

San Francisco Tax Update

Overview

Beginning January 1, 2019, a number of tax law changes will become effective in the City of San Francisco (the "City"). Two of these resulted from recent voter-enacted initiatives, notably:

- The Homelessness Gross Receipts Tax, which was passed on the November 6, 2018 ballot, is imposed on the gross receipts of a business above \$50,000,000 that are attributable to the City. The monies raised are intended to fund services for the homeless. The Homelessness Gross Receipts tax is in addition to, and incorporates the rules, of the existing City Gross Receipts Tax ("GRT"); and
- The Commercial Rents Tax, which passed on the June 5, 2018 ballot, is imposed on the gross receipts earned from a lease or sublease, at the rates of 3.5% for commercial space and 1% for warehouses and industrial space in the City. The monies raised are intended to fund early child care and education.

In addition, the City enacted an economic presence nexus rule, whereby a remote seller or service provider with more than \$500,000 in annual gross receipts attributable to the City will be considered as "engaging in business within the City", and therefore subject to registration and gross receipts tax filing requirements.¹

Finally, the City also announced that the Payroll Expense Tax, which was originally scheduled to phase out in 2018 will remain in place at the rate of 0.38%.

This tax alert summarizes these law changes.

Homelessness Gross Receipts Tax

The Homelessness Gross Receipts Tax imposes an annual tax, in addition to the existing GRT, on San Francisco taxable gross receipts above \$50,000,000.² Otherwise, the tax base is the same as the existing GRT. Like the GRT, the tax rate depends on the type of business activity from which the gross receipts are earned, as follows:³

Business Activity Set	Tax Rate
Section 953.1: RETAIL TRADE; WHOLESALE TRADE; AND CERTAIN SERVICES.	0.175%
Section 953.2: MANUFACTURING; TRANSPORTATION AND WAREHOUSING; INFORMATION; BIOTECHNOLOGY; CLEAN TECHNOLOGY; AND FOOD SERVICES	0.500%
Section 953.3: ACCOMMODATIONS; UTILITIES; AND ARTS, ENTERTAINMENT AND RECREATION	0.425%

¹ Proposition D was passed as part of the Cannabis Business Tax, Article 30 (appearing on the ballot Nov. 2018).

² Proposition C, Homelessness Gross Receipts Tax Ordinance, Article 28, Sec. 2804 (appearing on the ballot Nov. 2018).

³ *Id.*

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Section 953.4: PRIVATE EDUCATION AND HEALTH SERVICES; ADMINISTRATIVE AND SUPPORT SERVICES; AND MISCELLANEOUS BUSINESS ACTIVITIES.	0.690%
Section 953.5: CONSTRUCTION.	0.475%
Section 953.6: FINANCIAL SERVICES; INSURANCE; AND PROFESSIONAL, SCIENTIFIC AND TECHNICAL SERVICES.	0.600%
Section 953.7: REAL ESTATE AND RENTAL AND LEASING SERVICES.	0.325%

Gross receipts that are subject to the Commercial Rents Tax are exempt from the Homelessness Gross Receipts Tax.⁴

Certain taxpayers with over \$1b of revenue and 1,000 employees in the United States who are subject to the existing Administrative Office Tax are also exempt. In lieu of both the new Homelessness Gross Receipts Tax and the existing GRT, any taxpayer who meets the definition of an "Administrative Office" is now subject to a total payroll tax of 3.28% on payroll expense attributable to the City.⁵

Commercial Rents Tax

Effective January 1, 2019, San Francisco joins the New York City borough of Manhattan in imposing a commercial rents tax.⁶ Unlike Manhattan, San Francisco's Commercial Rents Tax will be imposed on the landlord, not the tenant.⁷ Gross receipts from a lease (or sublease) will be taxable at the following rates:⁸

- 3.5% tax on gross receipts from the lease of commercial space; and
- 1% tax on gross receipts from the lease of warehouse space.

The term "lease" is not defined. However, the Commercial Rents Tax incorporates⁹ many of the definitions from the existing GRT rules, including a broad general definition of "gross receipts" as:

- All amounts that constitute gross income for federal income tax purposes including amounts derived from services, dealings in property, interest and rents; and
- Payments for any services that are part of the lease or rental, whether received in money or otherwise, that are paid to, on behalf of, or for the benefit of, the lessor, and all receipts, cash, credits, property of any kind or character and the fair market value of services so paid or rendered by the lessee.¹⁰

The City recently released a proposed regulation intended to clarify the treatment of certain costs that landlords may pass through to tenants, depending on the type of lease, as follows:

All amounts received from the lease of commercial space in properties in the City, including without limitation, property taxes, insurance premiums, maintenance costs, and other charges passed on to

⁴ Article 28, S.F. Bus. & Tax Reg. Code. at Sec. 2805(c).

