CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Kim Walesh

SUBJECT: **SEE BELOW**

DATE: September 10, 2019

Approved D:DSyC Date 9/13/19

SUBJECT: REVENUE CAPTURE AGREEMENT BETWEEN CITY OF SAN JOSÉ AND EBAY INC.

RECOMMENDATION

(a) Conduct a Public Hearing pursuant to California Government Code Section 53083 in connection with a Revenue Capture Agreement between the City and eBay Inc., (eBay).

(b) Adopt a resolution authorizing the City Manager to negotiate and execute a Revenue Capture Agreement between the City and eBay from October 1, 2019 – June 30, 2034, which allows the City to capture additional sales tax revenues and to make certain payments to eBay equal to 30% of the increased revenues to the City in excess of the minimum sales tax threshold of $5 million, increased by 3% annually, as set forth herein.

OUTCOME

Approval of this recommendation authorizes the City Manager to enter into an agreement with eBay to capture additional sales tax revenue for San José.

BACKGROUND

Wayfair in California

Like many cities in California, San José relies heavily on sales tax revenue to fund City services. Sales tax is currently the second largest revenue source, after property taxes, of the City's $1.35 billion General Fund, with $258.3 million budgeted for 2019-20. San José sales tax is primarily derived from four economic sectors: general retail, food products, business-to-business transactions and transportation (in that order). In recent years, the growth of online ecommerce

platforms has threatened to undermine these traditional revenue generators because online sales transactions are taxed differently or, in some cases, not at all.

In 2018, the U.S. Supreme Court issued a major ruling affecting online sales taxes in the case known as *South Dakota vs. Wayfair Inc.* This landmark decision expanded the ability of states to collect sales and use taxes from online sales. Specifically, the Wayfair decision removed long-standing precedent that online sellers needed to have an in-state physical presence (such as a warehouse, headquarters, or physical store) for a state to require them to collect sales and use taxes on e-commerce transactions. A 2017 estimate from the Government Accountability Office estimated that states were missing out on between $8.5 billion and $13.4 billion in sales taxes under the longstanding online tax framework.

Since *Wayfair*, many states have implemented legislative changes to require these out-of-state, "remote sellers" to collect taxes. On April 25, 2019, California passed Assembly Bill 147, which amended the State's Revenue and Taxation Code (RTC) to require remote sellers to register with the California Department of Tax and Fee Administration (CDTFA) and collect California sales and use tax on sales transactions, if their annual sales exceed $500,000. As included in the 2019-2020 Adopted Budget, the City of San José estimated a positive budget impact related to *Wayfair* of roughly $5 million for 2019-20.

AB 147 also will affect so-called "marketplace facilitators," platforms that facilitate third-party sales. Such companies enable buyers and sellers to find each other and transact sales, but do not sell their own stock of goods. Marketplace facilitators were provided more time to implement back-office changes to their tax collection systems. On October 1, 2019, marketplace facilitators will be considered retailers for tax purposes and are required to collect and remit sales and use tax in California on behalf of their platforms' users.

ANALYSIS

One of the largest marketplace facilitators in the country is eBay Inc., which was founded in San José in 1995 and has long been headquartered at its 24-acre, company-owned campus on Hamilton Avenue. Among the City's largest employers, eBay has more than 3,500 employees in San José, or about 30% of its worldwide and roughly 50% of its U.S. workforce. Executive management, corporate functions (such as marketing, accounting, and human resources), engineering, and R&D are all based in San José. However, as a marketplace facilitator, eBay's role to date has been that of facilitating the connection between buyers and sellers; it has never collected or remitted sales and use tax.

Now, as eBay is considered a retailer for tax purposes under AB 147, the company will have to calculate, process, and remit the applicable sales and use tax for millions of independent sellers, ranging from small mom-and-pops to larger operations. While this change is creating a significant impact on the company's operations, it also represents an opportunity for the City to receive new tax revenue. Aware of this potential, eBay reached out to City staff to explore ways

in which the company could help maximize the opportunity for San José, and support its transition to and ongoing maintenance of this new operational model.

Following AB 147, eBay's headquarters is expected to serve as "point of sale" for some California taxable transactions where both buyer and seller are located in state and should generate revenue for San José. This opportunity exists because California sales tax law establishes that the local portion of sales tax revenue is distributed to the jurisdiction where the point of sale occurs. Because AB 147 was only signed in April 2019, revenues from marketplace facilitators were not anticipated in the City's current fiscal-year budget. Over the past several months, staff has been working with eBay to better understand the potential impact of these tax changes and establish an anticipated expected revenue baseline. Based on the company's published data, eBay's marketplace processed roughly $90 billion in gross merchandise volume in 2018, and staff estimates the U.S. accounted for about 39%, or $36 billion. Using population as a proxy for national sales distribution, staff estimates that sales both originating from and destined for California, and therefore subject to local sales tax under AB 147, could generate an anticipated baseline of roughly $5 million for the City. However, actual receipts will depend on a number of factors and could potentially be significantly lower or higher.

