



NATIONAL UNIVERSITY SYSTEM  
INSTITUTE FOR POLICY RESEARCH

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# **RETHINKING SAN DIEGO'S BUSINESS LICENSE TAX**

**The Benefits of a Tax Amnesty and Holiday**  
**FEBRUARY 2009**

## *Executive Summary*

Local government efforts to hasten enrollment in the City of San Diego's business license tax can be improved in a business-friendly way, fostering greater economic growth. A more responsible and equitable method of generating greater government revenue would be to improve compliance and reduce long-term administrative costs through temporary tax amnesty and holiday initiatives.

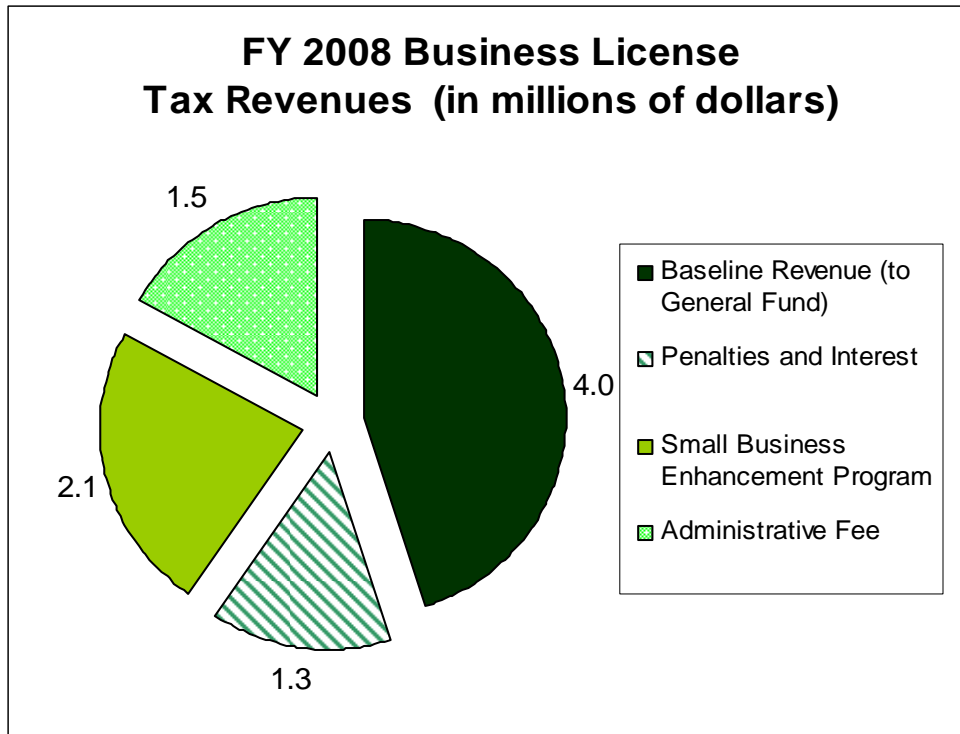
- \* The City of San Diego's business license tax collects a de minimis amount of revenue, providing only \$4.06 million (less than ½ of 1%) for a \$1.1 billion General Fund budget.
- \* \$1.3 million is collected in fines and penalties for the tax.
- \* Currently the City spends \$1.5 million to collect and administer this tax.
- \* Current City efforts to enroll delinquent business are cumbersome and only modestly effective.
- \* The experience of the cities of Anaheim and Los Angeles suggest that implementing a 100-day tax amnesty and holiday initiative will enroll taxpayers at a much lower cost to the City and, over time, increase revenues to the City.

*Introduction to San Diego's Business License Tax*

A business tax license is required of anyone conducting business activity within the city of San Diego.<sup>1</sup> As of December 31<sup>st</sup>, 2008, the City lists approximately 93,799 active and inactive licensed businesses within its jurisdiction, of which small businesses (12 or fewer employees) comprise 93.6% of all certificate holders.

Currently, the City of San Diego charges \$34 for a business license tax for enterprises with twelve employees or less, and \$125 plus \$5 per every employee for companies with thirteen employees or more. Individuals seeking a license tax certificate must also pay an additional \$25 certificate processing fee, as well as an annual \$15 renewal fee.

In Fiscal Year 2008 the tax provided only \$6.1 million in revenue, with related penalties and fees bringing in an additional \$3.4 million. As \$2.1 million is diverted for the costs of the non-general fund supported Small Business Enhancement Program, the base tax only provides \$4 million (0.36%) of the City's \$1.1 Billion General Fund. City data shows that the processing fee, added to the bill to cover the cost of staff time to administer the program brought in an additional \$1.5 million.



