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The San Francisco Proposition E Gross Receipts Tax Ordinance: A Mixed Bag for Investment Fund Managers

By Gregory J. Hartker, Ronald J. Reigstad

On November 6, 2012, San Francisco residents approved Proposition E (the "Gross Receipts Tax Ordinance") instituting a new gross receipts tax to replace the City's 1.5% payroll tax. The new gross receipts tax is phased in over a five-year period, beginning in 2014, as the current payroll tax is phased out. For managers and general partners of investment funds engaging in business in San Francisco, the enactment of the ordinance is a mixed bag. While there is some comfort that the ordinance exempts receipts of the underlying investment funds for purposes of the potential application of the tax to such funds, there is some unfavorable statutory language that would subject the manager's management fee and will likely subject performance allocations to the tax.

General Rule

Under the Gross Receipts Tax Ordinance, subject to certain exceptions, every person engaged in business within the City of San Francisco is required to pay an annual tax measured by such person's gross receipts from all taxable business activities attributable to the City of San Francisco. The term gross receipts is defined broadly to include "all amounts received by a person from whatever source derived" including all amounts that constitute gross income for federal income tax purposes. Section 952.3(a).[1] The Gross Receipts Tax Ordinance provides that the tax rates applicable to financial services activities range from 0.400% for gross receipts up to $1,000,000 to 0.560% for gross receipts above $25,000,000.

The Impact of the Tax on Funds

The Gross Receipts Tax Ordinance has a few carve-outs that apply to investment funds. For example, "gross receipts" do not include "investment receipts." Investment receipts generally include interest, dividends, capital gains and other amounts received on account of financial instruments and distributions from business entities, provided such items are derived exclusively from the investment of capital and not from the sale of property other than financial instruments, or from the provision of services, to any person. Further, "gross receipts" do not include the amount received on issuance of financial instruments (which term includes rights to participate in the assets of any business). Thus, regardless of where the investment manager or general partner conducts business, investment funds and feeder entities should generally not be subject to tax (i) on the receipt of proceeds upon the issuance of equity in connection with the capital raise or subsequent capital calls or (ii) upon the sale of the underlying securities or financial instruments.

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[1] Unless otherwise indicated, all section references are to the City of San Francisco's Business and Tax Regulations Code.

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The Impact on General Partner/Investment Advisor Receipts

With respect to income or returns to the general partner and/or investment advisor, the language of the Gross Receipts Tax Ordinance is not helpful, and, in some cases, produces uncertainty for investment advisors. For one, there is no specific carve-out for management fee type income.

There is an exception to the definition of gross receipts for allocations of income or gain, or distributions from an entity treated as a partnership or pass-through for federal income tax purposes. However, this exception only applies if such allocations or distributions are "derived **exclusively** from an investment in such entity and not from…any services provided to such entity." Section 952.3(e) (emphasis added). Although this language protects the returns of fund investors/limited partners, any allocations or distributions relating to the carried interest or promote of the general partner or investment advisor, will likely constitute includible gross receipts, since they are typically not derived as a result of a non-service related activity.

More troubling is the situation where the same general partner entity not only has a carried interest in an investment fund but also has made a capital investment in the fund. Under general partnership tax rules, a partner is generally treated as having one unified partnership interest. It is not clear whether, for purposes of the gross receipts tax, a distribution or allocation can be traced so that the general partner can treat a portion of its return as derived from its capital investment and a portion as attributable to the carried interest. For those familiar with the federal carried interest legislative proposals, this is an issue of great focus and interest.

Gross Receipts Tax Effective Date

Although the tax becomes operative as of January 1, 2014, it will be phased in, and the existing payroll expense tax will be phased out, incrementally over a five-year period. From 2014 to 2018, the gross receipts tax rates will be set annually by multiplying the maximum rates listed above by phase-in factors ranging from 10% in 2014 to 100% in 2018. Over the same period, the payroll expense tax rate will be phased out to 0%, provided that the gross receipts tax achieves certain specified revenue targets.

Practice Tips and Highlights

- The gains and income of most investment fund vehicles will generally be exempt from the tax.
- The management fees received by the investment managers or general partners will be treated as includible gross receipts for purposes of the tax. In addition, converting a management fee into a special allocation of fund income would likely not qualify such allocations from exclusion from the definition of gross receipts.
- Investment advisors should consider having a separate entity (which would not be considered to be engaged in business in San Francisco) hold and receive the carried interest, especially if the investment advisor is making a capital investment into the fund. This is yet another reason to have a separate entity hold the carry. Investment advisors may also consider funding the carried interest with proceeds from a loan and whether the cost/interest outweighs any potential for exclusion.
- The Gross Receipts Tax Ordinance grants the Board of Supervisors the authority to amend the ordinance without a vote of the people. Thus, there is still a potential opportunity for voices to be heard regarding the interpretation or application of the ordinance.

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Authors:

Gregory J. Hartker
greg.hartker@klgates.com
+1.949.623.3518

Ronald J. Reigstad
ron.reigstad@klgates.com
+1.949.623.3575

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