Government of the District of Columbia
Office of the Chief Financial Officer

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TAX ABATEMENT FINANCIAL ANALYSIS

TO:	**The Honorable Vincent C. Gray** **Mayor, District of Columbia** **The Honorable Kwame R. Brown** **Chairman, Council of the District of Columbia**
FROM:	**Natwar M. Gandhi** **Chief Financial Officer**
DATE:	**May 22, 2012**
SUBJECT:	**"Social E-Commerce Job Creation Tax Incentive Act of 2012"**
REFERENCE:	**Draft bill from April 11, 2012**

Findings

The Exemptions and Abatements Information Requirements Act of 2011 (TAFA Act) requires the Office of the Chief Financial Officer (OCFO) to provide a financial analysis that advises whether the proposed recipient of the tax subsidy could meet its fiscal needs without the proposed exemption. The Social E-Commerce Job Creation Tax Incentive Act of 2012 (Act) has been introduced for a different purpose.

The tax exemptions proposed by the Social E-Commerce Job Creation Tax Incentive Act of 2012 are not projected to be necessary in order for the company to meet its expenses and remain in operation from 2016 through 2025. The estimated real property tax liability and corporate franchise tax are well below the projected taxable income of the company in these years.

The purpose of the Act is to encourage LivingSocial to locate its headquarters in the District and to hire District residents. The Act intends to meet this goal by reducing LivingSocial's real property tax liability between 2016 and 2025 and its corporate franchise tax liability between 2016 and 2020, based on the percentage of District residents hired by the company.

The Act reduces the cost differential of office rental, real estate taxes and corporate income taxes between the District and other jurisdictions in Maryland and Virginia by between 45 percent and 65 percent. It is estimated that the combined cost of office rental, real estate taxes and corporate income taxes is between $7.5 million and $11 million greater in the District than in surrounding suburban jurisdictions. The Act would reduce these costs by $5 million annually on average from 2016 through 2020 and $1.5 million annually from 2021 through 2025. It is important to note that taxes make up a very small percentage of a business's overall expenses.

The cost of the proposed subsidies is approximately $37,000 per job created for District residents, assuming that LivingSocial takes advantage of the full amount ($32.5 million) of the credits offered. However, if LivingSocial does not hire any District residents, the company would remain eligible for $16.5 million in credits, provided that it satisfies other requirements as set forth below.

The OCFO does not analyze the potential economic benefits that may be associated with LivingSocial locating its headquarters in the District. A comprehensive summary of the proposed community benefits as submitted by LivingSocial is attached to this analysis.

Research indicates that tax incentives are generally not a critical factor in corporate locational decisions. Without fully understanding the criteria LivingSocial is using to make its locational decision or knowing which other cities are in contention, the OCFO cannot opine definitively on the necessity or value of the subsidies. However, the $32.5 million in potential subsidies proposed in the Act may be necessary to induce LivingSocial to locate its new headquarters in the District and, therefore, entice new residents and create new jobs for District residents.

Background

The proposed legislation provides real property and corporate franchise income tax credits to social e-commerce companies.[1] Given the bill's definition of a Qualified Social E-commerce Company, the OCFO projects that only one company currently headquartered in the District, LivingSocial, could qualify for the proposed tax credits.

LivingSocial is a privately held, DC-based e-commerce company that operates in hundreds of markets across six continents and has 65 million subscribers. LivingSocial has approximately 5,000 employees distributed across the United States and 22 other countries, with more than 1,000 employees in the District.

Under current law, LivingSocial is a Qualified High Technology Company (QHTC) that can claim various tax incentives. However, although LivingSocial qualifies as a QHTC, it is currently unable to benefit from tax advantages such as wage tax credits and corporate franchise tax exemptions, as it has not yet generated taxable income. The legislation would allow LivingSocial to utilize wage tax credits authorized under the current QHTC law to offset its future real property tax liabilities, as well as move the franchise tax abatement period forward to a period in which the company has taxable income.