<sup>1</sup> See SDMC § 31.0121. The cost of the City of San Diego's average business license tax today is one of the lowest among the ten largest cities of California, an accomplishment can be attributed to the leadership of former Mayor Susan Golding. Shortly after taking office in December 1992, Golding stumped for cutting red tape and taxes for small businesses, the driver of San Diego's economy, as part of a broader overhaul of business regulations. The base tax rate for businesses with twelve employees or less was reduced by 73% across two years of cuts, missing Golding's ultimate objective of completely eliminating the tax for small business, but an impressive feat nonetheless.

Total Fiscal Year 2009 business tax revenues are expected to increase \$1.5 million to a cumulative \$11 million, with an additional \$2.2 million collected to offset processing costs.

In contrast, the City of San Diego collects \$385.7 million in property taxes, \$247.9 million in sales taxes, and \$173 million in hotel taxes.

### *Upping Enforcement: To What End*

A high percentage of the revenue collected in this program (36% of total) comes from penalties and late fees. For small businesses that fail to register or pay back taxes, the City levies a \$68 surcharge; businesses with thirteen or more employees are charged \$250. Additional penalties include a \$25 late fee or 10% of total business tax due for companies that do not pay business taxes fifteen days after they become due. A 1% per month interest penalty charge is also added to any past due taxes and penalties, which the city can collect for up to three years of owed back taxes. The cost of collection, as a percentage of total revenue (13.6%) is also high.<sup>2</sup>

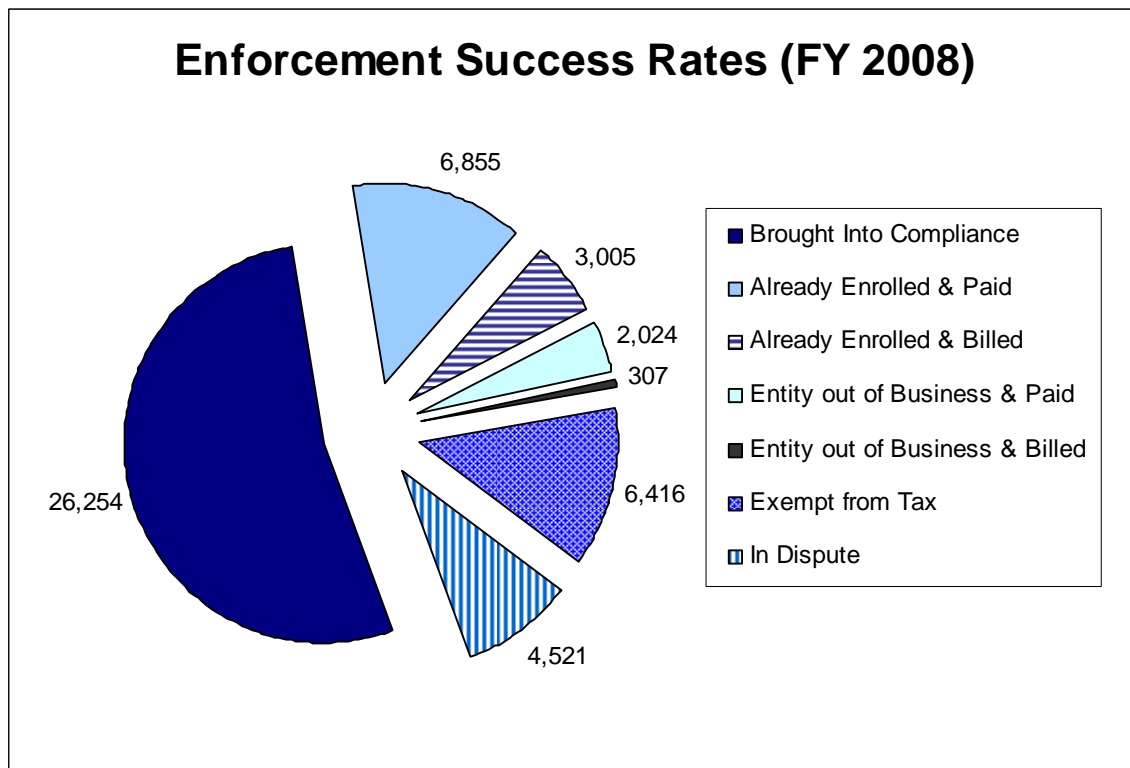
Enforcement efforts have recently picked up. Using data from state tax returns filed with the California Franchise Tax Board, the City has begun identifying supposed non-compliant businesses and mailing intimidating letters. Those who do not respond to the initial notice letters sent from the City within 30 days are charged a \$68 non-compliance fee, along with a Notice of Tax Liability statement. A small business or self-employed individual with three or more years of non-registration with the City could typically face a liability statement with more than \$300 in back taxes, fees, and surcharges owed. This amount could be even higher for contractors and corporations that owe back business improvement district (BID) fees, which range from \$40 to \$1,200 each year, and have additional penalties for delinquent certificate holders.

