City and County of San Francisco

Office of the Controller – Office of Economic Analysis

# Enacting a Gross Receipts Tax, and Phasing-Out the Payroll Expense Tax: Economic Impact Report

Items #120681 & 120682

Controller's Office of Economic Analysis

July 18th, 2012

Corrected August 24th, 2012

City and County of San Francisco

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# Background

- On June 12th, two motions were introduced that would place changes to the City's business tax on the November 2012 ballot.
- Both measures involve an increase in a general tax, and would become effective with a simple majority of votes in favor.
- The economic impact of the City's 1.5% Payroll Expense Tax has been a subject of controversy for many years.
- At the request of the Mayor and Board President, since last Fall the Controller's Office has been researching alternatives to the City's current business tax.
- On May 10th, the Controller's Office issued a report that proposed replacing the payroll tax with a new Gross Receipts tax, and changes to the business registration fee.
- Both measures are based on the recommendations in that report, and, as amended on July 12th, have two differences:
  - Item #120681 (Mayor/President Chiu) would generate $13 million in new business registration fee revenue, while setting Gross Receipts rates to equalize the revenue currently generated by the payroll tax.
  - Item #120682 (Sup. Avalos) would generate $40 million in new business registration fee revenue, and would charge a slightly higher Gross Receipts tax rate on the Real Estate, Accommodations, and Arts, Entertainment, and Recreation.

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# History of Payroll Tax Reform in San Francisco

- In the 1970s, San Francisco adopted a hybrid business tax. In this system, businesses calculated a gross receipts payment, and a payroll tax payment, and paid whichever was greater.
- In the late 1990s, a lawsuit in Los Angeles led to that city's similar tax system being declared unconstitutional. As a result, San Francisco abandoned its Gross receipts tax.
- In the process, the City's business tax revenue was reduced by approximately $25 million in 2001, and the City issued approximately $70 million in bonds to pay settlement costs with various litigants.
- Subsequent efforts to amend the business tax at the ballot, in 2002 and 2004, were unsuccessful.
- Over the past ten years, the City has adopted several exclusions to the payroll tax, including ones covering the biotechnology industry and Clean Tech industry.
- In 2011, the City adopted additional exclusions covering the Central Market street area, and the stock-based compensation of pre-IPO companies.

# The Payroll Tax is the City's Second Largest Source of General Fund Revenue

| Tax | General Fund Revenue ($M) |
|---|---:|
| Property Tax | $1,060 |
| Business Tax (Payroll Tax & Business License Fee) | $410 |
| Sales Tax | $188 |
| Hotel Tax | $177 |
| Property Transfer Tax | $163 |
| Utility User / Access Line Taxes | $131 |
| Parking Tax | $75 |

Source: Controller's Office, "FY2011-12 Six-Month Budget Status Report", February, 2012

# Criteria for Effective Tax Systems

- Based on existing research, the Controller's Office has considered four criteria in evaluating the current, and potential alternative, business tax systems.

  1. **Economic Growth**: Does the tax minimize the cost to the economy of raising revenue?
  2. **Administrability**: Can the tax be administered and collected in a straightforward, inexpensive way? Is it easy for taxpayers to calculate their tax?
  3. **Stability**: Is the tax highly volatile, or unpredictable?
  4. **Equity**: Does the tax align with taxpayer's ability to pay, and/or their use of City services?

- The City's Payroll Tax has been in place for nearly 40 years, and is relatively easy to administer. However, the tax has been faulted on economic, stability, and equity grounds.

See: "Evaluation of Alternatives to the City's Gross Receipts Business Tax", City of Los Angeles Office of Finance, 2004.
U.S. Government Accountability Office, "Understanding the Tax Reform Debate: Background, Criteria, and Questions", 2005.

# Economic Impact of the City's Payroll Tax: Prior Reports

"Economists generally agree that a payroll tax is more likely to fall heavily on workers than other kinds of business taxes. Firms faced with a high payroll tax are likely to reduce payroll through wage cuts, layoffs, [and] net attrition and relocation of workforce."

---San Francisco Chamber of Commerce, "The Economic Impact of the Payroll Tax", 2001

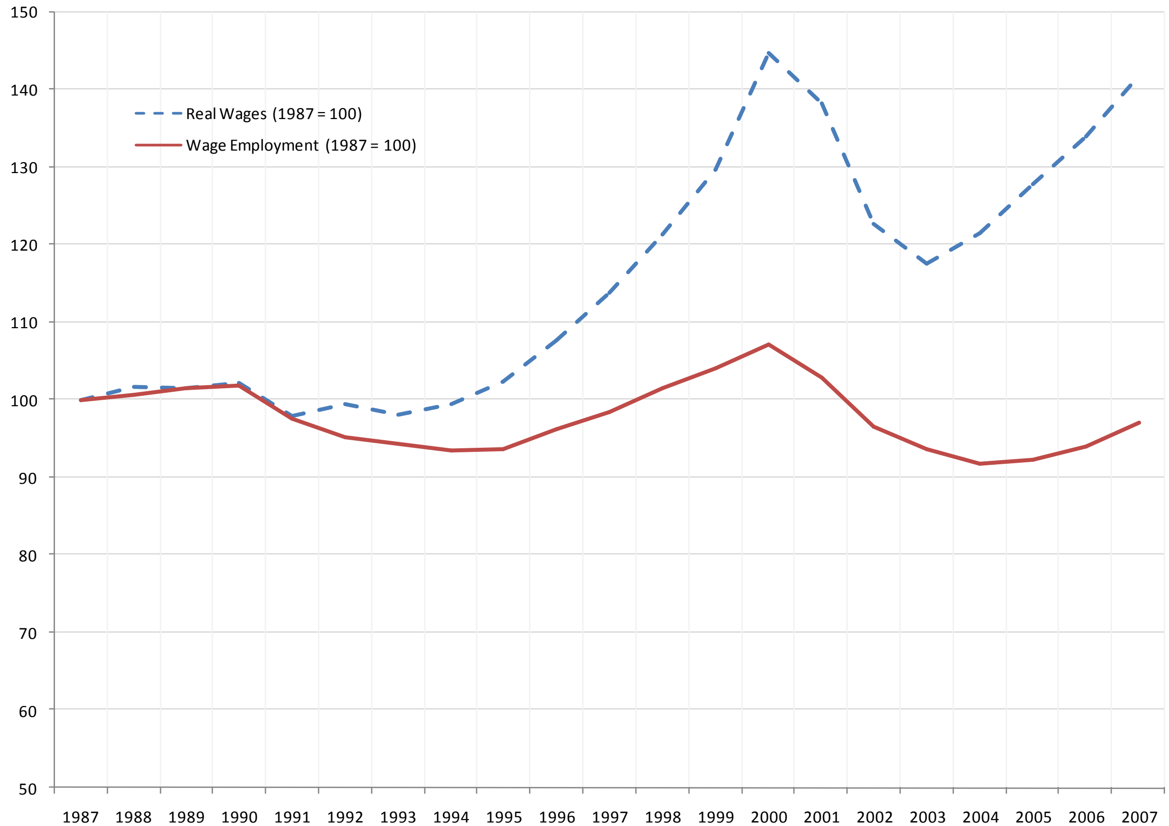
"A payroll tax may also have particularly strong negative effects on employment...It is probably true that gross receipts taxes have less of a direct, negative impact on payrolls through wages and employment levels than do payroll taxes."

