

San Francisco Voters Pass New Gross Receipts Tax; Current Payroll Expense Tax To Be Phased Out

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Overview

The voters of San Francisco (the “City”) recently approved Proposition E, a gross receipts tax that will be phased in over five years beginning in 2014.¹ This gross receipts tax will gradually replace the existing 1.5% payroll expense tax, which will be phased out by 2018 other than as applied to administrative offices. During the five-year phase-in period taxpayers will pay both the payroll tax and gross receipts tax. As with the current payroll tax, the new gross receipts tax is imposed at the entity level on the person “engaging in business” within the City.² Each separate business activity is assigned to one of seven industry classifications,³ which determine the applicable tax rates, apportionment methodology and, in certain cases, special industry-related rules.⁴

The new gross receipts tax appears to be unique among jurisdictions that impose a tax of this nature in that the new tax is based on the gross receipts of all members of the California worldwide combined unitary group, or the water’s-edge unitary group if there is a water’s-edge election in effect.⁵ Receipts received from a related entity that is part of the same combined unitary group for California income tax purposes are excluded.⁶ Gross receipts are then apportioned based on the location of the property, payroll, or the benefit received - or some combination of these factors.⁷ There are a number of exemptions and exclusions from the gross receipts tax such as for small businesses with San Francisco gross receipts under \$1 million.⁸

In this Tax Alert we highlight some of the key features of the new gross receipts tax.

Definition of Gross Receipts

The term “gross receipts” is defined broadly in the San Francisco ordinance. It includes, “the total amounts received or accrued by a person from whatever source derived, including, but not limited to, amounts derived from sales, services, dealings in property, interest, rent, royalties, dividends, licensing fees, other fees, commissions and distributed amounts from other business

¹ Proposition E, San Francisco Gross Receipts Tax Ordinance Article 12-A-1 (“Gross Receipts Tax Ordinance”), approved by voters on November 6, 2012.

² Gross Receipts Tax Ordinance §953(a), (b) and (d). San Francisco. Bus. & Tax Reg. Code § 6.2-12, 15. “Person” is defined broadly to include any individual, company, flow-through, or other legal entity.

³ Gross Receipts Tax Ordinance §§ 953.1 to 953-7 and 952.4. The business activities are based on definitions and descriptions from the North American Industry Classification System (“NAICS”). The NAICS code is used by the federal government to classify business establishments.

⁴ Additionally, there are special rules for businesses with activities that may be described in more than one industry classification. Gross Receipts Tax Ordinance § 953.9.

⁵ Gross Receipts Tax Ordinance § 956.3. For instance, the Los Angeles gross receipts tax is based on the receipts attributed to the location in Los Angeles, on a separate accounting basis. Los Angeles does not contain a unitary concept. Therefore, the San Francisco gross receipts tax differs greatly from Los Angeles.

⁶ Gross Receipts Tax Ordinance § 952.3(d). The term “related” is defined in Gross Receipts Tax Ordinance § 952.5 by reference to the California unitary group per Cal. Rev. & Tax Code § 25102 *et seq.*

⁷ Gross Receipts Tax Ordinance § 956.

⁸ Gross Receipts Tax Ordinance § 954.1(b)(1). Although small businesses are exempt from the tax, they are still required to register and pay a registration fee.

entities.⁹ The definition also includes “all amounts that constitute gross income for federal income tax purposes” at the time such receipts are recognized as gross income for federal income tax reporting purposes.¹⁰

Gross receipts do not include any federal, state or local tax on retail sales, regardless of whether the tax is separately stated or included as part of the sales price.¹¹ Federal, state or local taxes that are either refunded or reimbursed are also excluded from the definition of gross receipts as well as any third-party taxes that a taxpayer collects from or on behalf of the taxpayer’s customers and remits to the appropriate governmental entity.¹²

Gross receipts generally include the receipts of all related entities; however, receipts between members of the same combined unitary group (determined for California corporate income tax purposes) are excluded.¹³ Because partnerships, flow-through entities, and other non-unitary affiliates do not generally file combined, they may not be considered related for purposes of the exclusion. Regardless, “Gross receipts shall not include any allocations of income or gain, or distributions (such as dividends, interest and other returns on capital) from an entity treated as a pass-through entity for federal income tax purposes, provided such allocations or distributions are derived exclusively from an investment in such entity, and not from any other property sold to, or services provided to, such entity.”¹⁴