This approach is yielding a fairly low rate of success. Last fiscal year, the City of San Diego pursued approximately 47,000 leads, of which only 56% were ultimately taxpayers that needed to fully comply with the program. 6,416 of the businesses contacted were found to be exempt from the tax - that is, the City of San Diego identified businessmen and women who lived in the city but had businesses that worked outside of city limits, and other similar situations. Another 18% of the independent contractors and enterprises investigated were found to already be paid in full with the City's Business Office, and 5% had already closed up shop and halted business activity within city limits.

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<sup>2</sup>. By way of comparison, the federal government reported that less than 1% of the total revenue collected in the federal tax system comes from penalties and interest. See <http://www.irs.gov/taxstats/compliancestats/article/0,,id=97177,00.html>. It is estimated that the federal government's cost of administering the federal income tax are about ½%. The cost of administering the sales taxes programs in states range from between ½ and 1%. See Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System (The Beacon Hill Institute at Suffolk University, September 2007).

## Enforcement Success Rates (FY 2008)



One of the reasons for both the relatively high percentage of revenue being collected through fees and the poor effectiveness in increasing compliance is that there is a large amount of confusion with the program. Many of these “businesses” targeted in the enforcement efforts are, individuals who may receive secondary income as an independent contractor in addition to their normal income. Thus an individual who receives secondary income as a soccer referee or receive compensation from freelance writing, no matter how the level of income, is treated as businesses for the purposes of the program, requiring them to obtain the business license certificate. Indeed, if a minor child making money as a babysitter or from mowing lawns choose to file a tax return they would be caught up in the City’s enforcement efforts.

While the City of San Diego’s rules are not unique (most San Diego municipalities with business taxes require those receiving income as independent contractors to obtain a certificate), its enforcement efforts are aggressive. During the month of January SDI contacted the cities of Chula Vista and Escondido to determine whether they were also pursuing a similar effort to boost business tax revenue collection. Neither municipality is chasing after potentially delinquent businesses nor contractors with old state tax information.

It is also not clear that targeting independent contractors is an effective long-term tax strategy. One way to measure different tax systems is in respect to their “efficiencies” – the extent to which they distort and change economic behavior such as where business

locate, how much they work, and who they employ.<sup>3</sup> Under the current rules, an independent contractor must make at least \$75 before they cover the annual cost of the program. While a low amount, it is not unrealistic to think that some contractors will choose to avoid clients and customers in the City of San Diego, so as to avoid tax liability. Others may decide that there are advantages to moving their legal place of business outside of the city's jurisdiction to evade taxes and BID fees. Others, such as independent contractors receiving a small amount of compensation for services that are more an avocation rather than a profession, may simply choose to stop engaging in the activity.<sup>4</sup>

In sum, the City of San Diego's tax collection efforts underway are bureaucratic and only modestly effective. It seems efforts to collect hundreds of dollars from independent contractors, small businesses and home-based businesses come at an economically fragile time in our nation's history is pennywise and pound foolish.

There is another way. Two initiatives employed with great success by other Southern California municipalities bear closer examination.

#### *Anaheim's Approach: 100 Day Business Tax Reform*

Under Mayor Curt Pringle, during the Spring of 2005, the City of Anaheim established a 100 day "business tax holiday" from April 15 – July 29 2005, waiving the \$68 minimum business license tax, application processing fee and home occupation registration fee from new businesses registering with the City. According to the *Los Angeles Times*, the tax holiday saved business owners an average of \$133.<sup>5</sup> Ultimately, more than 2,000 new businesses were formed within the three and a half month holiday, a 33% increase from the same time length the prior year.