---San Francisco Planning and Urban Research (SPUR), "Business Taxes in San Francisco", 2004

"From an economic point of view, a tax on payroll raises the cost of labor to businesses, and discourages hiring."

---Controller's Office, "Improving San Francisco's Business Tax", 2010

# Stability: Payroll Tax Revenue Has Been Volatile



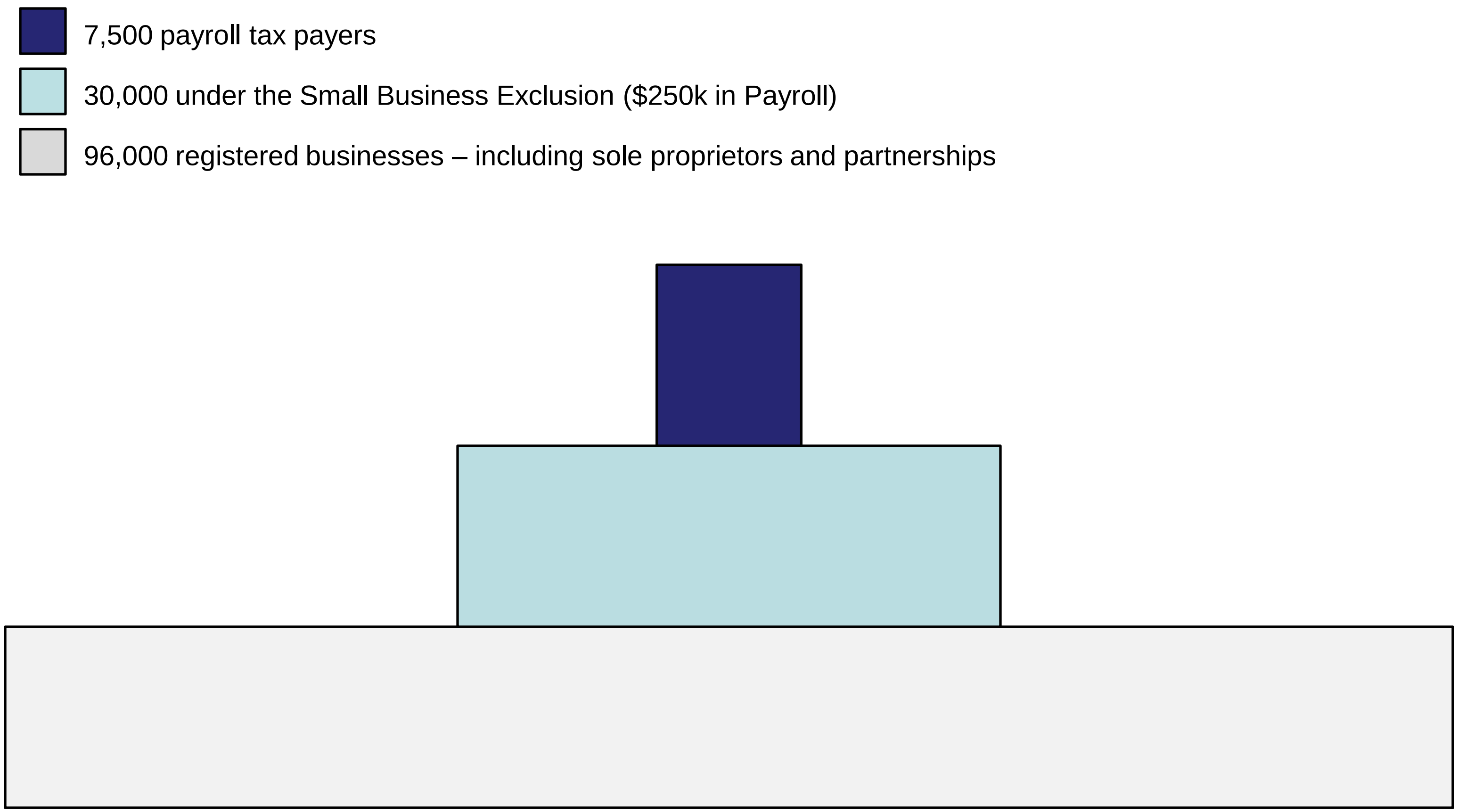

The stability of payroll tax revenue depends on the stability of the underlying tax base.

Over the past twenty years, real wages & total payroll in San Francisco has been much more volatile than other economic indicators, like total employment.

In recent years, payroll tax revenue has both increased and decreased by over 10% per year.

