

San Francisco Voters Approve Ballot Measures Overhauling City's Business Taxes and Imposing a New "Overpaid Executive Gross Receipts Tax"

Overview

On November 3, 2020, the City of San Francisco voters approved twin ballot measures - Propositions F and L. Effective in 2021, Proposition F¹ (1) repeals the 0.38% Payroll Expense Tax, (2) increases the Gross Receipts Tax rates across industries as well as increasing the annual registration fees for certain taxpayers, (3) decreases the annual registration fees and expands the eligibility for the small business exemption to \$2,000,000 of gross receipts attributable to the City per year, and (4) imposes a backstop in the form of tax rate increases in the event that certain existing taxes are struck down by the courts.² Proposition L³, the Disproportionate Executive Pay Tax, takes effect in 2022 and creates a new receipts tax that will be known as the Overpaid Executive Gross Receipts Tax which will be imposed on businesses with executive pay ratios greater than 100 to 1.⁴

This Tax Alert provides a brief overview of these two ballot measures and provides taxpayer considerations.

Business Tax Overhaul

San Francisco has imposed both a payroll tax and a gross receipts tax since 2014 on persons "engaging in business" within the City.⁵ The current Payroll Expense Tax was originally set to phase out ratably between 2014 and 2018 but was postponed by the City in 2018.⁶ The passage of Proposition F fully repeals the City's Payroll Expense Tax, which has existed in one form or another since 1970, effective in 2021. While the Payroll Expense Tax will be repealed, the passage of Proposition F will result in increases in the gross receipts tax rates, which will vary depending on the applicable industry code.

Certain industries impacted by the COVID-19 pandemic – such as retail, manufacturing, accommodation, arts, entertainment and recreation - will see their rates temporarily decrease for two

¹ Business Tax Overhaul, Legal Text available at

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LT.pdf

² Revenues collected from both Proposition C's (i.e., the Homelessness Tax and the Commercial Rents Tax) have been impounded by the City Controller's Office due to on-going litigation. The backstop feature would permit the City to take advantage of the impounded funds and replace the tax revenues for 20 years through an increase in Gross Receipts Tax, if the City loses the litigation. In September, the California Supreme Court declined to hear the gross receipts tax litigation related to the Homelessness Tax after a lower court ruled in the City's favor. Challenges to the Commercial Rents Tax remains active. See *Howard Jarvis Taxpayers Association v. City and County of San Francisco*, No.A157983 (Cal. App. 1st, 2019) ; see also San Francisco City Legislative Digest page 4 available at

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LD.pdf

³ Overpaid Executive Gross Receipts Tax Legislative Language available at

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200629_ExecutivePay_LT.pdf

⁴ Overpaid Executive Gross Receipts Tax Legislative Language available at

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200629_ExecutivePay_LT.pdf

⁵ Deloitte, "San Francisco Voters Pass New Gross Receipts Tax; Current Payroll Expense Tax to be Phased Out", Multi-State Tax Alert, January 22, 2013 available at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-mts-alert-san-francisco-voters-pass-new-gross-receipts-tax-current-payroll-expense-tax-to-be-phased-out-012213.pdf>

⁶ Deloitte, "San Francisco Update," Multi-State Tax Alert, December 13, 2018 available at

<https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-san-francisco-tax-update-3-28-19.pdf>

or possibly three years, depending on the rate of economic recovery.⁷ Other industries will see significant rate increases, in some cases up to 52% by 2025 on average.⁸ For example, tax rates for the highest marginal rate applicable to the Information Services industry will rise from 0.475% to 0.879% from 2021 to 2024.⁹ The precise tax rate increases and applicable tax years vary by industry.

The rate changes will also impact the quarterly estimated tax payments calculations available under the current safe harbor provision.¹⁰ Under current rules, taxpayers may rely on 25% of their prior year business tax liability when making their estimated tax payments.¹¹ With the passage of Proposition F, for the safe harbor to apply, the quarterly estimated tax payments must be calculated using the current year's tax rates as applied to prior year's taxable gross receipts.¹²

The passage of Proposition F also eliminates the tax credit for taxpayers paying "substantially similar" gross receipts taxes to any other taxing jurisdiction on San Francisco-sourced gross receipts.¹³

Businesses subject to the Administrative Office Tax¹⁴ will continue to be subject to a payroll tax, in lieu of the Gross Receipts Tax, at an incrementally increased rate of 1.47% in 2022 to 1.61% for tax years 2024 and beyond.¹⁵

The San Francisco City Office of the Controller anticipates that the passage of this measure would raise approximately \$97 million annually once fully implemented.¹⁶

