



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Nanci Klein  
Chris Burton  
John Ristow

**SUBJECT:** SEE BELOW

**DATE:** April 8, 2024

Approved

Date

4/16/24

**SUBJECT: AMENDMENT TO TITLE 4 OF THE SAN JOSE MUNICIPAL CODE  
FOR THE COMMERCIAL-RESIDENTIAL-MOBILEHOME PARK  
BUILDING TAX**

## **RECOMMENDATION**

Approve an ordinance amending Section 4.47.095 of Chapter 4.47 of Title 4 of the San José Municipal Code to extend the temporary partial suspension of the Commercial-Residential-Mobilehome Park Building Tax (San José Municipal Code Chapter 4.47) at the rate of .5% for the following office uses until June 30, 2029:

- a. Office, General Business (San José Municipal Code 20.200.813); and
- b. Office, Research and Development (San José Municipal Code 20.200.818).

## **SUMMARY AND OUTCOME**

Approval of the recommendation above will extend the rate for the listed uses, ensuring that San José remains a competitive market in the region for the development and leasing of commercial real estate by driving industry companies. Additionally, approval of this action will provide clarity and consistency to the development and business community regarding the applicability of the City's construction taxes. The result is that projects designated for these office uses will continue to be taxed at a combined rate of 2.0% rather than the 4.5% rate for commercially designated projects.

**BACKGROUND****Construction-Related Taxes**

San José has four construction-related taxes, but the vast majority of taxes are collected through two taxes: the Building and Structure Construction Tax (San José Municipal Code 4.46) and the Commercial-Residential-Mobilehome Park Building Tax (San José Municipal Code 4.47). These two taxes represent a sizeable portion of the cost of many building permits issued by the City and fund the majority of the Traffic Capital Improvement Program projects. The Building and Structure Construction Tax and Commercial-Residential-Mobilehome Park Building Tax are applicable to all building permits, including both new construction and tenant improvements. For the purposes of collecting these taxes, permit applications are deemed by the Planning, Building, and Code Enforcement Department's permitting staff to be residential, commercial, or industrial. The Building and Structure Construction Tax is a special tax, the revenues from which must be used for the construction and enhancement of major collectors and arterial streets in the City. The Commercial-Residential-Mobilehome Park Building Tax is an excise tax with no restrictions on expenditure, but has historically been used for transportation purposes to fund pedestrian and traffic safety initiatives, operations and maintenance, and grant-funded projects requiring a local match.

Rates for the Building and Structure Construction and Commercial-Residential-Mobilehome Park Building taxes vary based on the intended use of the building or structure being permitted. Construction taxes are collected against the valuation of the project derived from the higher of either the International Code Council's building valuation data table or the project valuation estimate submitted by the project applicant. The **Table 1** below outlines the tax rates applied to the different building uses.

**Table 1: Construction Tax Rates**

<b>Use</b>	<b>Building and Structure Construction Tax</b>	<b>Commercial-Residential-Mobilehome Park Building Tax</b>	<b>Total</b>
Residential <sup>1</sup>	1.75%	2.75%	<b>4.5%</b>
Commercial	1.5%	3%	<b>4.5%</b>
Industrial	1%	N/A	<b>1%</b>

**Prior Amendments**

Following the adoption of the City's first Comprehensive Economic Strategy in 2003, the City Council approved an ordinance in June 2004 amending Title 4 to temporarily expand the list of uses that were taxed at the lower industrial rate of 1% to include uses that represent the types of

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<sup>1</sup> Residential project taxes are assessed on 88% of the project valuation, whereas commercial and industrial projects are assessed based on 100% of the project valuation. For comparison, the effective combined tax rate for residential projects is 3.96%.

industries that occur in the City's industrial areas and help drive job and general purpose revenue growth. These uses were:

- Industrial services;
- Retail or wholesale commercial entity, single occupant greater than 100,000 gross square feet;
- Sales, office furniture, industrial equipment, machinery;
- Printing and publishing;
- Base load facility photovoltaic;
- Sale or lease of commercial trucks, buses, trailers, campers, boats, mobile homes, and construction equipment;
- Software development;
- Internet applications;
- Server farms and co-location facilities; and,
- Telephone switching gear, telecommunication facilities, wireless communication facilities, antenna, and equipment.

The ordinance included a sunset provision of five years, or until June 30, 2009, to allow the City to determine if these sectors continued to generate a significant number of middle- and high-paying jobs, and thus merit a further extension of the new industrial rate. The amendment sunseted on June 30, 2009.

