll Tax Exclusion Utilization

Year	Number of Businesses	Employees	PET Foregone ($M)
2011	1	1,975	$1.5
2012	2	2,134	$3.4
2013	1	1,336	$0.6
2014	0	0	$0.0
2015	1	849	$0.1
2016	1	1,348	$0.6
2017	1	2,183	$1.2
Annual Average	1	1,404	$1.1

Source: Office of the Treasurer and Tax Collector; Bureau of Labor Statistics.

It is important to note that businesses could not utilize both the Central Market exclusion, and the Stock-based Compensation Exclusion. As the Controller's Office noted in our 2014 review of the Central Market Exclusion[1], many of the companies utilizing the Central Market exclusion were early-stage technology companies. In fact, far more companies used the Central Market exclusion than the Stock-based Compensation Exclusion, between 2011 and 2017.

Over the seven years, as Table 1 shows, the Stock-Based Compensation Exclusion resulted in an average of $1.1 million in foregone PET, meaning the City would have received that amount in additional tax revenue, had the Exclusion not been in place, and had the affected businesses remained in San Francisco.

Because stock-based compensation was only excludable above the $750,000 ceiling, and because other compensation such as wages and salaries remained fully taxable, these businesses did pay some PET. Additionally, after 2014, they also paid Gross Receipts tax, which began to phase-in in that year. The

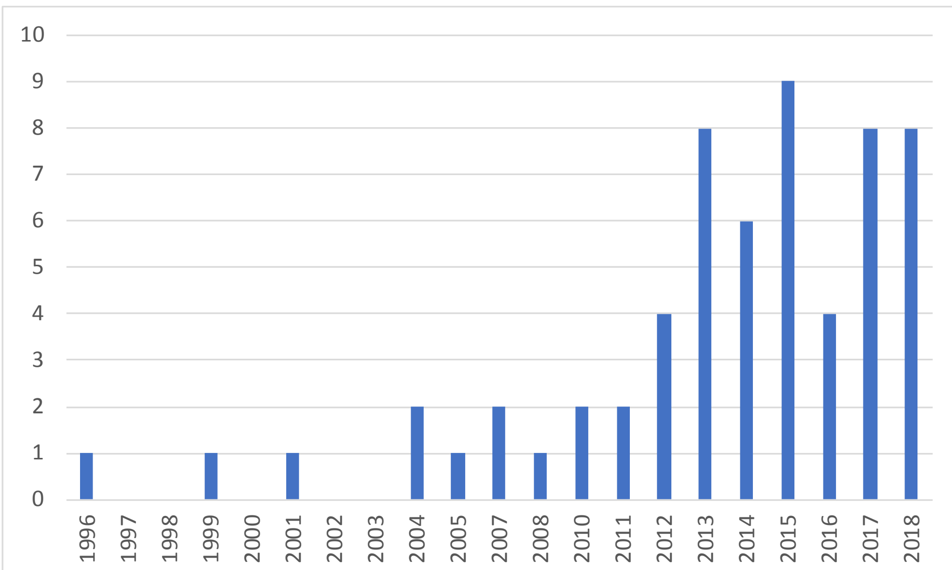
[1] "Review of the Impact of the Central Market Payroll Expense Tax Exclusion", Controller's Office, October 27, 2014.

Exclusion had no effect on Gross Receipts Tax liability. This revenue would have been lost to the City had the businesses relocated outside of San Francisco.

As the Controller's Office noted in our 2011 economic impact report[2] on the Exclusion when it was proposed, relatively few technology companies in San Francisco had had an IPO prior to that time. Since then, however, the situation has changed. As Figure 1 illustrates, since 2010, 39 San Francisco technology companies have had an IPO on U.S. stock exchange.

Figure 1

U.S. IPOs by San Francisco Technology Companies by Year, 1996-2018



Source: CrunchBase

To put this trend into context, prior to 2010, the technology industry was a relatively small part of the city's economy. By 2017, however, it accounted for 12% of all private sector jobs in San Francisco, and has been the city's fastest-growing sector for most of the decade. It is worth noting, however, that the number of technology IPOs in the city greatly exceeded the number of companies that utilized either the Stock-Based Compensation Exclusion, or the Central Market Exclusion. The vast majority of the technology companies that had an IPO in San Francisco after 2010 did not utilize the Stock-Based Compensation Exclusion or the Central Market Exclusion.

Looking back, the economic impact of the Exclusion is difficult to quantify, for two main reasons. First, very few businesses used it, so it is challenging to statistically determine if it played any role in keeping them in the City, as decision-makers had hoped in 2011. Similarly, it is difficult to determine if it played any indirect role in the new, post-2010 trend of technology companies going public in San Francisco. Its limited use by San Francisco businesses, and the large number of technology companies that had an IPO without using it or any other City tax incentive, suggest its impact was probably very limited.

[2] "Excluding Stock Options from the Payroll Tax: Economic Impact Report", Controller's Office, May 3, 2011.

To summarize this review of the impact of the Exclusion:

- The Stock-Based Compensation Payroll Expense Tax Exclusion that was in place in San Francisco from 2011 to 2017 was little used, with an average of one company a year using it.
- On average, $1.1 million in annual Payroll Expense Tax was foregone because of the Exclusion. Businesses using the Exclusion continued to pay Payroll Expense and Gross Receipts taxes, and this revenue would have been lost to the City had the businesses relocated out of San Francisco. The Controller's Office is unable to determine if any of affected businesses remained in San Francisco because of the Exclusion.
- Since 2010, the number of technology IPOs in San Francisco has increased. However, the vast majority did so without using any City tax incentive. Because of this, and because so few companies did use the Exclusion, it likely had little impact on the local economy.