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Office of the Mayor

ACTION CALENDAR
November 12, 2024
(Continued from October 15, 2024)

To: Honorable Members of the City Council

From: Mayor Jesse Arreguín

Subject: Amending BMC Section 9.04.165 -Tax Exemption for Research & Development Grants

RECOMMENDATION

Adopt a first reading of an Ordinance amending Berkeley Municipal Code Section 9.04.165 to exempt the taxation of business gross receipts relating to government and philanthropic research and development grants in the public interest.

BACKGROUND

Home to the University of California, Berkeley, ranked number one worldwide for the number of venture-backed startups founded by undergraduate alumni[1] and the Lawrence Berkeley National Laboratory (one of 17 national Department of Energy research laboratories), the city of Berkeley is an attractive place for technology startups and research and development (R&D) companies.

As of late 2023, the city had approximately 400 innovation sector companies, with 325 of them (81%) considered "startups". Of these, 35% are in Healthcare & Life Sciences, 14% in CleanTech (aka ClimateTech), 13% in Hardware, and 2% in FoodTech.[2]

All of these innovation industry subsectors leverage R&D grant funding to develop solutions that serve environmental and societal objectives, such as solutions for human health, environmental quality, climate change mitigation and adaptation, and national defense. These grants come from various federal agencies, such as the Environmental Protection Agency, National Science Foundation, and Departments of Energy, Defense, or Health and Human Services, as well as state agencies like the California Energy

[1] 2023 Pitchbook University Rankings. https://pitchbook.com/news/articles/pitchbook-university-rankings

[2] Companies defined as startups are for-profit businesses that sell innovative technology products or services OR substantively use innovative technologies to develop and manufacture their products or provide their services AND are developing repeatable and scalable business models that aren't yet profitable. See the *2023 Citywide Economic Dashboard*, published by the City of Berkeley Office of Economic Development for more details. https://berkeleyca.gov/sites/default/files/documents/Economic%20Dashboard%202023.pdf

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Commission or Department of Food and Agriculture, and philanthropic non-profit organizations like the Bill & Melinda Gates Foundation and the Grantham Foundation[3]. Additionally, many of the early-stage companies in Berkeley's many accelerator and incubator programs, such as Berkeley SkyDeck, Activate-Berkeley, Cyclotron Road at the Berkeley Lab, Bakar Labs, Bonneville Labs and CITRIS Foundry, are recipients of government and philanthropic R&D grants, including environmental technology companies like All Power Labs, Twelve, and Widesense, foodtech companies like Akorn Technology and Novel Farms, hardware companies like Squishy Robotics and Sonera Magnetics, and biotech companies like Valitor, Xalud Therapeutics, Resvita Bio, and Glyphic Bio.

These companies are undertaking research and development in the public interest, to develop renewable energy technologies, sustainable aviation fuels and plastics, electric vehicle fleet management software, bio-based coatings to reduce food waste, plant-based meat products, safer assessment tools for first responders, treatments for a wide range of debilitating and life threatening diseases, and other solutions for society's pressing health and environmental problems, all while providing our community with jobs and opportunities for wealth creation.

For startups and R&D companies that are dependent on R&D grants as their primary source of financing, the City of Berkeley's gross receipts taxation of such grants poses a disincentive for them to locate or grow in Berkeley, as Berkeley's business license tax rate is already one of highest among Bay Area cities[4]. It also creates a perception that Berkeley is not startup-friendly, despite the city's status as a hub of intellectual creativity and technological innovation.

As such, in 2019, my office, with support from the Office of Economic Development and Finance Department, brought forth an item to provide tax waivers for Berkeley small businesses that have received governmental R&D grants, which was approved by Council on May 28, 2019. The Berkeley Municipal Code (Section 9.04.165) was amended to include the following local tax exemption:

> *Any person subject to a license under provisions of this section with less than $100,000 in annual gross receipts, as defined in Section 9.04.025, net of governmental research grants, may exclude from gross receipts up to $1,000,000 received from governmental research grants, providing that a list of those grants and the amounts of payments received are reported to the City as defined by the Director of Finance.*

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[3] The Bill & Melinda Gates Foundation is a nonprofit fighting poverty, disease, and inequity with a mission to create a world where every person has the opportunity to live a healthy, productive life. The Grantham Foundation is a 501(c)(3) private foundation with a mission to protect and conserve the natural environment.

[4] *Business Taxes in the Bay Area: A City Level Analysis. Bay Area Council Economic Institute, February 2023. https://www.bayareaeconomy.org/files/pdf/BACEI-SF-Business-Tax-Feb2023.pdf*

Since then, 21 companies have received a R&D grant tax waiver, of which four (almost one-fifth) have reached the $1 million maximum and several companies have been denied the waiver because they either had other gross receipts exceeding $100,000 (e.g. from interest income on equity investments made in the company, tax credits, or subcontract awards for R&D services) or received a R&D grant from a non-profit philanthropic organization, rather than government entity.

