San Francisco Business Tax Reform: Annual Report for 2017

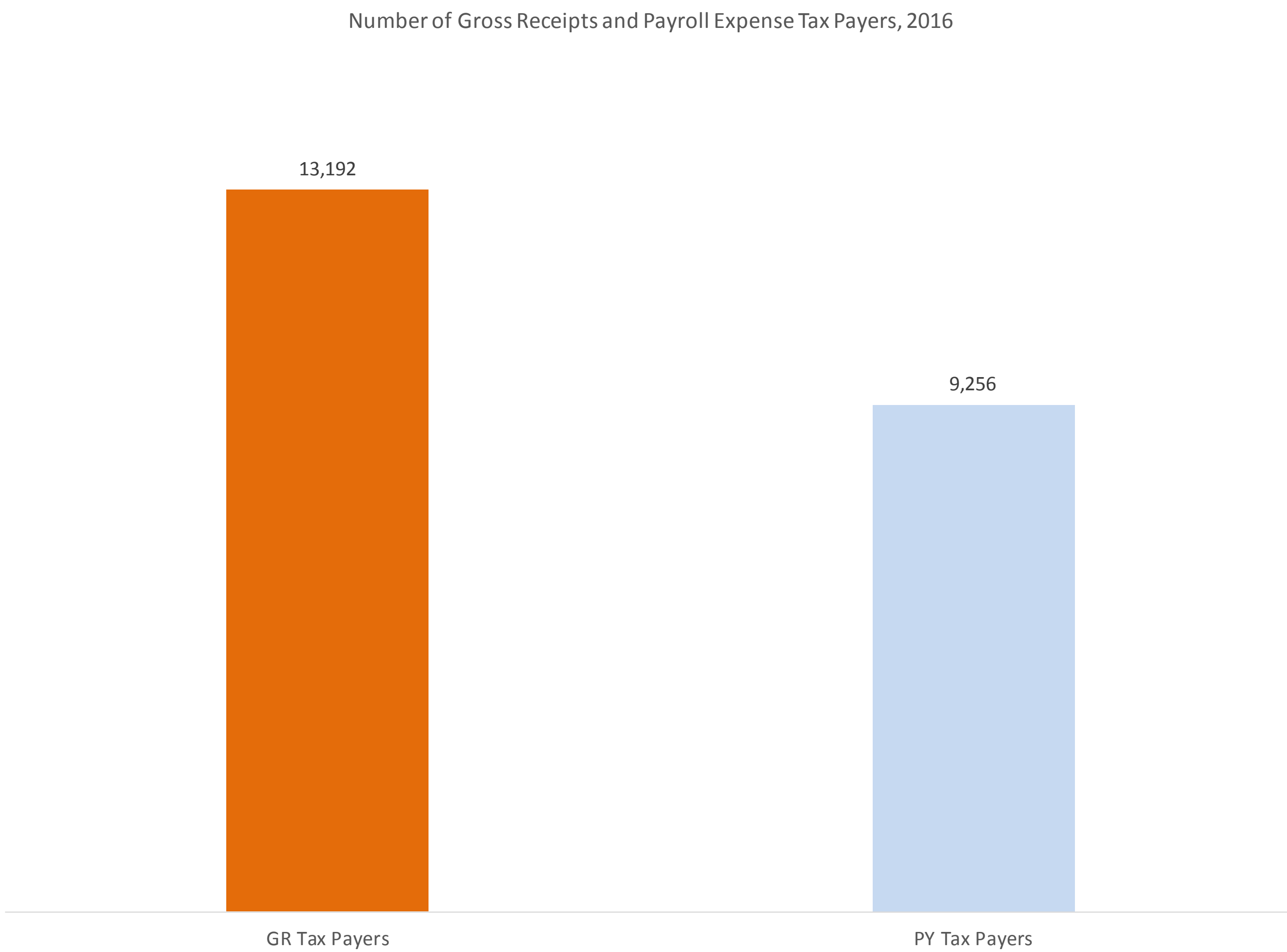
City and County of San Francisco
Office of the Controller
Office of the Treasurer & Tax Collector

October, 2017

Background

- Until 2013, San Francisco levied a 1.5% tax on the payroll expense of larger businesses in the city. San Francisco was the only city in California to base its business tax on payroll expense.
- In 2012, voters approved a shift from the payroll expense tax to one based on gross receipts. The change was intended to promote economic growth, greater revenue stability, and better equity in the business tax system.
- To protect the City's fiscal position, and business tax payers, the new gross receipts tax was set to phase in, and the payroll expense tax was set to phase out, during a five-year period from 2014 to 2018.
- The 2012 Gross Receipts Tax Ordinance also requires the Controller's Office and Treasurer's Office to prepare annual reports during the phase-in of the new tax system. This report, based on business filings for tax year 2016, is the third such report.