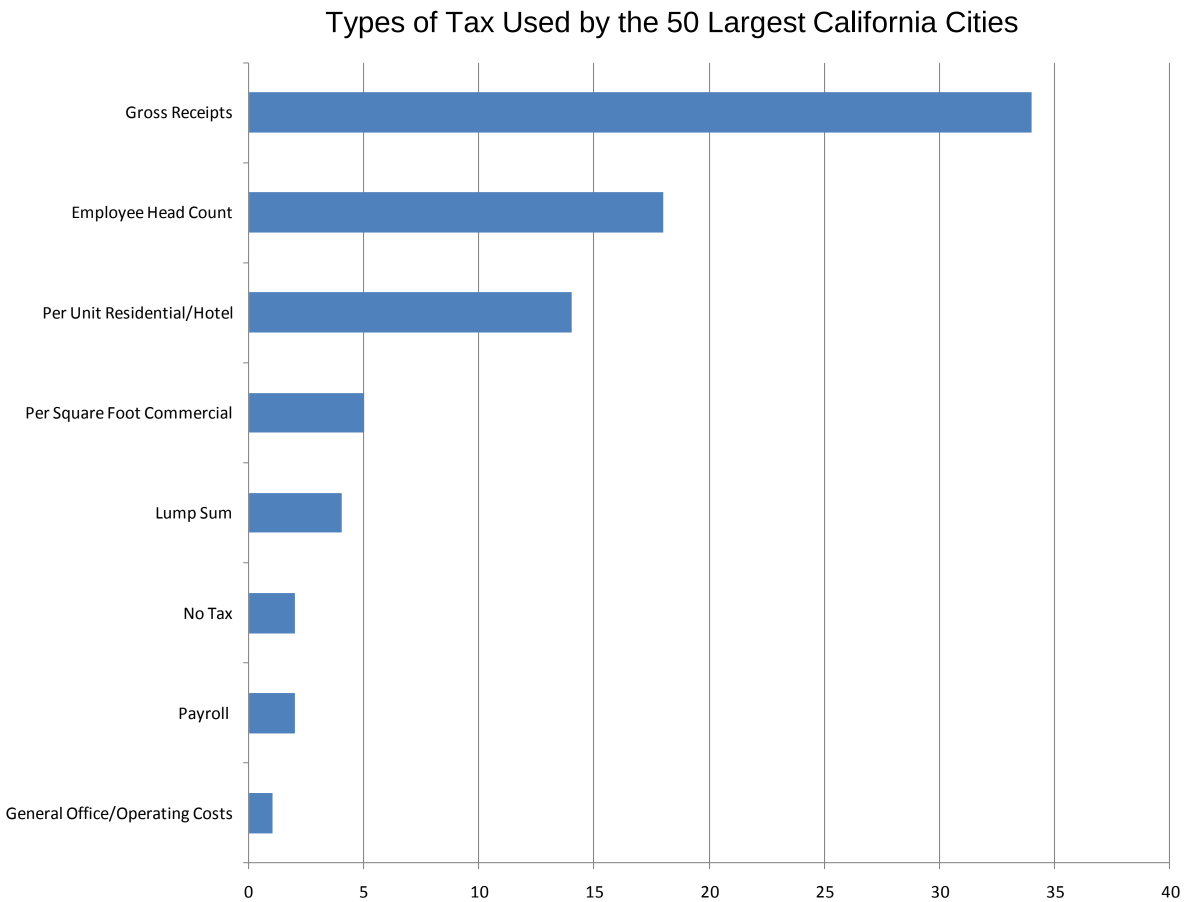
Source: Controller's Office REMI model

# Equity: In 2010, Less Than 10% of Registered Businesses Paid the Payroll Tax




Source: Office of the Treasurer / Tax Collector

# Most Large Cities in California Use a Gross Receipts Tax




Over thirty of the largest fifty cities in California use a Gross Receipts Tax, in which a business's revenue, not its payroll, is the basis for calculating the tax payment. It is by far the most common form of local business taxation in the state of California.

Other a Gross Receipts tax, cities also rely on employee head count, residential, hotel, and commercial real estate occupancy, fixed lump sum fees, or no taxes.

Source: *2009 Kosmont-Rose Institute Cost of Doing Business Survey*. Note: some cities use more than one type of tax.

# Key Features of Both Ordinances

- Exclusions from Gross Receipts
- Small Business and Other Exemptions
- Apportionment
- Handling of Multiple Business Activities
- Treatment of Administrative Offices
- Phase-In of Gross Receipts Tax Rates
- Phase-Out of Payroll Expense Tax Rate
- Existing Payroll Expense Tax Exclusions
- Cancellation of Existing Registration Fees, Establishment of New Registration Fees

# Exclusions from Gross Receipts

- Financial Services 952.3(e): Gross Receipts excludes the cost to acquire financial instruments.
  - In addition, a business whose sole activity is the receipt of interest and/or dividends from passive investments in financial instruments is not subject to the tax.
- Construction 953.5(c): Gross Receipts excludes payments to construction subcontractors.
- Rent-Controlled Housing 954(d): Gross Receipts excludes 50% of receipts from rent-controlled buildings.
- Sales of Real Estate 954(e): Gross Receipts excludes sales of real property that are subject to the Transfer Tax.

# Small Business and Other Exemptions (Sec. 954.1)

- Except for residential real estate lessors, all businesses with San Francisco gross receipts of less than $1 million are exempt from the gross receipts tax.
- Residential real estate lessors are exempt from the tax associated with any building having less than four units. Residential real estate lessors can also report and pay the tax on a building-by-building basis.
- As is currently the case, non-profit organizations are exempt from the gross receipts tax and the business license fee.
- In addition, existing State constitutional exemptions, for banks, insurers, and others will continue to apply.

# Schedule 1 Maximum Gross Receipts Tax Rates (Sec. 953.1) Applicable to Businesses with Over $1 million in Gross Receipts

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $1,000,000 | 0.075% of Gross Receipts |
| $1,000,001 - $2.5 million | 0.100% of Gross Receipts |
| $2.5 million - $25 million | 0.150% of Gross Receipts |
| $25 million + | 0.175% of Gross Receipts |

- Schedule 1 applies to Retail Trade, Wholesale Trade, and Personal Services (NAICS 81)

# Schedule 2 Maximum Gross Receipts Tax Rates (Sec. 953.2) Applicable to Businesses with Over $1 million in Gross Receipts

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $1,000,000 | 0.125% of Gross Receipts |
| $1,000,001 - $2.5 million | 0.200% of Gross Receipts |
| $2.5 million - $25 million | 0.350% of Gross Receipts |
| $25 million + | 0.450% of Gross Receipts |

- Schedule 2 applies to Manufacturing; Transportation & Warehousing; Information; Biotechnology; Clean Technology; and Food Services.