An opportunity exists to increase these revenues beyond staff's anticipated baseline if eBay undertakes additional work as part of the proposed Revenue Capture Agreement. Under the proposed Agreement, eBay will take those actions necessary to ensure that transactions involving sales to or within California are attributable to San José, thereby creating additional sales tax revenue for the City. In consideration of the opportunity, staff is proposing that the City make certain payments to eBay in an amount equal to a percentage of the additional revenue to the City above a baseline threshold amount through a Revenue Capture Agreement.

Proposed Terms

Under the proposed terms, the City would keep 100% of sales tax revenue attributable to eBay up to $5 million. On revenue above $5 million, the City would retain 70% and make certain payments to eBay equaling 30% of the increased revenues above the $5 million threshold. In order to preserve the value of the $5 million threshold to the City, the proposed Agreement includes a 3% escalator on the $5 million threshold, compounded annually on July 1. During the first nine months of the Agreement period, the $5 million threshold would be prorated at 75% (e.g., $3.75 million) to account for the shortened period of sales tax collection. These terms are summarized below.

Proposal Terms

Sales Tax Revenue Received	% to City	% to Company
Up to $5M threshold*	100%	0%
Above $5M threshold	70%	30%
Length of Agreement	15 years	
Threshold escalator	3% compounded annually on $5 million threshold, starting July 1, 2020.	

** Pro-rated for initial 9 months at $3.75 million.*

The proposed length of the Agreement, 15 years, aligns eBay's and the City's interests long-term, locking in the agreement amid the potential for regulatory or operational changes that could reduce the ability to collect these sales taxes in the future. It is important to note that the City portion is net-new revenue that would otherwise not be collected absent eBay's effort.

The following chart provides an estimate of revenue for the first full year of the Agreement under three different revenue scenarios. The City Sales Tax Revenue entries include the $5 million threshold along with 70% of the remaining revenue above $5 million.

Annual Sales Tax Revenue Example	**$5M/year**	**$20M/year**	**$40M/year**
City Revenue	**$5M**	**$15.5M** *($5M + $10. 5M)*	**$29.5M** *($5M+$24. 5M)*
Company Revenue	**$0**	**$4.5M**	**10.5M**
Effective City/ eBay split*	**100% City/ 0% eBay**	**77.5% City/ 22.5% eBay**	**74% City/ 26% eBay**

* *The effective split accounts for the initial $5 million threshold, in which all monies flow to the City.*

Since AB 147 has yet to be fully implemented, there remains considerable uncertainty about the potential for future revenue generation. In working through various considerations with eBay, staff's proposed agreement prioritizes the retention and certainty of a threshold revenue estimate to the City that will escalate over time. Beyond this $5 million threshold, the Agreement promotes the opportunity for eBay to maximize City revenues by capturing any additional available attributable sales.

Even revenue along the lines of the lower-end models would be significant. Sales tax revenue has been relatively flat in inflation-adjusted dollars since the Great Recession ended in 2009, and San José has long experienced lower sales-tax per capita compared to other local cities. For example, San José's annual sales tax revenue per capita for 2019 is roughly $159. That compares to $412 per capita in Palo Alto, $373 per capita in Santa Clara, and $230 in Campbell. This deficiency is a key reason why the City has fewer resources to deploy for services such as police, fire, and parks, and is among the most thinly staffed large cities in the United States. San José's City employee staffing averages 5.9 employees for every 1,000 residents, well below the rate for other large California cities. For example, Los Angeles averages slightly more than 12:1,000 and Oakland averages 10:1,000. At the same time, the retail landscape is shifting as more brick-and-mortar stores transition to concepts based on services or experiences, which do not produce sales tax.

Conventional sales tax sharing agreements can be found in California and nationwide, and are usually used to attract or retain major employers. Several in-state examples include retailers, warehouse/distribution centers, hardware manufacturers, and oil and natural gas producers. It is common for revenue contributions back to the company to exceed 50% and require the relocation or expansion of facilities or employment in return. The City's proposed Agreement, on the other hand, is not intended to lure away a company from another city, but rather is aligning partnership interests with a long-time, San José born-and-bred company. The revenues at stake represent previously uncollected and unanticipated monies and do not result in loss of existing revenue to the City or another jurisdiction. Additionally, the $5 million threshold, along with the annual escalator, provides additional certainty that San José will receive a significant portion of revenue before any payments are made to eBay.

