Client Alert.

April 28, 2010

Proposed New San Francisco Business Tax Scheme

By Thomas H. Steele, Peter B. Kanter, and Kirsten Wolff

The City and County of San Francisco, like many jurisdictions throughout California and the U.S., is facing a huge budget shortfall. For fiscal year 2010-11, the City Controller's Office projects that the shortfall will total nearly $483 million. For fiscal year 2011-12, the cumulative projected shortfall will reach $787 million. In the face of this budgetary crisis, San Francisco is exploring ways to raise additional revenue, including modifying the tax regime for businesses.

Currently, San Francisco imposes a payroll expense tax on every entity engaging in business in the City at the rate of 1.5% of the portion of the entity's payroll expense attributable to the City. See S.F. Bus. & Tax Regs. Code Art. 12-A §§ 903, 903.1, 904.

According to a draft report from the Controller's Office, the City is considering two alternative proposals to modify or replace the existing payroll expense tax.

A GROSS RECEIPTS TAX

The first proposal would replace the payroll expense tax with a gross receipts tax. Businesses would be subject to the gross receipts tax at one of several different rates that vary by industry, ranging from 0.050% for retail trade to 0.575% for business and professional services. For example, businesses in the leisure and hospitality sector would pay at the rate of 0.175% and those engaged in financial activities would be taxed at 0.085%. It appears that businesses that are currently exempt from the current payroll expense tax (e.g., banks and financial corporations, non-profit organizations, and certain small businesses) would also be exempt from the new gross receipts tax. The proposed gross receipts tax would extend to businesses in the Presidio and sole proprietorships (both currently not taxed), but would raise the exemption threshold for small businesses.

In addition – and perhaps most significantly – the proposal would tax gross receipts from commercial rent at the rate of 1.395%. The tax on commercial rent presumably would be passed on to tenants by their landlords. Thus, even exempt businesses would shoulder a portion of the burden of the tax on commercial rent by way of an increase in their rent. The Controller's report seems to show that most of the additional revenue that the City estimates it will receive under the new gross receipts tax would come from commercial rent tax passed on to businesses that do not currently pay the payroll expense tax.

A PROGRESSIVE PAYROLL TAX

The second alternative proposal described in the Controller's report would retain the current payroll expense tax but would separate the taxable payroll into two rate brackets: payroll for employees earning more than $85,000 would be taxed at the current rate of 1.5% and payroll for employees earning less than $85,000 would be taxed at a reduced rate of 1.2%. In addition, the City would impose a tax on commercial rent, as described above, at the rate of 1.395%.

The modified payroll expense tax would include an increased exemption for small businesses and would apparently retain the exemptions currently in place, including, e.g., the exemptions for banks and financial corporations, as described above.

The Controller estimates that the City will raise the same amount of revenue from the commercial rent tax, whether it is imposed in conjunction with the gross receipts tax or with the two-bracket payroll expense tax. However, the Controller projects that the modified payroll expense tax proposal will raise more additional revenue overall (approximately $29 million) than the gross receipts tax proposal ($20 million).

One of these proposals may well appear (perhaps in a substantially modified form) on the November ballot. Because the California Constitution prohibits the City from imposing, extending, or increasing a general tax without a majority vote of the electorate (or a two-thirds vote for a special tax), the City cannot act without first going to the voters. Cal. Const. art. XIIIC §§ 2(b), (d). Of course, given the uncertainties inherent in election outcomes, we cannot predict whether or if either of these proposed new tax schemes will ultimately apply to businesses in San Francisco. Nevertheless, in light of the potentially substantial changes to San Francisco's business tax environment, we will continue to monitor the development of these proposals.

Contact:

Thomas H. Steele	**Peter B. Kanter**	**Kirsten Wolff**
(415) 268-7039	(415) 268-6005	(415) 268-6638
tsteele@mofo.com	pkanter@mofo.com	kwolff@mofo.com