More specifically, the bill provides a real property tax credit (Property Tax Credit), which is capped at $15 million in total between FY 2016 and FY 2025. In order to use the Property Tax Credit, LivingSocial must occupy at least 200,000 square feet of office space that will be constructed or rehabilitated after June 2012. The bill also provides for a corporate franchise tax credit (Income

[1] The bill defines a social e-commerce company as one that is a Qualified High Technology Company, which hired at least 850 employees to work in the District of Columbia between December 31, 2009 and January 1, 2012, and with "a primary business of marketing or promoting retail or service businesses by delivering or providing members or users with access to discounts or other commerce-based benefits."

Tax Credit), which is capped at $17.5 million. The Income Tax Credit may be taken for five years beginning in FY 2016.

In addition, although LivingSocial cannot take advantage of all of the incentives authorized under the current QHTC law, there are some provisions that are applicable. For example, QHTCs are exempt from sales taxes and personal property taxes. In addition, QHTCs are eligible for relocation credits against corporate franchise tax liability based both on the number of new jobs and the number of new residents that they bring to the District. Assuming $9 million in purchases, $24 million in personal property and 315 new hires eligible for relocation credits, the existing Qualified High Technology incentives could save LivingSocial approximately $5 million beginning in FY 2015.[2] In addition, if LivingSocial hires more employees than can be used against the Property Tax Credit, the company will be able to take advantage of the wage credit against corporate franchise tax liability that is available to all QHTCs.

Financial Analysis

The Exemptions and Abatements Information Requirements Act of 2011 requires the analysis provided by the Office of the Chief Financial Officer to contain certain information. The required information is included below.

A separate fiscal impact statement has been prepared on the proposed legislation.

1. <u>Terms of the Exemption or Abatement</u>

The bill provides a real property tax credit, called the New Hire Wage Credit (Property Tax Credit), which equals 10 percent of the salaries paid to employees hired between January 2010 and December 2015 (with a cap of $5,000 per new hire per year) in the first 24 months of their employment, adjusted for the ratio of District residents in the new hire pool. The adjusted Property Tax Credit is capped at $15 million between FY 2016 and FY 2025. LivingSocial will receive 100 percent of the Property Tax Credit if at least 50 percent of new hires are District residents, 75 percent if between 40 percent and 50 percent of new hires are District residents or 50 percent if less than 40 percent of new hires are District residents.[3] For example, to reach the $15 million cap, LivingSocial would have to hire 1,500 new employees between 2010 and 2015, half of whom are District residents.

The bill also provides for a corporate franchise tax credit (Income Tax Credit) for five years starting in FY 2016. The Income Tax Credit is capped based on the ratio of District residents in the new hire pool as follows:

- $17.5 million, if at least 50 percent of new hires are District residents;
- $13.5 million, if between 40 percent and 50 percent of new hires are District residents; or
- $9 million, if less than 40 percent of new hires are District residents.

The proposed legislation requires LivingSocial to meet the following requirements:

- Make at least 50 new hires annually;

[2] All numbers in the comparative analysis do not take present value into account.
[3] In order to use the Property Tax Credit, LivingSocial must occupy at least 200,000 square feet of office space that will be constructed or rehabilitated after June 2012.

- Employ at least 1,000 persons in the District starting FY 2016, through FY 2025;
- Occupy at least 200,000 square feet of office space that will be constructed or rehabilitated after June 2012;
- Develop a joint business activity plan with the Office of the Deputy Mayor for Planning and Economic Development;
- Occupy the real property that is eligible for the New Hire Wage Credit through the duration of the abatement period; and
- Not file for bankruptcy.

2. <u>Annual Proposed Value of the Exemption or Abatement</u>

Assuming that the company meets its future hiring and taxable income projections, the OCFO estimates the proposed value of the exemptions to be the full amount authorized, as follows:

- $15 million in real property tax between FY 2016 and FY 2025
- $17.5 million in corporate franchise tax between FY 2016 and FY 2020[4]

3. <u>Summary of the Proposed Community Benefits</u>

According to information provided by LivingSocial, almost half of their local workforce resides in the District. The company is currently hiring approximately 30 to 45 new employees per month, and intends to begin construction on a new consolidated global headquarters with between 200,000 and 300,000 square feet of space. The company's plan is to hire over 1,000 people[5] to work in the headquarters during the next five years, with an average salary of $60,000 per year. LivingSocial has stated that the new facility will house the company's worldwide headquarters operations, encompassing growth in various functions, including: Sales Management and Support, Production, Business & Corporate Development, Accounting/Finance, Human Resources, Information Technology and Product Development, Legal, Operations Management, and New Business Initiatives.

