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California: San Francisco business tax overhaul measure (and others) approved by voters

San Francisco voters on November 3, 2020, approved three ballot measures that may affect business taxpayers.

- Proposition F overhauls the city's gross receipts tax regime, including increasing gross receipts tax rates for all businesses when the measure is fully implemented. This measure also repeals the payroll expense tax, revises the computation of the city's annual registration fee, and increases the small business exemption threshold.

- Proposition I doubles the realty transfer tax rate for properties valued at over $10 million.

- Proposition L adopts an additional gross receipts tax that applies to businesses whose highest paid managerial employee earns more than 100 times or more the amount earned by workers based in the city.

Additional details on these measures are below.

Proposition F – business tax overhaul

Background: Beginning in 2014, the City of San Francisco implemented reforms to its then-current payroll tax regime. Central to the reform was the eventual phase-out of the payroll tax and the phase-in of a new gross receipts tax (GRT). The basic rationale underlying the phase-in was that the combination of revenues received under the GRT being phased-in and the payroll tax being phased-out would be revenue neutral. The GRT, however, never generated as much revenue as expected, and the city continued to impose a GRT and a payroll expense tax on most businesses. The GRT was imposed on persons (which is defined to include combined groups) engaging in business in the city. Beginning January 1, 2019, the definition of "engaging in business within the city" was expanded to persons with annual gross receipts exceeding $500,000 assigned to the city regardless of any other presence in the city. Certain taxpayers engaged in "administrative office business activities" are not subject to the GRT (or the payroll tax), but instead pay a 1.4% tax on total payroll expense.

Repeal of payroll expense tax: Proposition F repeals the payroll expense tax as of January 1, 2021.

Increased small business exemption: Certain businesses—such as "small businesses" (less than $1 million in city gross receipts), passive investment entities, non-profit organizations (except to the extent they have unrelated business taxable income (UBTI)), and entities otherwise exempt from local taxes under federal or state law (e.g., transportation and motor carriers)—are not subject to the GRT. Proposition F increases the small business exemption to persons (except for lessors of residential real estate) whose city gross receipts do not exceed $2 million annually. This amount will be adjusted annually for inflation, as does the current $1 million small business exemption amount (i.e., the exemption amount is currently $1.17 million).

Rate changes: The GRT rates are incredibly complex and vary based on industry or type of business and the volume of a person's gross receipts. For example, the rates applied to the business activity of insurance for the 2021 tax year are:

Gross receipts from insurance business activity for 2021	GRT rates
$0 - $1 million	0.56%
$1.0 - $2.5 million	0.644%
$2.5 - $25 million	0.714%
Over $25 million	0.784%

If a person engages in more than one business activity to which different GRT rates apply, special rules are used to determine the rates.

Proposition F adopts increased GRT rates for certain businesses beginning in 2021, including but not limited to, insurance, information businesses, financial services, and professional, scientific and technical services. The rates generally are increased again for the 2022, 2023, 2024 tax years and beyond. However, recognizing that COVID-19 has affected the city's economy, there are provisions that would freeze the rates applicable to some industries for certain tax years if the city's overall revenues do not meet or exceed expectations. For example, using the insurance rates addressed above, the rates would increase for 2022, but would not increase in 2023 unless the city's revenues meet 90% of the amount expected. By the 2025 tax year, all GRT rate increases will be fully implemented. The GRT rates for certain industries—such as retail businesses, accommodations providers, and restaurants—are reduced in 2021, but those rates will then be increased over time. As noted above, the GRT rate structure is incredibly complex and review of **Proposition F** [PDF 8 MB] is required to determine the exact rates applicable to a taxpayer's industry.

The tax imposed on administrative office businesses is increased from 1.4% to 1.47% for 2022, to 1.54% for 2023, and to 1.61% for 2024 and beyond. However, the increases in 2023 and 2024 are delayed if city revenues do not meet expectations.