Pringle also included a tax amnesty provision in his holiday initiative, during which all businesses which began operations prior to April 15, 2005 and who owe business license taxes yet have failed to obtain a license were exempt from all interest and penalties owed. They were still required to pay the application fee and all business taxes owed. 550 enterprises ultimately participated in the program, receiving a waiver from costly late fees, back taxes, and additional interest rate penalties.<sup>6</sup>

The greater community pitched in to help with Mayor Pringle's effort. During the 100 days, the Anaheim Chamber of Commerce offered a free one-year membership to business owners taking advantage of the tax holiday, and the public utility offered suspended connection fees to new businesses.

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<sup>3</sup> See "Tax Policy is Economic Policy", Jed Kolko, Public Policy Institute of California. Presentation before the California Commission on the 21<sup>st</sup> Century Economy, January 22, 2009)

<sup>4</sup> For some of the small businesses caught up in this program see "DeMaio seeks break for sole proprietors on license code", *San Diego Union-Tribune* 12 January 2009.

<sup>5</sup> Kriel, Lomi. "Businesses in Anaheim Get a Break." *Los Angeles Times*. 18 June 2005: B-3.

<sup>6</sup> City of Anaheim: Ordinance No. 5958.

Anaheim budget documents indicate that there was little negative impact on revenues from the tax holiday and amnesty. **Indeed, the City saw revenues *increase 7.9%* between FY 2004 and FY 2006.**

**Table 1**  
**Business License Tax Revenues City of Anaheim FY 2004 -2008<sup>7</sup>**

Fiscal Year	Revenue Collected
2004	\$5,506,921
2005	\$5,630,311
2006	\$5,942,543
2007	\$5,815,504 <sup>8</sup>
2008	\$5,855,439 <sup>9</sup>

*Tax Amnesty in Los Angeles*

Los Angeles has also successfully implemented a tax amnesty program, hosting three license amnesty initiatives in the last fifteen years, including a 2001 program that yielded more than \$14 million in tax revenue and a six month tax amnesty that netted \$5 million in 2002 across six months.<sup>10</sup>

The 2001 amnesty lasted from October to December 31<sup>st</sup>, and applied to municipal business and payroll taxes. Businesses that paid back taxes in full plus interest by December 31<sup>st</sup> were not liable for the maximum 40% penalty which the city could collect within their legal rights. At the time, government estimates were that 1/3 of all businesses in Los Angeles were not paying local taxes. The amnesty initiative was part of package of tax delinquency policies, including the creation of a new settlement bureau within the city attorney's office to negotiate tax settlements, and a new whistleblower program to encourage people to identify taxpayers who have not filed taxes or underreported taxes. Based upon the Internal Revenue System's whistleblower model, the City of Los Angeles awarded 10% of recovered assets to whistleblowers. Ultimately, the amnesty created an additional \$14.7 million in tax revenue.

Now facing a \$440 million budget deficit, Los Angeles Mayor Villaraigosa is pressing for a new business tax amnesty that is projected to haul in approximately \$5 million beginning this fiscal year.<sup>11</sup> A vote by the L.A. Council is expected in early 2009, which should be interest to the San Diego's elected city leaders, which are on the clock to come

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<sup>7</sup> Budget, City of Anaheim

<sup>8</sup> Amended

<sup>9</sup> Budgeted

<sup>10</sup> Orlov, Rick. "\$5 million-plus collected business-tax amnesty brings in much more than city officials expected." *Los Angeles Daily News*. 2 July 2003.

<sup>11</sup> Office of the Mayor of Los Angeles. "Mid-year Budget Adjustments." Memorandum to the City Council dated December 12, 2008, p. 3.

up with ways to close a multi-million dollar budget gap in time for the passage of Fiscal Year 2010's budget this summer.

### *Policy Recommendations*

Members of the San Diego Council should consider some combination of a tax holiday and tax amnesty program. During a set period, the city could, for example, waive penalties for existing businesses obtaining a business certificate and offer a one year holiday to new businesses registering with the City. While depressing general fund revenues in the short-term, if combined with a public information campaign, the long-term cost of administering and enforcing the program should either offset or exceed the forgone revenue as businesses see a benefit of filing with the City and coming into compliance. If combined with a new citizen's committee to review additional changes to the tax code that would make it more enforceable, more efficient, and more effective, it would strengthen the City's business climate.

There appears to be some reception to this policy reform. In early January, City Councilmember Carl DeMaio announced his support for a tax amnesty and holiday plan, noting the many challenges our small business community faces in weathering the national economic storm. The Mayor and other Councilmembers should also take a look at the program, considering the long term benefits of helping new small businesses get off the ground and more efficiently bringing existing small businesses and independent contractors into compliance with City regulations.