Client Alert.

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Update on San Francisco's Proposed New Business Tax Scheme

By Thomas Steele, Peter Kanter and Kirsten Wolff

In our Client Alert, dated April 28, 2010, we described two proposals to change the payroll expense tax system in the City and County of San Francisco. The first proposal would replace the current payroll expense tax with a gross receipts tax (the "Gross Receipts Tax"). The second proposal would modify the existing payroll expense tax to separate the taxable payroll into two rate brackets based on the amounts earned by individual employees (the "Progressive Payroll Tax"). Both proposals would include a new gross receipts tax on real estate commercial rents which the City intends will be passed through to tenants.

On June 7, the City Controller's Office published a report, "Improving San Francisco's Business Tax: An Analysis of Two Alternatives" (the "Final Report"), analyzing the two alternatives and modifying certain terms of the proposals. We summarize the most significant changes to the proposals below. The Final Report is available on the City's website. On June 8, Supervisor Chiu introduced a proposed ordinance to the Board of Supervisors setting out the details of a two-tiered progressive payroll expense tax that differs in certain respects from the proposal outlined in the Final Report. We summarize the terms of the proposed ordinance below. It is anticipated that a separate proposal will be introduced with the new gross receipts tax.

THE FINAL REPORT

The Final Report proposes a Progressive Payroll Tax that would impose tax at the rate of 1.5% on payroll for employees earning more than $85,000 and at the rate of 1.3% on payroll for employees earning less than $85,000. In addition, consistent with our prior Client Alert, under the Final Report's proposal, the City would impose a tax on commercial rent at the rate of 1.395%.

The Final Report modifies the proposed Gross Receipts Tax in several respects: First, in the case of "corporate headquarters" operations, the Final Report would not impose a tax on gross receipts at all, but rather would retain the payroll expense tax at the rate of 1.4%. According to the Final Report, the purpose of this special tax on corporate headquarters is to avoid the difficulty of apportioning the gross receipts from a company's operations to its headquarters. Second, the Final Report changes a variety of the tax rates proposed for individual industry sectors. For example, under the Final Report, financial activities would be subject to Gross Receipts Tax at a rate of 0.350%, instead of the previously proposed rate of 0.085%. Similarly, under the Final Report, the leisure and hospitality industry would be subject to Gross Receipts Tax at the rate of 0.375%, which represents an increase over the previously proposed rate of 0.175%. By contrast, the Final Report proposes to tax gross receipts in the business and professional services sector at the rate of 0.525%, which represents a reduction from the previously proposed rate of 0.575%. Further, like the Progressive Payroll Tax proposal, the Gross Receipts Tax proposal includes a tax on commercial rent at the rate of 1.395%.

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Finally, the Final Report introduces a credit—applicable to both the Progressive Payroll and the Gross Receipts Taxes—of up to $1,500 to be taken by every taxpayer each year.

THE PROGRESSIVE PAYROLL TAX ORDINANCE

Supervisor Chiu's proposed ordinance (the "Ordinance") adopts the basic structure of the Progressive Payroll Tax as proposed in the Final Report, but modifies certain aspects of that proposal. The Ordinance, following the Final Report, introduces a tax on commercial rent, but increases the rate to 1.895%. In addition, the Ordinance would phase in the commercial rent tax by imposing it at the rate of 0.632% in 2011, at the rate of 1.263% in 2012, and at the full rate of 1.895% in 2013 and subsequent years.

The Ordinance would separate the payroll expense tax into two rate brackets: payroll for employees earning more than $85,000 would be subject to tax at the rate of 1.5%, and payroll for employees earning $85,000 or less would be subject to tax at a rate of up to 1.2%. For the years 2011 through 2014, the Ordinance sets out a complex formula that fixes the applicable rate for the lower bracket for each year. The formula to determine the lower bracket rate for a given year is based in part on the amount of revenue the City actually collects in commercial rent tax for prior years. The rate as determined by this formula for 2014 will persist as the applicable rate for 2015 and subsequent tax years.

Finally, the Ordinance retains the tax credit proposed in the Final Report, but phases this credit in over a three-year period, so that taxpayers would be permitted a credit in the amount of $500 in 2011, $1,000 in 2012, and $1,500 in 2013 and subsequent years.

It still remains to be seen whether Supervisor Chiu's proposed ordinance—or an alternative ordinance that would impose the Gross Receipts Tax—will appear on the November ballot. As we noted in our previous Client Alert, the California Constitution prohibits the City from imposing, extending, or increasing a general tax without a majority vote of the electorate. Cal. Const. art. XIIIC §§ 2(b), (d). Accordingly, the City cannot adopt Supervisor Chiu's ordinance or any other similar ordinance without first going to the voters. We cannot predict the developments that might take place before or as a result of the November election, but we will continue to monitor those developments and provide updates as appropriate.

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