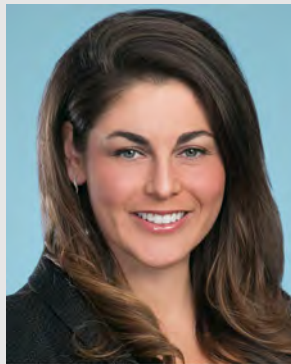


San Francisco's New Tax Provisions May Have Unintended Consequences

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In this installment of SeeSALT Digest, the authors examine three recent significant tax propositions enacted by voters in San Francisco.

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On November 3, 2020, San Francisco voters passed the following three significant tax measures:

- Proposition F, effective January 1, 2021, increases San Francisco's gross receipts tax rate by 40 percent and eliminates the payroll tax, in response to historical and ongoing criticisms that the payroll tax system discourages hiring.¹
- Proposition L, effective January 1, 2022, imposes an additional gross receipts tax on companies that pay their top employees at least 100 times more than the median salary of their San Francisco employees, to decrease pay inequities.²
- Proposition I, effective January 1, 2021, doubles San Francisco's real estate transfer tax to 5.5 percent on transactions of \$10 million or more and 6 percent on transactions of \$25 million or more, in order raise additional revenue in the face of the COVID-19 pandemic.³

A closer examination of these propositions raises questions about whether they will accomplish their stated objectives.

Proposition F

Nearly 10 years ago, voters approved the controversial Proposition E to address concerns that San Francisco's payroll tax was discouraging hiring in the city by taxing employment. Proposition E became effective on January 1, 2014,

¹ Proposition F amended article 12-A-1 of the San Francisco Business and Tax Regulations Code (SF BTR Code).

² Proposition L added article 33 to the SF BTR Code, consisting of sections 3301 through 3313.

³ Proposition I amended SF BTR Code article 12-C, section 1102.

and was designed to replace the payroll tax⁴ with a gross receipts tax.⁵ The payroll tax was supposed to be phased out over a five-year period as the new gross receipts tax was being phased in. The full phaseout of the payroll tax — scheduled for the end of 2018 — never happened because the gross receipts tax failed to produce sufficient revenue. Proposition F was passed by voters in November 2020 to effectuate the full phaseout of the payroll tax⁶ and increase gross receipts tax rates by 40 percent to fill the revenue gap.⁷

Directly contrary to its underlying objective, Proposition F may deter hiring in much the same way as the payroll tax that it is replacing, because both taxes focus heavily on the taxpayers' San Francisco payrolls. With the passage of Proposition F, virtually all taxpayers are required to use their San Francisco payroll to calculate the measure of their San Francisco gross receipts subject to tax.⁸ Taxpayers begin by calculating the ratio of their San Francisco payroll to their overall payroll to determine their San Francisco payroll ratio. From there, the gross receipts tax calculation for most service businesses apportions the taxpayer's total companywide gross receipts to San Francisco⁹ based on the ratio — the measure of San Francisco gross receipts subject to tax is the taxpayer's San Francisco payroll ratio multiplied

by their total companywide gross receipts.¹⁰ For all other businesses, half of the taxpayer's measure of taxable gross receipts is apportioned based on this ratio while the other half is based on the taxpayer's revenue from San Francisco customers.¹¹ In either case, the taxpayer's San Francisco payroll largely affects the calculation.

As a result, Proposition F's gross receipts tax rate increase could easily cause taxpayers to restrict their San Francisco hiring to limit the San Francisco payroll ratio used to calculate the measure of their taxable gross receipts. This 40 percent tax rate increase is particularly ill-timed given that COVID-19 has caused a large portion of the San Francisco workforce to work remotely, likely outside the city. This substantial increase to a gross receipts tax driven by a taxpayer's San Francisco payroll ratio only further encourages taxpayers to carefully segregate payroll inside and outside of San Francisco, aggressively encourage remote work, and judiciously study whether their San Francisco presence can be reduced either in terms of their employees or office footprint.

Proposition L

The genesis of San Francisco's Proposition L¹² can be traced back to the federal Dodd-Frank legislation in 2010, which introduced new executive compensation disclosures. This federal

⁴ SF BTR Code article 12-A.

⁵ *Id.*

⁶ Administrative office taxpayers are still subject to the payroll tax in lieu of the gross receipts tax. This class constitutes taxpayers with more than 1,000 employees worldwide, and with over 50 percent of their San Francisco payroll providing management and administrative services. SF BTR Code article 12-A-1, section 953.8.

⁷ There are exceptions to the general 40 percent gross receipts tax rate increase. For example, industries hit particularly hard by COVID-19 (retail, food services, biotechnology, manufacturing, and accommodations) received temporary rate decreases (with the 40 percent increase phased in over several years), while other industries, including real estate, information, and financial services, are slated to receive additional rate increases (beyond the 40 percent) after 2021.