A comprehensive summary of the proposed community benefits as submitted by LivingSocial is attached to this analysis.

4. <u>Financial Analysis</u>

   A. *Review and Analysis of the Financial Condition of the Recipient and Advisory Opinion Stating Whether or Not It Is Likely that the Recipient Could Be Reasonably Expected to Meet Its Fiscal Needs without the Proposed Exemption or Abatement.*

LivingSocial provided the OCFO with financial information outlining expected future income, hiring trends and real property tax liability. Based on the OCFO's analysis of the information provided, the

[4] If LivingSocial was eligible for the entire $17.5 million between FY 2016 and FY 2020, the company would be one of the top companies in the District, in terms of corporate franchise liability.
[5] LivingSocial's financial model assumes 1,950 new hires between January 2010 and December 2015.

proposed tax exemptions are not projected to be necessary for LivingSocial to be able to pay its expenses and remain in operation from 2016 through 2025. The estimated real property tax liability and corporate franchise tax liability in these years are well below the projected taxable income of the company.

LivingSocial is a company that is still in start-up mode. To date, it has not made a profit. Despite current losses, investors have been willing to invest in the company's future growth. These investment dollars provide funds for LivingSocial to pay its current expenses, including real property taxes on the properties that it currently leases.

According to the financial information provided by LivingSocial, the company does not expect to have corporate franchise tax liability until calendar year 2015. Because it is so difficult to project the future earnings of a company in growth mode in a new industry, the OCFO has used the projections provided by LivingSocial. These projections show that LivingSocial will have at least $17.5 million in corporate franchise tax liability between FY 2016 and FY 2020 (which is the maximum amount of the Income Tax Credit). We have also assumed that the company will meet the 50 percent District resident requirement for the minimum required new hires (50 per year) in 2016 through 2020, allowing the company to take the full $17.5 million Income Tax Credit.

The Property Tax Credit is not dependent on the financial performance of the company. Rather it is tied to the number of employees hired between January 2010 and December 2015 who are District residents. The Property Tax Credit is capped at $15 million if at least 50 percent of new hires in this period are District residents. The Property Tax Credit is calculated by taking the total number of new hires (regardless of whether they are District residents) and multiplying that number by $10,000.[6] As a result, if 1,500 employees are hired between January 2010 and December 2015, LivingSocial would be eligible for $15 million in the Property Tax Credit, as long as 50 percent of those hires are District residents.

To be eligible for the maximum benefit of $17.5 million in the Income Tax Credit and $15 million in the Property Tax Credit, LivingSocial would need to hire 750 District residents between FY 2010 and FY 2015 and 125 District residents between FY 2016 and FY 2020.[7] Based on this analysis, the cost per District job of these two tax incentives is approximately $37,000. It is also important to note that the legislation does not provide a floor on the number of District residents hired. If less than 40 percent and as low as 0 percent of new hires are District residents, LivingSocial would still be entitled to $7.5 million in the Property Tax Credit and $9 million in the Income Tax Credit, for a total of $16.5 million. However, in order to achieve this benefit LivingSocial must comply with the other requirements listed in Section 1, above.

In addition to job creation, there may be additional benefits associated with the retention and expansion of the company in the District. If new employees locate their residences to the District, the District will receive individual income and/or real property taxes from these employees. Regardless of whether new employees live in the District, employees will likely spend money on dining, retail and entertainment in the District, bringing in additional sales tax revenues. Because

[6] The annual credit is 10 percent of the employee's salary, but it is capped at $5,000 per employee. The credit is available for the first two years after the employee is hired, which equates to $10,000 per employee hired.
[7] Because of the way the credits are calculated, the exact new hires numbers could vary. For example, LivingSocial could hire 1,950 new employees, 40 percent of whom are District residents.