These companies, along with startups that are currently ineligible for the R&D grant tax waiver, have since brought to the City's attention that the size of the grant award does not correspond to the company's profitability or likelihood of success. Rather, companies have to propose to hit aggressive milestones to receive government grant funding and once they do, they need to use that funding to achieve those milestones (e.g. hire researchers, purchase equipment to run experiments, etc.). At the federal level, taxes are not allowable costs in SBIR and STTR grant awards, either as direct or facilities and administrative (F&A) costs, so the local tax burden impacts a company receiving a $200,000 dollar R&D grant just as much as a company that receives a grant of $2 million: funds paid towards local taxes diminish the company's ability to achieve grant milestones. In other words, a company's committed project scope scales commensurately with the dollar amount of the grant, and thus the $1 million cap in the current BMC language fails to achieve the policy's intent to help early-stage companies conducting R&D in the public interest to achieve their goals and grow in Berkeley.

Further, the landscape of Berkeley startups has changed a lot in the past 5 years. It now includes more biotech and climate-tech companies where timelines for federal approval of drugs and medical devices are longer, and large capital investments are required to demonstrate proof of concept. As such, more companies are receiving larger grant awards from federal, state, and other impact-oriented nonprofits and it is these very same companies that the City wants to support, not only for economic development, but also to address the community (and world's) environmental and health challenges.

Similarly, companies that receive R&D grant funding from non-profit foundations and philanthropic organizations face the same issues with regard to the efficiency with which they develop high-impact solutions, but they do not currently have the opportunity to apply for this tax waiver. And, in these cases, Berkeley R&D companies are at a disadvantage to those from other cities when they apply for grant funding, as donors prefer to invest in places where grant money can be used most efficiently by the grantee to achieve its proposed outcomes.

Updating the ordinance tax language to recognize both government and *philanthropic* R&D grants, and provide the benefit to any business receiving such a grant, regardless of the size of the grant or other income, will enable more startups and R&D companies to grow in Berkeley, thereby leading to more potential overall business tax contributions to the City in the long run. Simultaneously, it will allow the full amount of R&D grant awards to be used to achieve the social, environmental and health challenges that these companies seek to address, and lessen local companies' incentives to move to another location with a less onerous tax structure.

RATIONALE FOR RECOMMENDATION

Providing a tax exemption on government and philanthropic R&D grants will greatly benefit innovation companies that rely on these grants to move forward on projects which are in the interest of society and the environment. Updates to the current ordinance could enable Berkeley's smaller companies to become tomorrow's engines of the economy. It will also provide an incentive for such business to remain in Berkeley and contribute to the city's tax base in the long run, thereby contributing to Berkeley's future economic vitality.

FINANCIAL IMPLICATIONS

Slight loss in tax revenue that will likely be recouped through more businesses remaining in Berkeley as they grow.

ENVIRONMENTAL SUSTAINABILITY

Not applicable.

CONTACT PERSON

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Attachments:

1. Ordinance

ORDINANCE NO. XXXX-N.S

AMENDING BERKELEY MUNICIPAL CODE CHAPTER 9.04, BUSINESS LICENSES

BE IT ORDAINED by the Council of the City of Berkeley as follows:

Section 1. That Section 9.04.165 of the Berkeley Municipal Code is amended to read as follows:

9.04.165 Professional--Semiprofessional--Connected business.

A. Finance, Insurance, Banking (including Savings and Loans) and Real Estate. Every person in any business, profession or occupation within the business field of finance, insurance and real estate, as described in the most practicable version of the U.S. Government Printing Office publication North American Industrial Classification System Manual, except for those persons whose business is primarily renting real property, as defined in Section 9.04.195, shall be classified as a professional-semiprofessional.

B. Health, Veterinary, Legal, Educational, Engineering-Architectural-Surveying, Accounting-Auditing-Bookkeeping, and Miscellaneous Services Not Classified Elsewhere. Every person in any business, profession, or occupation within the business fields of health, veterinary, legal, education, engineering-architectural surveying, accounting-auditing-bookkeeping, and miscellaneous services not classified elsewhere, as described in the current U.S. Government Printing Office publication entitled North American Industrial Classification System Manual shall be classified as professional-semi-professional.

C. Nothing contained in this section shall be deemed or construed as applying to any person engaged in any of the professions or occupations enumerated in this section solely as an employee or partner of any other person or entity conducting, managing or carrying on any such business in the City.

D. Any person subject to a license under provisions of this section may exclude from gross receipts the portion of those receipts paid to subcontractors, providing that a list of such subcontractors and the amounts of payment are reported to the Director of Finance. The Finance Department shall pursue collection of the business license tax from all reported subcontractors.

E. Any person subject to a license under provisions of this section ~~with less than $100,000 in annual gross receipts, as defined in Section 9.04.025, net of governmental research grants,~~ may exclude governmental or philanthropic research and development (“R&D”) grants from gross receipts (as defined in Section 9.04.025) ~~up to $1,000,000 received from governmental research grants~~, providing that a list of those grants and the amounts of payments received are reported to the City as defined by the Director of Finance. (Ord. 7655-NS § 1, 2019: Ord. 7338-NS § 5, 2014: Ord. 6714-NS § 2, 2002: Ord. 6598-NS § 2, 2000: Ord. 5984-NS § 1, 1990: Ord. 5017-NS § I (part), 1977)

Section 2. Copies of this Ordinance shall be posted for two days prior to adoption in the display case located near the walkway in front of the Maudelle Shirek Building, 2134 Martin Luther King Jr. Way. Within 15 days of adoption, copies of this Ordinance shall be filed at each branch of the Berkeley Public Library and the title shall be published in a newspaper of general circulation.