Additional Terms and Conditions

Additional terms and conditions of the Agreement include (but are not limited to) the following.

The City's payment to eBay will be due within 60 days following receipt by the City of sales tax dollars from the CDTFA above the sales tax threshold amount of $5 million as discussed above. In the event of a reallocation by the CDTFA, eBay is obligated to return the City's payment within 30 days of notification by City.

Either party may terminate this Agreement for cause. Examples of cause include a party's default (i.e., a breach of any of the terms or representations in the Agreement and failure to cure, where possible, within 30 days), or if a party makes a material misrepresentation or provides false information to the other party in connection with its obligations under the Agreement. In addition, either party may terminate this Agreement upon 30 days' written notice to the other if an event occurs which could materially impair a party's ability to perform its obligations under this Agreement. The Agreement cannot be terminated without cause.

The Agreement will be construed and governed in accordance with the laws of the State of California and venue will be vested in the state courts of Santa Clara County or, if otherwise appropriate, in the United States District Court, Northern District of California, San José.

Further, the parties will assist one another in connection with any third-party claims that seek to invalidate or that would impact the performance of a party under the Agreement. However, the Agreement does not obligate either party to assume or to contribute to the costs of the other party's legal defense.

Finally, the Agreement includes a provision that in the event of any differences, controversy, claim or dispute arising out of the Agreement between the parties, prior to initiating litigation, the parties agree to attempt in good faith to resolve any such disputes through informal negotiations first.

eBay's History and Importance to San José

Pierre Omidyar founded eBay in his San José living room in 1995. The company leased its first office, a small suite at 1025 Hamilton Avenue, the next year. The business allowed people to list new or used items for sale at an affordable fee – then a breakthrough concept – and grew rapidly, buoyed partly by toys, collectibles, and a culture of "feedback" that made consumers feel confident about buying through the site. Today, the company is a vibrant and trusted marketplace where customers can find almost anything, from furniture to fashion, tech to tricycles.

The company now owns the entire 24-acre headquarters campus where its first office was located, though it also maintains offices on North First Street. eBay is consistently among San José's Top 10 private employers. The main Hamilton Avenue campus is eBay's corporate nerve center, and the company recently invested in a new, 20,000-square-foot welcome center, executive briefing facility, and conference venue called "Main Street." As eBay grew into a global powerhouse, it engrained itself in its hometown. Over the last five years, eBay and eBay employees have provided $8.8 million in charitable donations in San José, plus roughly 7,500 volunteer hours. A recent example included a free legal clinic for small business entrepreneurs held at the eBay campus in partnership with the Lawyers' Committee for Civil Rights.

For these and other reasons, San José has a strong and vested interest in eBay's continued success. While eBay remains a worldwide e-commerce leader, today it is facing unprecedented changes to its industry. New entrants are competing for market share, and gross merchandise volume (a measure of the value of transactions) has been pressured by online sales taxes that have rolled out in other states. At the same time, eBay has shared that effectuating online sales tax is a difficult task because of the millions of buyers and sellers and the added complexity of collecting online sales and use tax, which it has not done before and varies in countless ways by jurisdiction. These changes represent a monumental shift and require investment in staffing, technology, and compliance.

COST IMPLICATIONS AND SUMMARY

The fiscal impact of this Agreement is difficult to estimate with certainty given that tax collection – post *Wayfair* and AB 147 – is still being implemented. Staff, in coordination with the City's sales tax consultant, has completed an analysis of potential revenues that could be achieved through implementation of the Agreement during the first year. This analysis has modeled revenue in increments up to $40 million, before any reimbursement to eBay. This would result in between $5 million and $29.5 million in net-new revenue to the City per year after sharing. At the high end of $40 million, the roughly $29.5 million annually in potential net-new sales tax for the City would represent 11% of the City's 2019-2020 Modified Budget for sales tax. This Agreement would not impact revenue the City receives under the 0.25% Transactions and Use Tax approved by San José voters in 2016; nor would it impact revenue received by VTA under its three existing district taxes.