Nexus and Filing Obligations

Proposition E incorporates the same nexus standards as exist currently for the payroll tax.¹⁵ The gross receipts tax is a privilege tax imposed upon a person engaging in business within the City. A person is considered “engaged in business” within the City if that person through their own activity (or the activity of an employee, representative or agent) meets one of the following conditions:¹⁶

- Maintains a fixed place of business in the City;
- Owns, rents, leases or hires real or personal property in the City for their benefit;
- Employs or loans capital on property within the City for benefit of the person;
- Solicits business, performs work, renders service or utilizes the streets in connection with the operation of motor vehicles for business purposes within the City for all or part of any seven days during the tax year;¹⁷
- Exercises corporate or franchise powers within the City for the benefit or partial benefit of the person;¹⁸ or
- Liquidates a business when the liquidator thereof holds themselves out to the public as conducting such business.¹⁹

Any one of the above scenarios creates nexus and therefore results in a registration and filing obligation. As mentioned previously, the returns must be filed on a combined basis with all of that person’s related entities that constitute a combined group.²⁰

Safe Harbors

A person shall *not* be deemed to be engaged in business in the City, and thus will not be required to register or file for gross receipts tax purposes, if that person’s activities within the

⁹ Gross Receipts Tax Ordinance § 952.3(a).

¹⁰ *Id.*

¹¹ Gross Receipts Tax Ordinance § 952.3(c).

¹² *Id.*

¹³ Gross Receipts Tax Ordinance § 952.3(d), describing exclusion of certain related-party transactions. Gross Receipts Tax Ordinance §§ 952.5 (defining a “related entity”) and 956.3 (explaining required combined filing).

¹⁴ Gross Receipts Tax Ordinance § 952.3(d).

¹⁵ S.F. Bus. & Tax Reg. Code § 6.2-12.

¹⁶ S.F. Bus. & Tax Reg. Code § 6.2-12(a), (b).

¹⁷ S.F. Bus. & Tax Reg. Code § 6.2-12(f), (g), (h).

¹⁸ S.F. Bus. & Tax Reg. Code § 6.2-12(i).

¹⁹ S.F. Bus. & Tax Reg. Code § 6.2-12(j).

²⁰ Gross Receipts Tax Ordinance § 956.3.

City consist solely of one or more of the following:

- 1) Using the services of any unrelated investment advisor or affiliate;
- 2) Maintaining documents of formation, incorporation or registration within the City;
- 3) Being an owner, member, or other participant in a pass-through entity (for federal income tax purposes) engaging in business within the City; or
- 4) Having trustees or directors who meet or reside within the City.²¹

Exclusions, Exemptions and Credits

Investment receipts are generally excluded so long as they are derived exclusively from the investment of capital and not from the sale of property or from the provision of services.²²

In certain instances, the cost to acquire the underlying asset may be excluded. For example, gross receipts from the “sale or exchange of stocks or other similar written instruments evidencing a right to participate in the assets of any business, or of bonds or other evidence of indebtedness, or of any other marketable securities (... referred to ... as financial instruments), do not include the cost to acquire the financial instrument(s).”²³

Receipts from the sale, lease or rental of real property located *outside* San Francisco may be excluded entirely.²⁴ Also, receipts from the sale of real estate located *within* San Francisco may be excluded entirely if San Francisco real property transfer tax is paid.²⁵ If not, the cost to acquire such real property (cost basis) is excludable.²⁶

As noted previously, the new law exempts small business from payment of the gross receipts tax, but not from the payment of the annual registration fees.²⁷ A “small business” is described as any entity whose gross receipts within the City for the preceding tax year did not exceed \$1 million.²⁸

Proposition E continues to recognize the two new jobs incentives that are in the current payroll tax, namely, the San Francisco Enterprise Zone credit and the Mid Street Market credit.²⁹

There appears to be no continued exclusion, however, for businesses located within the San Francisco Presidio. The City Attorney has opined that the current payroll tax does not apply to businesses operating within federal enclaves such as the Presidio.³⁰ However, the City Controller has stated at public meetings the City’s view that the current exclusion does not extend to a gross receipts tax.