LivingSocial is a global company with headquarters in the District, the District can expect some amount of hotel tax revenue from company employees who must visit from out of town.

Finally, the Council and the Mayor consider the multiplier effect of high technology companies located and expanding in the District. Many of the jobs associated with this industry are high-paying jobs for highly-skilled employees, who may potentially start or join other start-up companies or spin-off companies in the District.

Other Factors to Consider

Companies make locational decisions for a variety of reasons. Although the proposed exemptions are not necessary for LivingSocial to become a going concern, the tax incentives could be necessary to keep the company from locating outside of the District.

LivingSocial has informed the OCFO that the company has considered at least three different jurisdictions for the company's future growth. Since company officials have declined to disclose the alternative locations, it is impossible for the OCFO to compare location costs to LivingSocial. However, in order to provide the Council and the Mayor with some context, we have provided cost differentials for the District, suburban Virginia and suburban Maryland.

In general, rental costs, property tax rates and corporate income tax rates are higher in the District than in Virginia or Maryland. The following is a list of cost differentials for companies renting Class A Office space:

Jurisdiction	2011 Asking Rent Per Square Foot[8]	2011 All-In Office Property Tax Rate[9]	2010 Corporate Income Tax Rate[10]
DC Central Business District	$61	1.875%	9.975%
Chevy Chase/Bethesda, MD	$44	1.230%	7.000%
Silver Spring, MD	$29	1.455%	7.000%
Rosslyn, VA	$49	1.183%	6.000%
Tysons Corner/McLean, VA	$39	1.435%	6.000%

[8] Source: Cushman and Wakefield (see page 26 of the *DowntownDC Business Improvement District State of Downtown 2011 Report*)
[9] Source: see page 71 of the *DowntownDC Business Improvement District State of Downtown 2011 Report*
[10] Source: see page 19 of the Office of Revenue Analysis *Tax Rates and Tax Burdens: Washington Metropolitan Area 2010 Report*

The following table provides total cost differentials, assuming a company with $100 million in taxable income that rents 200,000 square feet of Class A office space:

Jurisdiction	Total Asking Rent	Assumed Property Tax Liability	Total Real Estate Costs	Income Tax Liability	Total Rent, Property Tax, Income Tax	One Year Differential
DC Central Business District	$12,200,000	$2,250,000	$14,450,000	$9,975,000	$24,425,000	$0
Chevy Chase/Bethesda	$8,800,000	$984,000	$9,784,000	$7,000,000	$16,784,000	($7,641,000)
Silver Spring	$5,800,000	$800,250	$6,600,250	$7,000,000	$13,600,250	($10,824,750)
Rosslyn	$9,800,000	$1,064,700	$10,864,700	$6,000,000	$16,864,700	($7,560,300)
Tysons Corner/McLean	$7,800,000	$861,000	$8,661,000	$6,000,000	$14,661,000	($9,764,000)

The total potential value of the tax credits provided in the proposed legislation is $32.5 million over ten years, beginning in FY 2016. In addition, assuming $9 million in purchases, $24 million in personal property and 315 new hires eligible for relocation credits, the existing Qualified High Technology incentives could save LivingSocial approximately $5 million beginning in FY 2015.[11]

Based on the analysis above, it is possible to state that the proposed exemptions could help the District to alleviate a good portion of the cost burden of locating in the District. However, research indicates that companies rarely make locational decisions based solely on cost. The District has a number of tangible and intangible benefits for a company locating within its borders. In addition to access to an extremely high quality labor pool (with access to District, Maryland and Virginia residents) and proximity to key Congressional decision-makers, the District offers companies a vibrant, urban work environment, with excellent transportation, dining and retail options. Companies often weigh all of these factors when making locational decisions.

The $32.5 million in potential subsidies proposed in the Act may be necessary to induce LivingSocial to locate its new headquarters in the District and, therefore, entice new employees and create new and permanent jobs for District residents. However, without fully understanding the criteria LivingSocial is using to make its locational decision or knowing which other cities are in contention, the OCFO cannot state definitively that these subsidies are required.

[11] All numbers in the comparative analysis do not take present value into account.