# Schedule 3 Maximum Gross Receipts Tax Rates (Sec. 953.3) Applicable to Businesses with Over $1 million in Gross Receipts

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $1,000,000 | 0.300% of Gross Receipts |
| $1,000,001 - $2.5 million | 0.325% of Gross Receipts (Mayor/Chiu)<br>0.350% of Gross Receipts (Avalos) |
| $2.5 million - $25 million | 0.325% of Gross Receipts (Mayor/Chiu)<br>0.375% of Gross Receipts (Avalos) |
| $25 million + | 0.400% of Gross Receipts |

- Schedule 3 applies to: Real Estate & Rental and Leasing Services; Accommodations; Arts, Entertainment, and Recreation.

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# Schedule 4 Maximum Gross Receipts Tax Rates (Sec. 953.4) Applicable to Businesses with Over $1 million in Gross Receipts

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $1,000,000 | 0.525% of Gross Receipts |
| $1,000,001 - $2.5 million | 0.550% of Gross Receipts |
| $2.5 million - $25 million | 0.600% of Gross Receipts |
| $25 million + | 0.650% of Gross Receipts |

- Schedule 4 applies to: Private Education and Health Services, and Administrative and Support Services.

# Schedule 5 Maximum Gross Receipts Tax Rates (Sec. 953.5) Applicable to Businesses with Over $1 million in Gross Receipts

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $1,000,000 | 0.300% of Gross Receipts |
| $1,000,001 - $2.5 million | 0.350% of Gross Receipts |
| $2.5 million - $25 million | 0.400% of Gross Receipts |
| $25 million + | 0.450% of Gross Receipts |

- Schedule 5 applies to Construction.

# Schedule 6 Maximum Gross Receipts Tax Rates (Sec. 953.6) Applicable to Businesses with Over $1 million in Gross Receipts

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $1,000,000 | 0.400% of Gross Receipts |
| $1,000,001 - $2.5 million | 0.450% of Gross Receipts |
| $2.5 million - $25 million | 0.500% of Gross Receipts |
| $25 million + | 0.550% of Gross Receipts |

- Schedule 6 applies to Financial Services, Insurance, and Professional, Scientific, and Technical Services.

# Apportionment (Sec. 956.1 and 956.2)

- The gross receipts of Real Estate, Rental and Leasing Services, and Accommodations industries is taxable if the property is rented or used within San Francisco. Sec. 953.3(f).
- Section 956.2 defines the allocation of gross receipts based on payroll. San Francisco gross receipts equal combined gross receipts, times San Francisco payroll, divided by combined payroll.
- The following industries apportion gross receipts entirely using 952.2: Certain Services (Schedule 1); Arts, Entertainment, and Recreation (Schedule 3); Education and Health Services, and Administrative and Support Services (Schedule 4); Financial Services, Insurance, and Professional, Technical, and Scientific Services (Schedule 6).
- Section 956.1 defines the allocation of gross receipts from tangible and intangible property sales into San Francisco based on the customer location.
- The following industries apportion 50% of their gross receipts using 956.1, and 50% using 956.2: Wholesale and Retail Trade (Schedule 1); Manufacturing, Transportation and Warehousing, Information, Biotechnology, Clean Technology, and Food Services (Schedule 2); Construction (Schedule 5).

# Rules for Multiple Business Activities (Sec. 953.7)

- If a business conducts multiple lines of business in San Francisco that cross multiple rate schedules, the following rules apply.
- If one activity accounts for more than 80% of the business's total gross receipts, then the business will use that activity's schedule for all of its gross receipts.
- If no activity accounts for more than 80% of the total, businesses must compute gross receipts for each line of business separately.
- However, any set of activities comprising less than 20% of gross receipts together may be combined, using the highest rate within the group.

# Treatment of Administrative Offices (Sec. 953.8)

- Any business having over 50% of its San Francisco payroll associated with administrative and management services is classified as an *Administrative Office*.
- Administrative and management services include activities that do not directly generate gross receipts, but involving managing or providing services to the rest of the enterprise: executive management, record-keeping, legal, accounting, personnel, etc.
- This exception was created to deal with the challenge of apportioning the gross receipts of administrative center that do not directly make or sell products, or provide services for customers.
- Such an establishment will not be subject to the Gross Receipts tax that applies to other businesses.
- Administrative Offices, thus defined, continue to pay a 1.5% tax on payroll expense, as it is currently defined.

# Phase-In of Gross Receipts Rates (Sec. 959)

- The Gross Receipts tax rates listed on the schedules are maximum rates. Both measures phase-in the Gross Receipts tax, while phasing-out the Payroll Expense tax depending on the revenue generated by the Gross Receipts tax.
- This approach insures the City, and business taxpayers, against errors in estimating revenue from a tax the City has not collected for many years.
- From 2014 to 2018, Gross Receipts rates will be set by a Controller calculation, involving multiplying the maximum rates by the following phase-in factors:
  - 2014: 10%
  - 2015: 25%
  - 2016: 50%
  - 2017: 75%
  - 2018: 100%
- If, in any year between 2015 and 2018, the payroll expense tax rate is phased-out to 0%, then the phase-in factor for Gross Receipts rates will be less than indicated above, and will remain at that reduced level for all future years.