The effect of the five years of suspension followed by two and a half years of no suspension caused confusion in the development community and directly impacted a number of driving industry projects in process or under consideration at the time. In January 2012, new land use definitions were included in the San José Municipal Code to clarify which uses were considered office/research and development (R&D) and to match what was occurring in the City's Major Employment Areas/Industrial Park Zoning Districts. These uses were eligible to pay the lower industrial rate of 1% and included the following:

- Office, R&D uses as defined by San José Municipal Code Title 20;
- Data centers; and,
- Installation of solar photovoltaic systems.

In April 2017, the City Council amended Title 4 of the San José Municipal Code to extend the temporary partial suspension of the Commercial-Residential-Mobilehome Park Building Tax to achieve a rate of 0.5% for the following uses:

- a. Office, General Business (San José Municipal Code 20.200.813); and,
- b. Office, R&D (San José Municipal Code 20.200.818).

Both of the above partial construction tax suspensions expired on March 31, 2024.

## **ANALYSIS**

Staff established the following principles to guide the modernization of the City's construction taxes and ensure that adjustments to the rate of tax for development, both new construction and existing building and equipment improvements, meet the following City goals.

1. **Competitive** – Align with the types of development that the City is interested in promoting, remain competitive with surrounding cities that do not charge construction taxes, and use alternate funding methods to finance major infrastructure needs.
2. **Revenue Neutral** – The April 2017 change to how office taxes are collected was designed to be revenue neutral and reflective of how the taxes had previously been allocated to commercial or industrial tax rates, so no further analysis is deemed necessary at this time, as taxes are paid under one single use definition.
3. **Administrative Simplicity** – Create clear definitions and processes to ensure that the development community has a better understanding of how the City charges these taxes and to ensure that staff has clear implementation guidelines.

Over the past several years, the changing nature of uses in the City's commercial and industrial buildings has created ambiguity and challenges in how construction tax rates are applied to some of San José's driving industries and commercial office development. Driving industries are sectors that disproportionally stimulate the local economy because they serve external markets and generate a larger number of jobs and financial investment in the community. As a result, these industries or types of uses typically have more options at a regional, state, or national level as to where they locate their facilities. Many of San José's driving industries are technology related, but in the same way that the terms "technology related" or "tech" have become too vague to encapsulate all of the variations in uses and users in these industries, so have the definitions used to determine the appropriate construction tax rate throughout the City.

When these taxes were enacted in the 1970s, there was a clearer delineation between R&D and office uses. Most R&D at the time occurred in a clean room, such as a laboratory, utilized significant capital equipment, and occupied the majority of the space in the building. Today R&D is more likely to require the use of computers in an open office environment, may have some specialized equipment or conditioned space, and is likely to be integrated with sales and administration teams in a single space. The inclusion of "office, R&D" as an eligible use to pay the reduced industrial rate of 1% in 2012 was intended to address some of the ambiguity between different R&D uses by defining it as "industrial or scientific research and product design that involves the use of computers and other related office equipment in an office setting, including administrative services, product design, and sales."

In addition to the changing nature of industrial uses, San José continues to experience a change in where these uses are located. Following the adoption of the Envision 2040 General Plan, technology-related employers expressed an interest in settling outside of the traditional employment and industrial centers of North San José and Edenvale. This trend is likely to

continue as the City works to attract more employers to address its jobs/housing imbalance and continues to plan more employment uses in mixed-use urban villages. This locational shift is also being driven by the changing nature of how employers choose their location. Amenity-rich locations continue to attract the talent that technology companies are looking to hire. In the years leading up to the COVID-19 pandemic, office uses in Downtown San José were increasingly shifting from traditional financial and professional services firms to technology-related firms. This was also occurring in other areas, such as West San José and specifically around Valley Fair Mall and Santana Row, due to proximity to amenities and other large/anchor technology companies. This trend is likely to pick back up again as employers are increasingly asking employees to return to on-site work at greater number of days per week. As a result, employers that would otherwise engage in uses consistent with industrial use for tax purposes will continue doing business outside of the City's traditional industrial areas.

The past solution to this challenge was to expand the list of uses eligible to pay the industrial rate. However, when considering options for relocation or expansion, many companies are less concerned with the way the City classifies their use and instead focus on the total cost of permitting the project. As such, considering these uses at the full commercial rate would make doing business in San José more expensive and less competitive with surrounding cities that do not have similar taxes.

As stated in the background section of this memorandum, in 2017, the City Council approved a partial suspension for Office, General Business, and Office, R&D uses. These uses were deemed to be commercial and would pay a reduced Commercial-Residential-Mobilehome Park Building Tax (San José Municipal Code 4.47) of 0.5%, thereby creating a combined effective tax rate of 2.0%, instead of the commercial rate of 4.5%.