⁸ SF BTR Code article 12-A-1, sections 956.1 and 956.2. The exception is real estate and rental and leasing services and accommodations, in which the gross receipts are limited to revenues derived from real estate and rental and leasing services for properties located in San Francisco. SF BTR Code article 12-A-1, sections 953.3(b) and (e) and 953.7.

⁹ The taxpayer's companywide payroll and companywide gross receipts generally include the worldwide gross receipts of its entire combined group (as defined for California income tax purposes) unless the taxpayer files a California water's-edge election, in which case the companywide payroll and companywide gross receipts are determined by the water's-edge group, which generally would be limited to the taxpayer's domestic operations.

¹⁰ See SF BTR Code article 12-A-1, sections 953.1(f), 953.3 (d) and (g), 953.4(d), and 953.6(e), providing that the measure of taxable gross receipts for some service businesses are determined entirely by the product of the taxpayer's San Francisco payroll ratio and the taxpayer's worldwide gross receipts under SF BTR Code article 12-A-1, section 956.2. The service businesses covered by SF BTR Code article 12-A-1, section 953.1(d) include repair and maintenance, personal and laundry, religious, grantmaking, civic, and professional services. The services covered by SF BTR Code article 12-A-1, section 953.3(d) include arts, entertainment, and recreation. The services covered by SF BTR Code article 12-A-1, section 953.4 include private education and health services, and administrative and support services. The services covered by SF BTR Code article 12-A-1, section 953.6 include financial services, insurance and professional services, and scientific and technical services. See also SF BTR Code article 12-A-1, section 953.4(a)(3) and (d), providing that any San Francisco business not otherwise described in SF BTR Code article 12-A-1, sections 953.1 through 953.8, must use the single-factor payroll formula to determine its gross receipts subject to tax.

¹¹ The businesses covered by this two-component formula include retail and wholesale trade (SF BTR Code article 12-A-1, section 953.1(b)-(e)); manufacturing, transportation, warehousing, information, biotechnology, clean technology, and food services (SF BTR Code article 12-A-1, section 953.2(b)-(g)); utilities (SF BTR Code article 12-A-1, section 953.3(c) and (f)); and construction (SF BTR Code article 12-A-1, section 953.5(b)-(c)).

¹² Newly added SF BTR Code article 33 (effective 2022).

legislation led the SEC to adopt Item 402(u) of Regulation S-K, requiring public companies to include the ratio of their top employees' compensation to their median employees' compensation (the "Executive Pay Ratio") in their financial statements starting with 2017. The first wave of these disclosures revealed instances of extreme ratios (some exceeding 500:1), which inevitably attracted the attention of public taxing authorities.

Portland, Oregon, reacted particularly quickly, imposing a flat surtax on top of its business license fee (a city income tax), but limiting the tax to public companies and based on the Executive Pay Ratio disclosed in the taxpayers' SEC reporting. Taxpayers with a ratio of 100:1 to 250:1 are subject to a 10 percent surtax, while taxpayers with a ratio of 250:1 or greater are subject to a 25 percent surtax.¹³

In 2019 Sen. Bernie Sanders, I-Vt., proposed legislation to increase the federal corporate income tax for public and private taxpayers with over \$100 million in revenue and whose reported Executive Pay Ratio was at least 50:1. The bill proposed to increase the federal income tax rate by 0.5 percent for those with a ratio of 50:1, and an additional 0.5 percent at each 50:1 increment thereafter, up to a total potential rate increase of 5 percent (for example, 1 percent for 100:1, 1.5 percent for 150:1, up to 5 percent for 500:1 or more).¹⁴ While the bill failed, it shone a national spotlight on the issue, causing many states to propose similar legislation, although none has passed to date.¹⁵

The passage of San Francisco's Proposition L makes it the first major jurisdiction since Portland to successfully pass this type of tax. There are several noteworthy elements of Proposition L, many of which make San Francisco's version of the tax much more complicated than Portland's simple surtax.

First, Proposition L applies to all San Francisco taxpayers, private and public, regardless of size. Second, Proposition L is a tax

on gross receipts, not on income. It applies regardless of whether a taxpayer is profitable and does not differentiate between types of businesses. It applies the same gross receipts tax rate increases to low-margin and high-margin businesses — an additional 0.1 percent gross receipts tax if the ratio is greater than 100:1, and an additional 0.1 percent increase for each 100:1 increment thereafter, up to 0.6 percent (for example, 0.2 percent for 200:1, 0.3 percent for 300:1, up to 0.6 percent for 600:1 or more).¹⁶ A high-margin taxpayer may be able to absorb such an increase, but it could be particularly harsh to a low-margin taxpayer.