# Phase-Out of Payroll Expense Tax Rates (Sec. 903.1)

- As the Gross Receipts tax rates are phased-in, the Payroll Expense tax rate will be phased-out, on the following schedule:
  - 2014: 1.35%
  - 2015: 1.125% +/- ADJ
  - 2016: 0.75% +/- ADJ
  - 2017: 0.375% +/- ADJ
  - 2018: 0% + ADJ
- In each year 2015 – 2018, the Controller will calculate an adjustment (ADJ) equaling the payroll expense tax rate required to achieve the specified revenue target, depending on the previous year's actual gross receipts collections.
- In any year that the calculation above would lead to a payroll expense tax rate less than 0%, the rate would be set at 0% for that year and all future years.
- If that does not happen, the payroll tax will remain at the rate established in 2018 for all future years.

# Implications of the Phase-In Process

- The fact that the City has not collected a Gross Receipts tax for over ten years creates challenges in revenue estimation and rate setting.
- Instead, the Controller's Office developed revenue estimates and rates based on Federal economic statistics for San Francisco.
- According to these estimates, the Gross Receipts tax rates should fully replace the payroll tax by 2018.
- However, these estimates inherently involve some error. The phase-in process was developed to ensure that revenue goals will be met, and not exceeded, by only lowering the payroll tax rate in proportion to Gross Receipts tax revenue received.
- The outcome of the phase-in process will be one of two things:
  - If Gross Receipts tax revenues are less than expected, the Gross Receipts tax rates will be phased-in fully by 2018, but the payroll tax will not be fully phased-out, and both taxes will remain in effect.
  - If Gross Receipts tax revenues are greater than expected, the Gross Receipts tax rates will not fully phase-in, the final Gross Receipts tax rates will be less than the voter-approved maximums contained in the legislation, and the payroll tax will be retired (except for Administrative Offices, as discussed on page 21).

# Existing Payroll Tax Exclusions

- The City currently maintains five payroll tax exclusions: for biotechnology, clean technology, the local enterprise zone, the Central Market area, and pre-IPO stock compensation.
- Both measures now treat these exclusions the same way.
- The biotechnology, clean technology, and enterprise zone exclusions would convert to a gross receipts tax credit equal to what the exclusion would be worth with a 1.5% payroll tax rate. (Sec. 960).
- In this legislation, the Central Market exclusion would convert to one in which an affected business's combined business tax payment would never exceed their base year level. (Sec. 961).
- In this legislation, the Pre-IPO stock compensation exclusion is not changed, and the existing expiration dates of the exclusions are retained.

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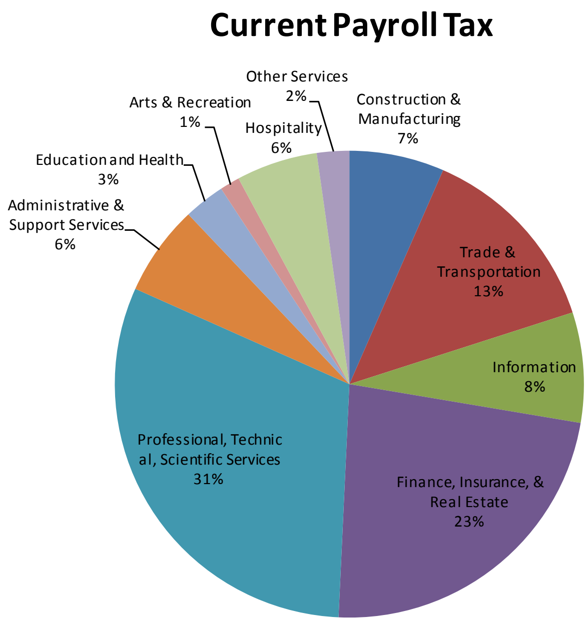
# Business Registration Fees to Replace Existing Fees and Generate $13 million (Mayor/President Chiu Legislation) (Sec. 855)

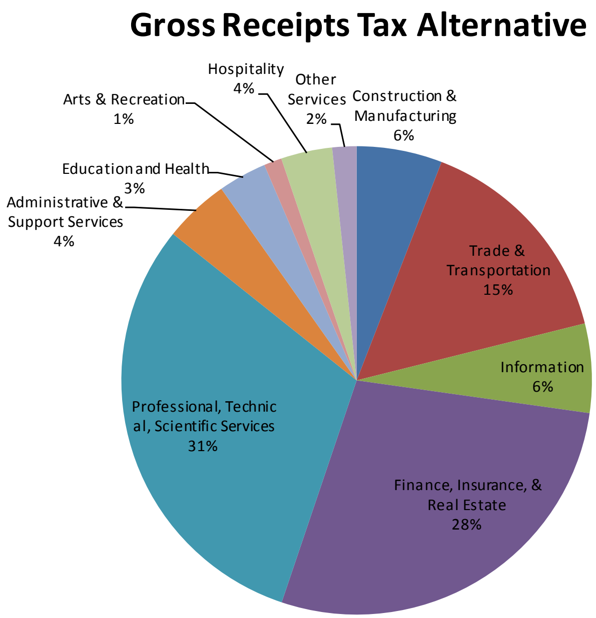
| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $100,000 | $75 |
| $100,001 - $250,000 | $150 |
| $250,001 - $500,000 | $250 |
| $500,001 - $750,000 | $500 |
| $750,001 - $1,000,000 | $700 |
| $1,000,000 - $2.5 million | $100 |
| $2.5 million - $7.5 million | $250 |
| $7.5 million - $15 million | $750 |
| $15 million - $25 million | $1,000 |
| $25 million - $50 million | $5,000 |
| $50 million - $100 million | $10,000 |
| $100 million and over | $20,000 |

# Business Registration Fees to Replace Existing Fees and Generate $40 million (Sup. Avalos Legislation) (Sec. 855)

| Gross Receipts Level | Required Payment |
|---|---|
| $0 - $100,000 | $50 |
| $100,001 - $250,000 | $100 |
| $250,001 - $500,000 | $100 |
| $500,001 - $750,000 | $200 |
| $750,001 - $1,000,000 | $300 |
| $1,000,000 - $2.5 million | $100 |
| $2.5 million - $7.5 million | $250 |
| $7.5 million - $15 million | $500 |
| $15 million - $25 million | $500 |
| $25 million - $50 million | $22,500 |
| $50 million - $100 million | $45,500 |
| $100 million and over | $100,000 |

# Tax Revenue by Industry: Current Payroll Tax vs. Gross Receipts Alternative




Note: Administrative Offices are excluded from both charts. Their tax is unchanged at 1.5% of payroll.