**Table 2** below illustrates the recommended extension of the suspension of Commercial-Residential-Mobilehome Park Building Tax for the Office, General Business and Office, R&D land uses.

**Table 2: Construction Tax Rates for Office, General Business and Office, R&D Uses with the Recommended Extension of Commercial-Residential-Mobilehome Park Taxes Suspension Included**

Use	Building & Structures Tax	Commercial-Residential-Mobilehome Park Building Tax	Total
Commercial	1.5%	3%	4.5%
Office, General Business	1.5%	0.5%	2.0%
Office, R&D	1.5%	0.5%	2.0%

### **Use of Taxes for Transportation Purposes**

The City relies on construction taxes to plan, develop, operate, and maintain the local transportation system, given the limited General Fund resources available for transportation purposes. The 2024-2028 Adopted Traffic Capital Improvement Program anticipates an average revenue from construction taxes of 76% in the Building and Structure Construction Tax Fund and 22% in the Commercial-Residential-Mobilehome Park Building Tax Fund. As mentioned previously, these revenues fund essential transportation projects and programs, including pedestrian and traffic safety initiatives (e.g., enhanced crossings by schools and radar speed signs), the operation and maintenance of traffic signals and streetlights, installation and upkeep of signs and markings, complete street projects, and pavement maintenance activities. San José is facing a transportation infrastructure maintenance backlog of approximately \$552 million for various assets ranging from streetlights to roadway markings, of which \$369 million is for pavement maintenance. Construction taxes are also utilized as required local matches for numerous transportation grant projects.

Despite the importance of the revenue generated by construction taxes to the City, San José is somewhat unique in its levy of these taxes on development, raising concerns about the City's competitiveness as it relates to attracting much-needed commercial development. Neighboring cities, including Santa Clara, Milpitas, and Fremont do not charge construction taxes. Other cities, such as Mountain View, Sunnyvale, and Cupertino, have either a low construction tax or a flat rate across commercial and industrial projects. The aforementioned cities are less reliant on construction tax revenue because they invest General Fund money into their transportation network, which San José has not had the ability to do given its structural budget limitations and significant general purpose needs.

### **EVALUATION AND FOLLOW-UP**

Staff recommends a further five-year extension of the partial suspension of construction taxes through an administrative process and will monitor the impact of the tax suspension on transportation funds.

### **COST SUMMARY/IMPLICATIONS**

The Building and Structure Construction Tax (San José Municipal Code 4.46) and the Commercial-Residential-Mobilehome Park Building Tax (San José Municipal Code 4.47) fund the majority of the Traffic Capital Improvement Program. Revenues from these taxes depend on the level and nature of construction activity moving through the building permit process.

If the partial suspension is extended, staff anticipates that tax revenues in the categories that have been partially suspended should generally be consistent with how they have been over the last few years. While the shift to remote work since the onset of the COVID-19 pandemic has affected office building construction, there is evidence of a shift back to the office gradually over

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time. If the extension is not approved, revenues could change as the Commercial-Residential-Mobilehome Park Building Tax rates for Office/General Business and Office/R&D would revert back to the commercial rate of 3.0%. A significant increase in the tax rate could also have a negative impact on the amount of office construction in the City and, therefore, reduce overall revenue to the Traffic Capital Improvement Program.

### **COORDINATION**

The memorandum has been coordinated with the City Attorney's Office and the City Manager's Budget Office.

### **PUBLIC OUTREACH**

This memorandum will be posted on the City's Council Agenda website for the April 30, 2024 City Council meeting.

### **COMMISSION RECOMMENDATION AND INPUT**

No commission recommendation or input is associated with this action.

### **CEQA**

Statutorily Exempt, File No. PP17-005, Statutory Exemption for Adjustment to Fees, Rates & Fares without changes to or expansion of services.

### **PUBLIC SUBSIDY REPORTING**

Subject to San José Municipal Code Chapter 14.10, a "Subsidy" is defined as the City's contribution of land, money, or other direct financial assistance to a private construction project; or the City's reduction, permanent suspension, or exemption of any fee or tax applicable to a single private construction project or to multiple private projects. Staff reviewed Section 14.10 with the City Attorney's Office and determined that this proposal falls within the exception as described in Section 14.10.300, whereby a fee or tax reduction is not considered a subsidy if it is applied uniformly to all private construction projects throughout the City within any of the following five general land use categories: residential, office, retail, R&D, or industrial.

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This item does not include a public subsidy as defined in section 53083 or 53083.1 of the California Government Code or the City's Open Government Resolution.

/s/

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