To avoid double-taxation, Proposition E provides for a dollar-for-dollar credit to the extent the taxpayer is subject to a similar gross receipts tax in another tax jurisdiction.³¹

Finally, nonprofits and tax-exempt organizations are exempt from the tax and registration fees unless the organization is also engaged in an unrelated trade or business in San Francisco.³²

Rates and Apportionment

Proposition E requires that all businesses in San Francisco be classified into one or more of the following industry classifications and subject to the following tax rates and apportionment methodologies:³³

²¹ Gross Receipts Tax Ordinance § 952.3(g).

²² Gross Receipts Tax Ordinance § 952.3(d).

²³ Gross Receipts Tax Ordinance § 952.3(e).

²⁴ Gross Receipts Tax Ordinance §§ 956.1(b) and 953.7(c).

²⁵ Gross Receipts Tax Ordinance § 954(e).

²⁶ Gross Receipts Tax Ordinance § 952.3(e).

²⁷ Gross Receipts Tax Ordinance § 954.1(a).

²⁸ Gross Receipts Tax Ordinance § 954.1(b).

²⁹ Gross Receipts Tax Ordinance §§ 960 and 961.

³⁰ *Opinion No. 2002-02, City and County of San Francisco City Attorney Memorandum* (January 29, 2002).

³¹ Gross Receipts Tax Ordinance § 954(g).

³² Gross Receipts Tax Ordinance § 954.

³³ Gross Receipts Tax Ordinance § 953. These sections also have descriptions of what constitutes the specified industry activities.

Industry Classification	NAICS Code	Tax Rate (range) ³⁴		Apportionment Methodology		
		Low	High	Payroll	Where Benefit Received / Receipts	Location of Real Property
Retail and Wholesale Trade ³⁵	42, 44, 45,	0.075%	0.160%	x	x	
Certain Miscellaneous Services ³⁶	811, 812, 813	0.075%	0.160%	x		
Manufacturing; Transportation and Warehousing; Information; Biotechnology; Clean Technology; and Food Services. ³⁷	31, 32, 33, 48, 49, 51, 722	0.125%	0.475%	x	x	
Accommodations ³⁸	721	0.300%	0.400%			x
Utilities ³⁹	22	0.300%	0.400%	x	x	
Arts, Entertainment and Recreation ⁴⁰	71	0.300%	0.400%	x		
Education, Health and Administrative Services ⁴¹	56, 61, 62	0.525%	0.650%	x		
Construction ⁴²	23	0.300%	0.450%	x	x	
Financial, Insurance and Professional Services ⁴³	54, 521, 522, 523, 524	0.400%	0.560%	x		
Real Estate, Rental and Leasing ⁴⁴	53	0.285%	0.300%			x

³⁴ The tax rate range is based on the incremental amount of gross receipts, with the highest rate applicable to gross receipts in excess of \$25 million.

³⁵ Gross Receipts Tax Ordinance § 953.1.

³⁶ *Id.*

³⁷ Gross Receipts Tax Ordinance § 953.2.

³⁸ Gross Receipts Tax Ordinance § 953.3.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Gross Receipts Tax Ordinance § 953.4.

⁴² Gross Receipts Tax Ordinance § 953.5. The gross receipts from construction are reduced by any amounts that were included in a person's gross receipts allocated to real, personal, tangible and intangible property under Gross Receipts Tax Ordinance § 956.1.

⁴³ Gross Receipts Tax Ordinance § 953.6.

⁴⁴ Gross Receipts Tax Ordinance § 953.7.

As noted in the foregoing chart, the City does not use the traditional three-factor apportionment formula that is used by many states. Rather, the apportionment rules depend on the industry classification. For example, entities classified within the “financial services” NAICS codes apportion unitary gross receipts using a single payroll factor - payroll in San Francisco over payroll everywhere. Payroll generally refers to compensation for services paid to employees. Compensation paid to owners, members or partners of flow-through entities is not included in payroll apportionment for purposes of the gross receipts tax, except for flow-throughs with no employees.⁴⁵ Businesses classified as “real estate” under NAICS code 53 do not generally apportion their receipts. Rather, they allocate only receipts from real property located in San Francisco.