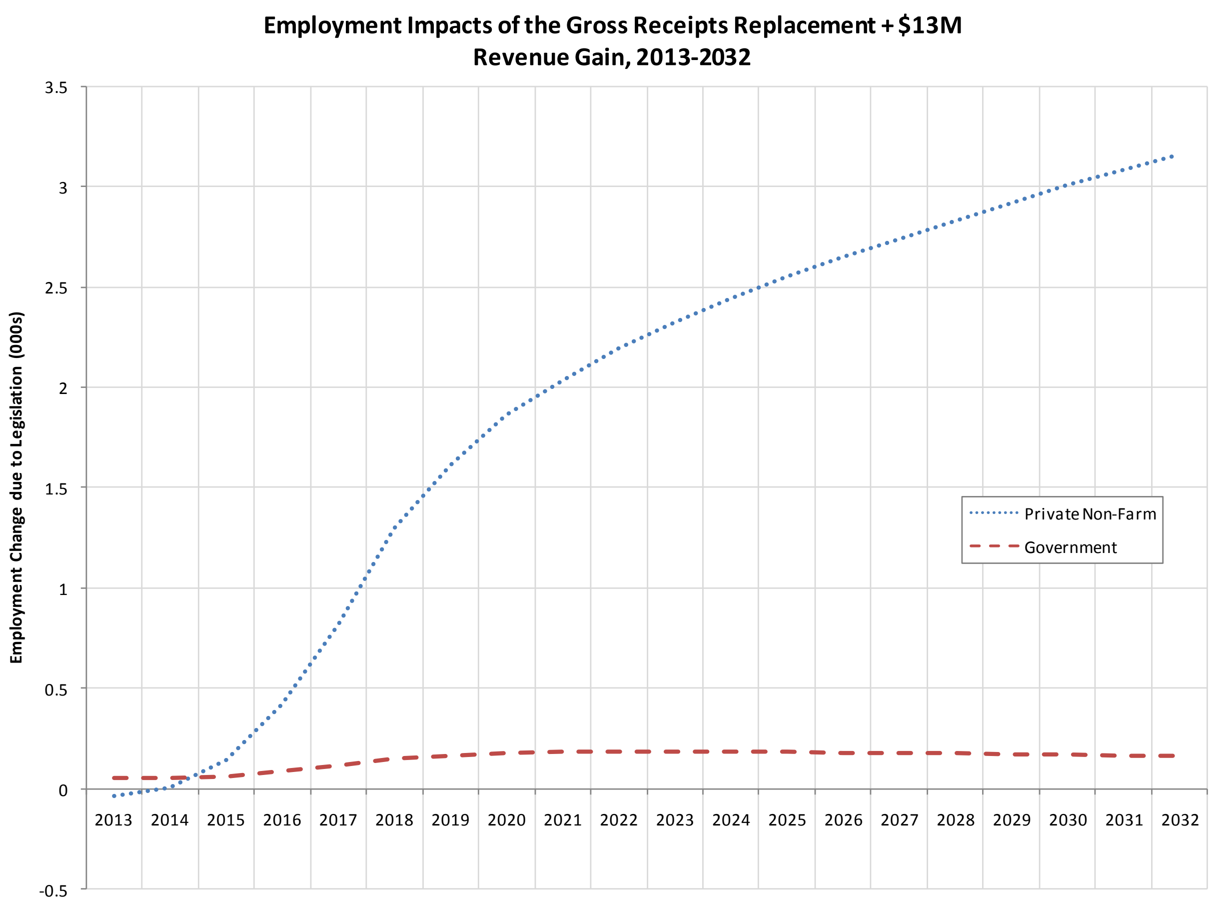
# Economic Impact Factors

Both measures affect the economy in similar ways. The tax change will have three different impacts simultaneously:

1. The reduction of the payroll expense tax reduces the cost of labor for affected businesses, creating an incentive to increase employment and expand economic activity in the city.
2. The imposition of a new Gross Receipts tax adds to business costs, creating an incentive to reduce all expenses in San Francisco, reducing economic activity.
3. The increase in City revenues generates multipliers effects, expanding economic activity in the city.
4. The increase in the business registration fees has the same effect as the Gross Receipts tax.

The net economic impact depends on the strength of these individual positive and negative impacts.

# Economic Impact Assessment (Mayor/President Chiu Legislation): Employment Impact




The OEA's REMI model of the San Francisco economy was used to simulate the impact of phasing-in the Gross Receipts tax and phasing-out the payroll tax, while generating $13 million in new license fees.

The combined affect is a net increase of an average of 1,905 private-sector jobs over the next 20 years, and 150 government jobs, for a total of 2,050.

The positive impact of eliminating the payroll tax outweighs the negative impact of the gross receipts tax, even with the higher business registration fees.