Third, Proposition L abandons the Executive Pay Ratio required by the SEC and instead requires each taxpayer to determine a specific San Francisco-centric ratio based on the taxpayer's top employee compensation companywide compared with its median compensation for its San Francisco employees ("San Francisco Executive Pay Ratio").¹⁷ San Francisco's use of a unique ratio creates uncertainties such as how employee benefits, equity compensation, and midyear acquisitions and dispositions factor into the San Francisco Executive Pay Ratio.

Fourth, Proposition L requires the compensation of San Francisco employees on part-time or partial-year schedules to be annualized to the full-year, full-time equivalent for purposes of the San Francisco Executive Pay Ratio.¹⁸

While the impact of Proposition L is yet to be seen, its emphasis on San Francisco employees' median compensation may cause taxpayers to be reluctant to hire entry-level, part-time, or seasonal workers for fear that it may decrease the overall median compensation of their San Francisco employees and thereby increase their tax exposures. COVID-19 has heightened the likelihood of this result by highlighting the ease of remote working, making it much easier for

¹³Portland City Code, section 7.02.500(E); and Portland Business Tax Administration Rule 500.17-1.

¹⁴Tax Excessive CEO Pay Act, S. 2849 (2019).

¹⁵These states include California, Connecticut, Hawaii, Illinois, Massachusetts, New York, Rhode Island, and Washington.

¹⁶SF BTR Code article 33, section 3303.

¹⁷There is also a small nuance in the numerator of the San Francisco Executive Pay Ratio because it is the highest-paid managerial employee's total compensation. However, this is likely a limited nuance because the highest-paid managerial employee is defined as any individual, employee, or officer with managerial responsibility in a business function. SF BTR Code article 33, sections 3301 and 3302.

¹⁸SF BTR Code article 33, section 3302.

taxpayers to simply hire people residing — and now working — outside of San Francisco.

Proposition I

Proposition I doubles San Francisco's real estate transfer tax rate from 2.75 percent to 5.5 percent for transactions of \$10 million or more, and from 3 percent to 6 percent for transactions of \$25 million or more.¹⁹

This is the fourth increase to San Francisco's real estate transfer tax since 2008. Before these increases, the tax rate was levied at a uniform rate of 0.75 percent for all transactions over \$1 million.²⁰ With the passage of Proposition I, the real estate transfer tax on transactions of \$25 million or more has increased 500 percent over just the last 12 years from 0.75 percent to 6 percent, giving San Francisco the highest transfer tax rate of any major U.S. city.

On the one hand, supporters of Proposition I focused on the need to raise revenue to support those who are struggling during the pandemic, arguing that "it's time to ask those selling buildings worth more than \$10 million to pay a little more to help those in need."²¹ On the other hand, opponents of Proposition I pointed to concerns that "it will deepen our recession and push more small businesses into bankruptcy because: Proposition I has no protections for small businesses [and] will increase rents on small neighborhood businesses, threaten their safety nets, and take away their financial stability."²²

It is too early to tell what impact Proposition I will have on the weakened real estate market or on small businesses, but it seems possible that this

significant increase could slow the number of San Francisco transactions over \$10 million, ultimately decreasing the real estate transfer taxes received by the city, at least in the near term.

Key Takeaways

Notwithstanding the objectives stated in support of San Francisco's new tax provisions, they may have unintended consequences — Proposition F may discourage hiring in San Francisco, Proposition L may in fact cause taxpayers to move entry-level positions out of San Francisco rather than increase workers' pay, and Proposition I may be ineffective in raising revenue given the struggling San Francisco real estate market. ■

¹⁹ SF BTR Code article 12-C, section 1102.

²⁰ In the first increase, San Francisco's 2008 Proposition N (effective January 1, 2009) increased the real estate transfer tax rate from 0.75 percent to 1.5 percent for all transactions of \$5 million or more. The tax rate was next increased by 2010's Proposition N (effective January 1, 2011), which increased it from 1.5 percent to 2 percent for transactions of \$5 million or more, and from 1.5 percent to 2.5 percent for transactions of \$10 million or more. The third increase came with 2016's Proposition W (effective January 1, 2017), which increased the tax rate from 2 percent to 2.25 percent for transactions of \$5 million or more, from 2.5 percent to 2.75 percent for transactions of \$10 million or more, and from 2.5 percent to 3 percent for transactions of \$25 million or more.

²¹ San Francisco Voter Information Pamphlet & Sample Ballot, Consolidated General Election, November 3, 2020, "Proposition I: Real Estate Transfer Tax." See the pamphlet for additional arguments for and against the proposition.

²² *Id.*