Overpaid Executive Gross Receipts Tax

Effective January 1, 2022, Proposition L creates the Overpaid Executive Gross Receipts Tax, an additional tax on the annual gross revenues of companies engaged in business in the City. The Tax is imposed where the ratio of compensation paid the taxpayer's highest-paid managerial employee, or officer, compared to the median employee based in the City exceeds 100 to 1 ("Executive Pay Ratio").¹⁷

For purposes of the tax, an employee is based in the City for a tax year if the employee's total working hours in the City during the tax year exceeds the employee's total working hours in any other single

⁷ See Office of the Controller City and County of San Francisco Analysis on Proposition F- Chartered Amendment adjusting the City baselines funding and Ordinance amending the Business Tax & Regulations Code *available at* <https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/Prop%20F%20-%20Business%20Tax%20Overhaul.pdf>; *see also* San Francisco City Legislative Digest *available at*

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LD.pdf

⁸ See San Francisco City Legislative Digest page 4 *available at*

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LD.pdf

⁹ *See id.*

¹⁰ San Francisco Business and Tax Regulations Code, Article 6 §6.9-3(3)

¹¹ *See id.*

¹² *See* Business Tax Overhaul, Legal Text *available at*

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LT.pdf; *see also* San Francisco City Legislative Digest *available at*

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LD.pdf

¹³ San Francisco Business and Tax Regulations Code, Article 12-1-A §954(g)

¹⁴ San Francisco Business and Tax Regulations Code, Article 12-1-A §953; The Administrative Office Tax (AOT) is a 1.4% tax on the San Francisco payroll expense of a person or combined group engaging in business within San Francisco as an administrative office if:

- (1) Over 50% of the total combined San Francisco payroll expense of that person and its related entities for the preceding tax year was associated with providing administrative or management services exclusively to that person and its related entities.
- (2) That person and its related entities had over 1,000 U.S. employees as of the most recent December 31st, and
- (3) over \$1 billion in combined gross receipts reported (or that will be reported) on United States federal income tax return(s) for the person or combined group's most recently completed federal income tax year.

¹⁵ San Francisco City Legislative Digest page 5 *available at*

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200648_BusinessTaxOverhaul_LD.pdf

¹⁶ *See* Office of the Controller City and County of San Francisco Analysis on Proposition F- Chartered Amendment adjusting the City baselines funding and Ordinance amending the Business Tax & Regulations Code *available at*

<https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/Prop%20F%20-%20Business%20Tax%20Overhaul.pdf>

¹⁷ Overpaid Executive Gross Receipts Tax Legislative Language *available at*

https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/200629_ExecutivePay_LT.pdf

location during the tax year.¹⁸ Compensation is based on the employee's total compensation, including wages, bonuses, commissions, and stock compensation. Compensation paid to a part-time employee will be determined on a full-time equivalency and compensation paid to an employee who worked for only a portion of the year will be annualized.¹⁹

Nonprofit organizations, insurance companies, banks, and financial corporations who are exempt from local business taxes will be exempt from the Overpaid Executive Gross Receipts Tax. Small businesses that are currently exempt under San Francisco Business and Tax Regulations Code Article 12-1-A will also be exempt from the tax.²⁰ For businesses subject to the Administrative Office Tax, the new tax rates range from 0.4% to 2.4% depending on the Executive Pay Ratio and will apply to its payroll expense attributable to the City.²¹

The San Francisco City Office of the Controller estimates that the tax will result in an additional revenue in the range of \$60 million to \$140 million annually.²²

Considerations

Persons currently operating in the City should consider the impact of these measures on their current operations in the City. While the elimination of the Payroll Expense Tax may offset some portion of the rate increases scheduled for tax years 2021 and onwards for many taxpayers, small businesses may see the most benefit stemming from the passage of the business tax overhaul under Proposition F. Taxpayers should review the impact of the rate increases and other technical changes brought by Proposition F.

Taxpayers should also take into consideration how their operations are impacted by the passage of the Overpaid Executive Gross Receipts Tax under Proposition L. A detailed calculation should be undertaken to quantify a business's potential liability under these measures.

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¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* The Overpaid Executive Tax is in addition to the Gross Receipts Tax or Administrative Office Tax, whichever is applicable.

²² See Office of the Controller City and County of San Francisco Analysis on Proposition L – Ordinance providing for an additional business tax on businesses with disproportionate executive pay available at

<https://sfelections.sfgov.org/sites/default/files/Documents/candidates/2020Nov/Prop%20L%20-%20Business%20Tax%20on%20Comparison%20of%20Top%20Executive%20Pay%20to%20Employee%20Pay.pdf>

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