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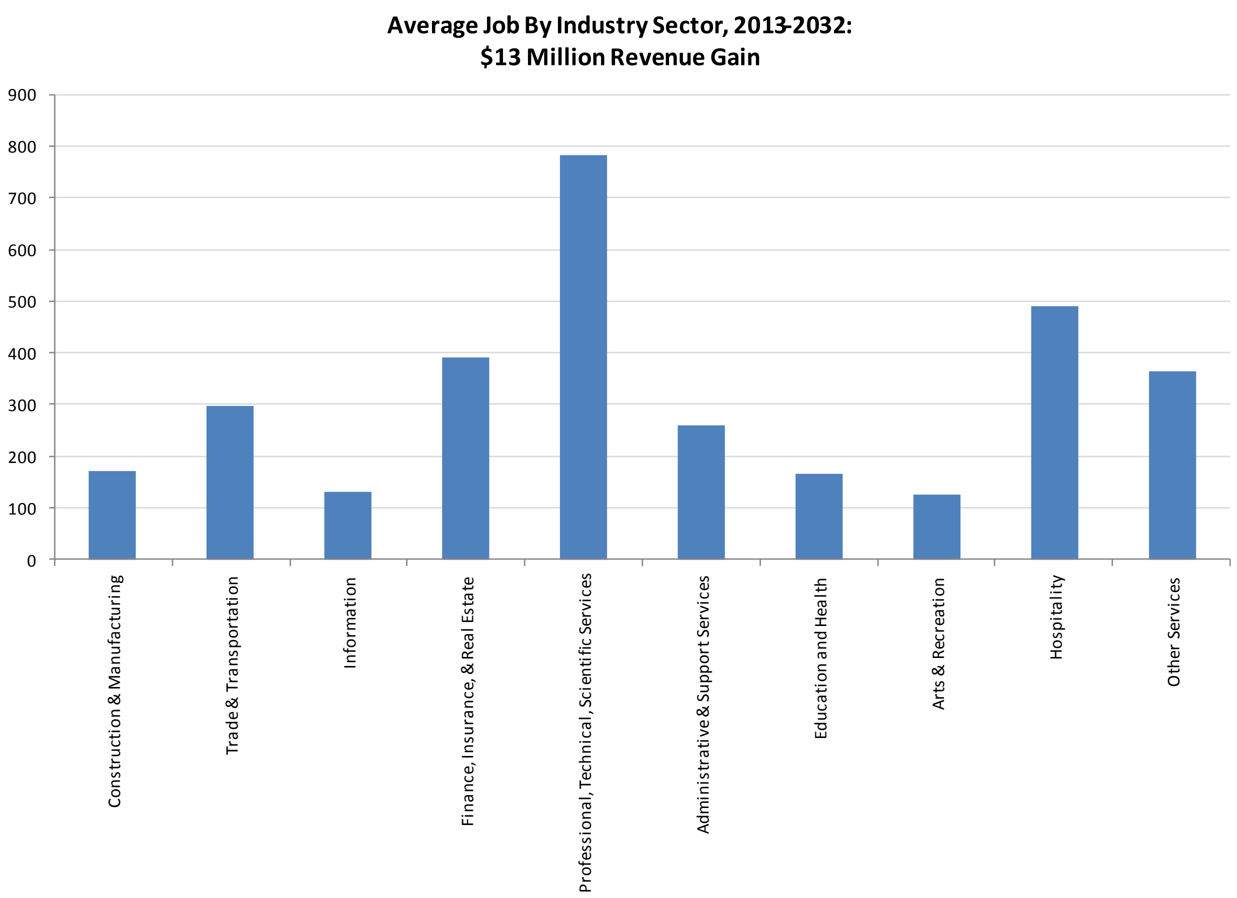
# Economic Impact Assessment (Mayor/President Chiu Legislation): Employment Change by Sector




The chart to the left breaks down the private sector job impacts by industry sector.

Every industry sector in the city is projected to increase employment from the switch to a Gross Receipts tax. The largest sectors in the city, including Professional Services, Hospitality, and Financial Services.

However, on a percentage basis, "Other Services" (personal and repair & maintenance services), Hospitality, and Information add the most jobs.