⁵ Consisting of a 1.4% Administrative Office Tax, 1.5% Homelessness Tax and .38% Payroll Expense Tax.

⁶ NYC Admin. Code, Title 11, Chapter 7, Enabling Act: Chapter 257 of the Laws of 1963. Commercial rent taxes are also found in certain jurisdictions in Arizona and the state of Washington.

⁷ Article 21, S.F. Bus. & Tax Reg. Code. at Sec. 2104(b)(1)- (2).

⁸ Amounts are included in the tax base only to the extent the receipts are not excluded from the definition of "gross receipts" under Article 12-A-1 of the Business and Tax Regulations Code.

⁹ Article 21, S.F. Bus. & Tax Reg. Code. at Sec. 2104(a).

¹⁰ Article 12-A-1, S.F. Bus. & Tax Reg. Code, Sec. 952.3(a) and (b).

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tenants, are gross receipts that are subject to the ... Commercial Rents Tax, to the extent not excluded from the definition of “gross receipts” under [the GRT].¹¹

It should be noted that the GRT does exclude “any federal, state or local tax imposed upon a person for which that person is reimbursed by means of a separately stated charge to a purchaser, lessee, licensee or customer.”¹² This local tax exclusion would appear to include reimbursements of property taxes, the GRT and the Commercial Rent Tax itself. There are also exemptions for small businesses exempt from the existing GRT, residential real estate, industrial use, art activities and retail sales or services that are not chain stores.¹³

State constitutional challenges raised regarding the validity of the voter initiatives

The Commercial Rents Tax and Homelessness Gross Receipts Tax are both local ballot initiatives that voters passed by a simple majority. Both taxes have attracted legal challenges based on the recent court decision in *California Cannabis Coalition v. City of Upland*,¹⁴ which held that initiatives placed on the ballot with the required number of signatures only need a simple majority rather than the two-thirds supermajority approval required under the California Constitution and Proposition 218.¹⁵ City officials have announced that they will seek to resolve the legal uncertainty surrounding the legislation.¹⁶

Economic presence nexus

Formerly, the term “engaging in business in the City” generally required a physical presence in the City, through maintaining a fixed place of business, utilizing the streets of San Francisco, or persons, employees or representatives rendering services or soliciting business for more than seven days during a tax year.¹⁷

Effective January 1, 2019, the term “engaging in business in the City” is expanded to include an economic nexus standard, set at \$500,000 or more of in annual gross receipts from sales to customers located within the City.¹⁸ If this new economic nexus standard applies, a remote seller or service provider would be required to register with the City as well as to determine whether the Homelessness Gross Receipts Tax, the existing GRT or any other City tax applies. The small business exemptions are still in effect and taxpayers with less than \$300,000 in City payroll expense and \$1,090,000 in City gross receipts are not subject to each tax, however they are still required to register and pay the annual registration fee.¹⁹

Payroll Expense Tax

Although the Payroll Expense Tax was originally scheduled to fully phase out in 2018, the City announced that because the tax revenue from the GRT was less than expected, the Payroll Expense Tax will remain in effect for 2018 (and potentially future years) at a rate of 0.38%.²⁰

Contacts:

If you have questions regarding any San Francisco tax matters, please contact either of the following Deloitte professionals.

¹¹ *Request for Comments: Draft Tax Collector Regulation to Clarify the Application of the Early Care and Education Commercial Rents Tax to Certain Leasing Activities*, Office of the Treasurer & Tax Collector (Oct. 25, 2018).

¹² Article 12-A-1, S.F. Bus. & Tax Reg. Code, Sec. 952.3(c).

¹³ *Id.* at Sec. 2105.

¹⁴ *California Cannabis Coalition v. City of Upland*, 3 Cal. 5th 924, 948 (2017).

¹⁵ Article XIIIIC of the California Constitution.

¹⁶ Press Release. “Mayor London Breed Initiates Effort To Validate Proposition C & Identify Immediate Funding for Homelessness.” November 19, 2018.

¹⁷ Article 6, S.F. Bus. & Tax Reg. Code.

¹⁸ Proposition D, Cannabis Business Tax, Article 30 (appearing on the ballot Nov. 2018).

¹⁹ Article 12-A-1, Section 954.1, S.F. Bus. & Tax Reg. Code; Article 12-A, Section 905-A, S.F. Bus. & Tax Reg. Code. The City may adjust the small business thresholds annually.

²⁰ See: <https://sftreasurer.org/py2018>

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