Proposition C tax replacements: Proposition F protects the city against Proposition C litigation. Over the last few years, two additional city taxes were approved by voters as Proposition C measures. These are the (1) "homelessness gross receipts tax" imposed on businesses with over $50 million in annual gross receipts or over $1 billion in annual gross receipts if an administrative office business, and (2) the "early child care and education tax" imposed on taxpayers engaged in the business of leasing commercial space in properties in the city. The revenue from both of these taxes must be spent on homelessness services and childcare, respectively. A simple majority of voters approved both these new taxes. Opponents have challenged these measures, arguing that a super-majority voter approval was required. As the matter is currently being litigated, the city has put revenues from these taxes into an escrow account. By adopting contingent replacement taxes if the courts ultimately strike down the Proposition C taxes, the city can use the escrowed funds for immediate purposes.

Annual business registration fees: San Francisco businesses are also subject to annual registration fees based on San Francisco gross receipts for the immediately preceding tax year. Under the general rule, the registration fee is $90 for businesses with less than $100,000 in receipts, which increases to $35,000 for businesses with more than $200 million in gross receipts. For businesses engaged in retail trade, wholesale trade, and certain services, the registration fee is $75 for businesses with less than $100,000, which increases to $30,000 for businesses with more than $200 million in gross receipts. For administrative office businesses, the registration fee is based on payroll expense and is $15,000 for businesses with $2.5 million or less of payroll expense. The fee increases to $35,000 for businesses with $25 million of payroll expense for the immediately preceding tax year.

Proposition F revises the registration fee structure for registration years beginning on or after July 1, 2021. Under the revised general rule, the registration fee is $52 for businesses with less than $100,000 in gross receipts. The new highest fee is $40,261 for businesses with more than $200 million in gross receipts. For businesses engaged in retail trade, wholesale trade, and certain services, the registration fee is $43 for businesses with less than $100,000 in gross receipts, which increases to $34,510 for businesses with more than $200 million gross receipts. Notably, businesses newly exempt under the enhanced small business exemption of up to $2 million will see their registration fee increased, while smaller businesses (having under $1 million in gross receipts) will pay a reduced registration fee. Proposition F did not change the fee imposed on administrative office businesses.

Proposition I – realty transfer tax increase

Effective January 1, 2021, the city’s realty transfer tax rate is increased from 2.75% to 5.5% on transfers of properties with a consideration or value of at least $10 million and less than $25 million. The rate is increased from 3% to 6% on transfers of properties with a consideration or value of at least $25 million.

Proposition L – overpaid executive gross receipts tax ordinance

Effective January 1, 2022, an additional GRT or “administrative office tax” is imposed on businesses that compensate their highest-paid managerial employee at least 100 times more than the median compensation paid to the business’s employees based in the city. This tax is virtually identical to a proposal adopted in Portland, Oregon, a few years ago.

The range of the additional GRT rates is as follows:

- 0.1% if the executive pay ratio is greater than 100:1 and less than 200:1
- 0.2% if the executive pay ratio is greater than 200:1 and less than 300:1
- 0.3% if the executive pay ratio is greater than 300:1 and less than 400:1
- 0.4% if the executive pay ratio is greater than 400:1 and less than 500:1
- 0.5% if the executive pay ratio is greater than 500:1 and less than 600:1
- 0.6% if the executive pay ratio is greater than 600:1

For administrative office taxpayers, the rates are based on total payroll expense attributable to the city and range from 0.4% to 2.4%.

The "executive pay ratio" is defined (for the person or combined group) as the ratio of the compensation of the highest-paid managerial employee for a tax year over the median compensation of the person or combined group's city full-time and part-time employees. A person is considered an employee based in the city if the employee's total working hours in the city exceeds the employee's total working hours in other jurisdictions. Part-time and partial-year employee compensation is annualized. The "highest-paid managerial employee" includes an employee or officer of a person or combined group with managerial responsibility who received the most compensation for the year, regardless of location.

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