Multiple Business Activities

If a person or combined group engages in multiple business activities, the gross receipts tax rates are determined based on specific calculations depending on the types of businesses. This is modified depending on if more than 80 percent of the gross receipts are from one of the business activities or if less than 20 percent is from the set of business activities. If more than 80 percent of the person’s gross receipts are from only one of the aforementioned business activities, then the rules applicable to that predominant activity will apply to all of the person’s gross receipts derived from all business activities (in and out of San Francisco).⁴⁶ On the other hand, if the person’s business activities in San Francisco are derived from multiple businesses where less than 20 percent of the total gross receipts are generated from the aforementioned industries in Sections 953.1 through 953.7, then the receipts and payroll of any such set of activities may be combined for all purposes related to computing the gross receipts tax in accordance to whichever set of activities are taxed at the highest rate.⁴⁷

Administrative Office Tax

Administrative offices (i.e., administrative headquarters) continue to be subject to a payroll tax at a 1.4% rate, in lieu of the gross receipts tax. An administrative office exists when over 50% of the total combined payroll expense within the City of that person and its related entities for the preceding tax year was associated with providing administrative or management services exclusively to that person or such related entities. Administrative or management services include support services provided on an enterprise-wide basis, such as: executive office oversight, company business strategy, recordkeeping, risk management, personnel administration, legal, accounting, market research and analysis, and training services. The administrative office tax only applies to large taxpayers where:

- The total combined number of U.S. employees of the person and its related entities as of the last day of the preceding tax year exceeded 1,000; and
- The total combined gross receipts of the person and its related entities reported on the federal income tax return(s) for the preceding tax year exceeded \$1 billion.⁴⁸

Transition Period: The Past and (Fading) Future of the Payroll Expense Tax

San Francisco has imposed a tax on payroll in one form or another since 1970.⁴⁹ Up until the passage of Proposition E, San Francisco was the only major city in California that continued to

⁴⁵ Currently, the payroll expense tax imposes taxes on partner compensation for personal services. Proposition Q, which was passed in 2008, had extended the applicability of payroll expense tax to include compensation for personal services paid to owners of flow-throughs. Proposition Q is currently in litigation. The new gross receipts tax omits this concept, except for partnerships with no employees. In such cases, the “owners or proprietors shall be treated as individuals to whom compensation is paid for purposes of” payroll apportionment.” Proposition Q’s tax on “partner compensation for services” continues to apply to the current payroll tax during the phase-out period.

⁴⁶ Gross Receipts Tax Ordinance § 953.9(a).

⁴⁷ See, Gross Receipts Tax Ordinance § 953.9(b) for specifics on the multiple business activity computation. Specifically, § 953.9(b)(4) states “the applicable rate for each set of business activities shall be determined in numbered order of the Sections describing each set of business activities; i.e., the gross receipts and tax for business activities described in Section 953.1 should be determined first, Section 953.2 second, and so on....”

⁴⁸ Gross Receipts Tax Ordinance § 953.8(b).

impose a payroll tax. The gross receipts tax will be completely phased in by 2018.⁵⁰ Beginning in 2014 and during the period of phase out, businesses will pay *both* the payroll tax and the gross receipts tax in relative proportion to each other.⁵¹ Other than as applied to administrative offices, the payroll tax will completely phase out by 2018.

Registration Fee

Every person or entity who “engages in business” in San Francisco is required to apply for a registration certificate and pay an annual registration fee ranging from \$75 to \$35,000, based on the amount of gross receipts⁵² attributable to San Francisco, in addition to the tax itself. A combined unitary group would apply for a single business license certificate and calculate its annual registration fee on combined unitary gross receipts attributable to San Francisco.⁵³

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⁴⁹ Prior to 2001, San Francisco maintained an alternative-measure business tax, consisting of a 1.5% payroll tax and a varying rate gross receipts tax. Every company doing business within the city calculated its tax payment under each system and paid whichever amount was higher. In response to litigation, San Francisco abandoned the gross receipts prong of the tax in 2001.

⁵⁰ Gross Receipts Tax Ordinance § 959.

⁵¹ Gross Receipts Tax Ordinance § 952.3(d). The gross receipts tax imposed under Art 12-A-1 is in addition to the payroll expense tax under Article 12-A. The manner in which the phase-out of the payroll tax expense may be accelerated is beyond the scope of this Alert.

⁵² Please note that from July 1, 2014 to June 20, 2015, the registration fee is based on payroll expense. Gross Receipts Tax Ordinance § 855(c).

⁵³ Gross Receipts Tax Ordinance § 856.