AB 147 becomes effective October 1, 2019. Any sales tax revenue generated due to the legislation would therefore be part of the fourth quarter sales tax receipts (October-December collections), which are not received by the City until February 2020. Since eBay's implementation of AB 147 as a marketplace facilitator is something new, staff is not currently recommending making any budget adjustments to the sales tax revenue category. Once the fourth quarter revenue is received, and staff analyzes the revenue related to eBay, a future budget adjustment may be recommended. In addition, a budgetary adjustment related to the sales tax revenue will likely include a recommendation to reserve the additional funding (and not allocate it for a specific purpose) until staff is confident that the funding is secure.

EVALUATION AND FOLLOW-UP

If approved, the City Manager will be authorized to negotiate and execute the Revenue Capture Agreement with eBay, and City staff will monitor the results of the Agreement and report them through the annual budget process.

PUBLIC OUTREACH

The memorandum will be posted on the City's website for the September 24, 2019 City Council agenda.

COORDINATION

This memorandum has been coordinated with the City Manager's Budget Office, the Department of Finance, and the City Attorney's Office.

COMMISSION RECOMMENDATION/INPUT

No commission recommendation is associated with this action.

FISCAL/POLICY ALIGNMENT

The proposal aligns with Strategic Goal No. 1 of the City's Economic Strategy: "Encourage Companies and Sectors that Can Drive the San José/Silicon Valley Economy and Generate Revenue for City Services and Infrastructure." In addition, it aligns with Major Strategy 8 of the Envision 2040 General Plan, "Fiscally Strong City."

Reporting Requirements

The information below addresses the requirements set forth in the State of California AB 562 (Government Code 53083) concerning economic subsidies over $100,000 for the purpose of stimulating economic development. These include publication of information and a public hearing. Although this agreement may not be a subsidy, City staff is providing the following State-required information out of an abundance of caution. The primary purpose of the recommended Agreement is also not to stimulate economic development. Rather, the Agreement will instead generate net-new revenue that would not be collected without the Agreement.

i. Name/address of benefiting business entity	eBay Inc., 2025 Hamilton Ave., San José, Calif., 95125
ii. Start and end dates	Beginning October 1, 2019 and ending June 30, 2034.
iii. Description and estimated total amount of expenditure of public funds or revenue lost	Under terms of the Agreement, the City will annually make payments to the Company in an amount equal to 30% of sales-tax revenue that is collected above a threshold. The threshold starts in the first full fiscal year at $5 million and increases by 3% each year, commencing July 1, 2020, for the term. In the event that sales tax collection does not exceed $5 million, then the City does not make a payment to the company. During the first nine months of the Agreement, this threshold is prorated at 75%, or $3.75 million. The expenditure of public funds varies based on revenue collected. For example, in the first full fiscal year of the Agreement, assuming sales tax collection of $40 million, the City would make a City payment of $10. 5 million to the Company ($40 million - $5 million = $35 million. 30% of $35 million = $10. 5 million). In Year 15, based on the same $40 million in revenue, the City would make a payment of approximately $9.7 million because the $5 million threshold increases to approximately $7.5 million based on the 3% escalation factor. Over the 15-year term, the City could make payments of approximately $150 million to the Company, assuming a static $40 million in annual revenue. The actual number would depend on several factors, including sales volume and the percentage of sales that are taxable.

iv. Statement of public purpose	San José suffers fiscal challenges related to its relatively weak tax base. This Agreement assists in increasing sales tax revenue to fund critical government services such as police, fire, parks and recreation programs, roads, and other services which residents and businesses expect and deserve. In this way, the Agreement is consistent with Major Strategy #8 of the Envision 2040 General Plan, which advocates for carefully managing existing fiscal resources and encouraging the cultivation of increased resources.
v. Projected tax revenue	Based on publicly available information on the Company's sales, staff believes that gross sales tax collection of $40 million annually is possible. In this scenario, the Agreement could generate an average of roughly $29 million annually in net-new sales tax for the City (for example, in the first full fiscal year: $5 million in threshold revenue, plus $24. 5M in additional sales tax after sharing back 30% of the revenue above $5 million with the Company). Actual sales tax generation will be affected by a variety of factors including sales volume. Over the 15-year term, the Agreement could generate approximately $440 million in net-new revenue for the city, not accounting for sales growth or fluctuations.
vi. Estimated number of jobs created, broken down by full time, part-time and temporary positions	The proposed Agreement is not anticipated to lead directly to the generation of any additional jobs.

CEQA

Not a Project; File No. PP17-003, Agreements/Contracts (New or Amended) resulting in no physical changes to the environment.

/s/
KIM WALESH
Deputy City Manager
Director of Economic Development

For questions, please contact Kim Walesh, Director of Economic Development at 408-535-8177.