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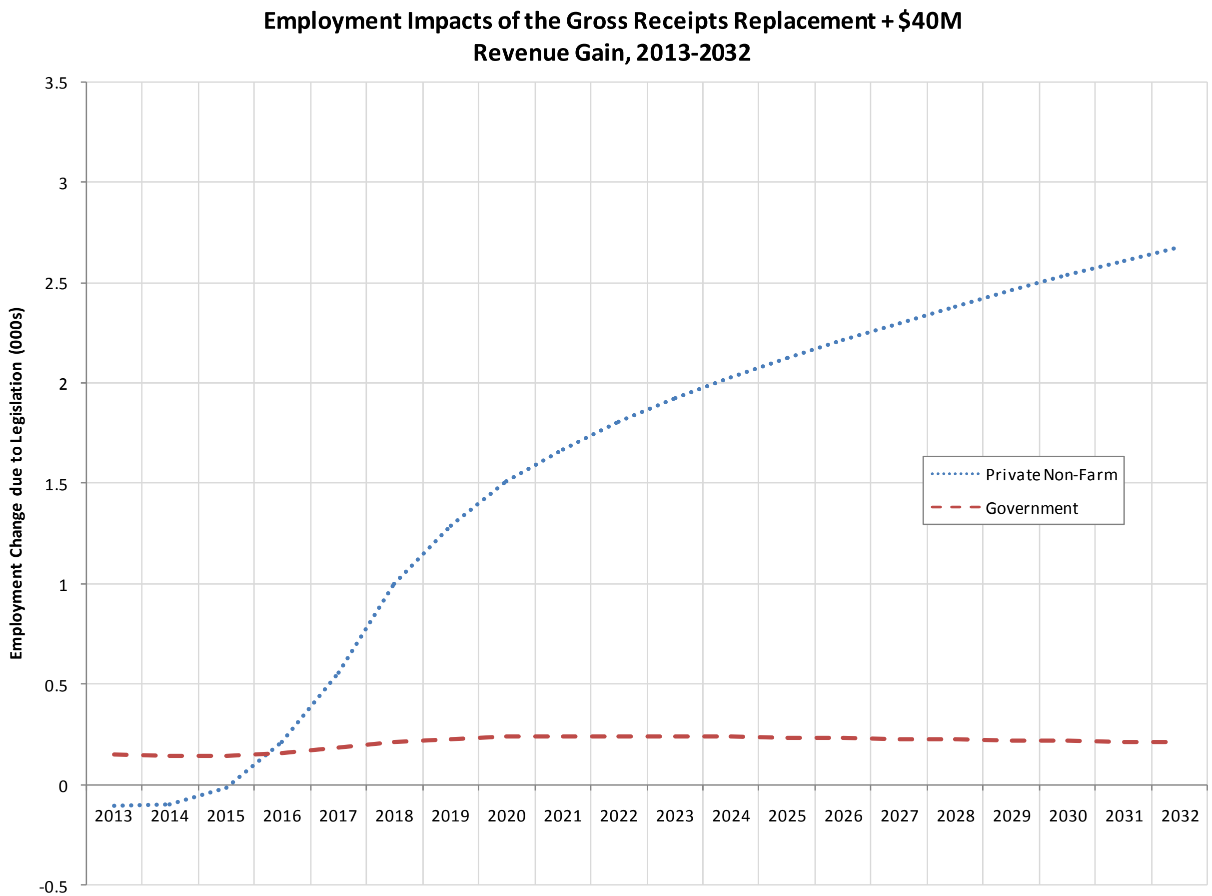
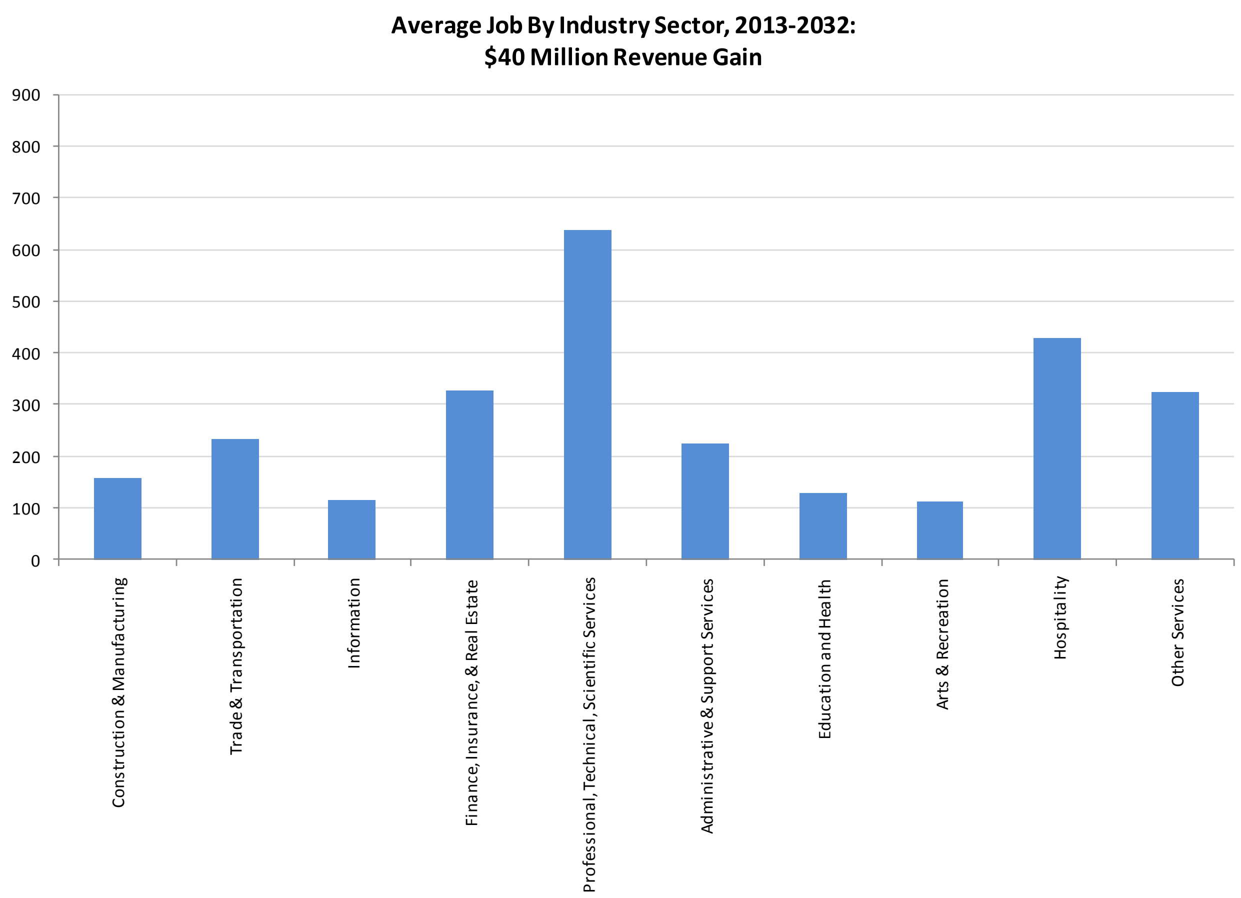
# Economic Impact Assessment (Sup. Avalos Legislation): Employment Impact




Item #120682, which raises business registration fee revenue by $40 million compared to today's levels, also has a positive impact on both private- and public-sector employment, although the private-sector job increase is less.

On average, this proposal will create 1,555 private sector jobs over the next 20 years, along with 210 government jobs, for a total of 1,765.

# Economic Impact Assessment (Sup. Avalos Legislation): Employment Change by Sector




The sector-by-sector job gains with the the $40 million proposal are lower than the $13 million proposal, though proportional.

Again, the largest sectors in the city's economy are expected to add the most jobs as a result of the tax change.

On a percentage basis, again "Other Services", Hospitality, and Information would grow the most.

# Summary: Both Measures are Likely to Generate Employment and Economic Growth, Increase Stability, and Improve Equity

| Tax Criteria | Current Payroll Tax | Gross Receipts Alternative |
|---|---|---|
| Economic Impact | • Discourages job creation by raising labor costs<br>• Increasing burden on the economy.<br>• Industry burden is arbitrary. | • Shifts tax burden away from labor costs.<br>• Will grow more slowly in the future.<br>• Industry burden shifted to promote job creation |
| Stability | • Less stable, given fluctuations in wages and other compensation paid, including stock compensation. | • Likely to be more stable. The gross receipts base is less volatile, and more payers are included in the tax. |
| Equity | • Tax paid by less than 10% of businesses.<br>• Sole proprietors and partnerships without employees are untaxed, regardless of earnings.<br>• Businesses in Federal enclaves are untaxed. | • Tax paid by twice as many businesses.<br>• Only businesses with less than $1 million in gross receipts are exempt.<br>• Sole proprietors and partnerships are taxed if above $1 million in gross receipts.<br>• Federal enclaves are taxed. |

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