40% More Businesses Pay the Gross Receipts Tax Than Paid the Payroll Expense Tax



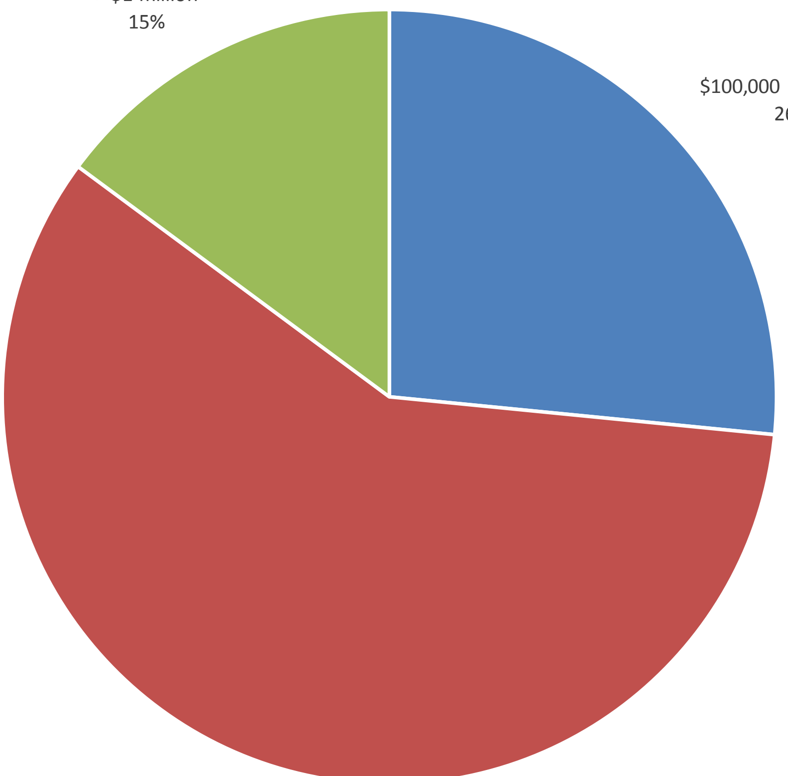
One of the goals of the 2012 business tax reform was to broaden the tax base, by increasing the businesses who pay at least some business tax.

Following the trend from earlier years, the 2016 data continues to make it clear that the gross receipts tax has broadened the tax base: about 40% more businesses pay the gross receipts tax than the payroll expense tax.

Expectations in 2012 were that the number of business tax payers would roughly double. These projections involved a high margin for error, however.

In Addition to the Payroll Expense and Gross Receipts Taxes, Over 64,000 Businesses Paid a Registration Fee in 2016

Distribution of Non-Exempt Registered Businesses by Gross Receipts Size, 2016

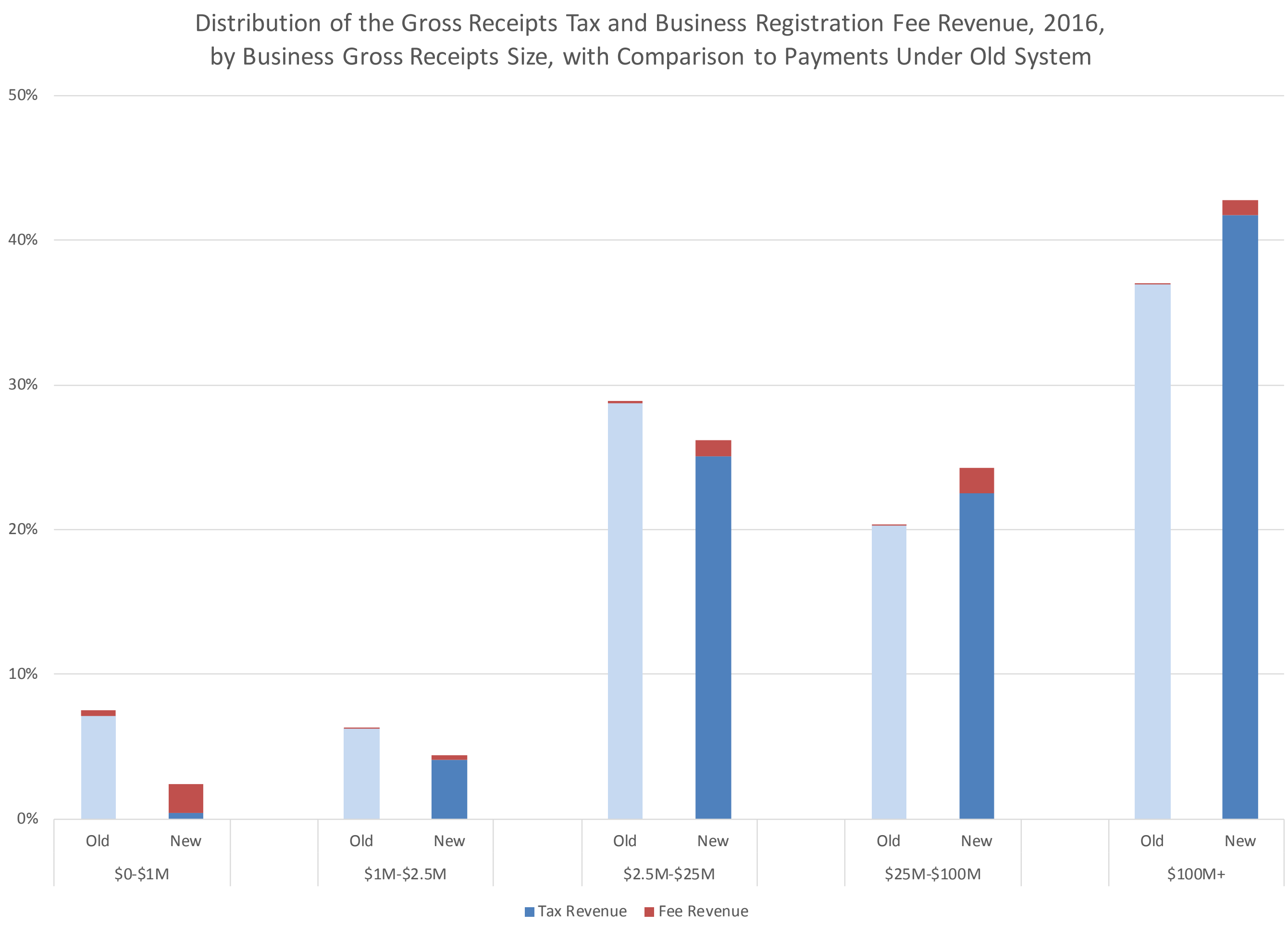


66,628 companies had registered to do business in San Francisco, for the fiscal year 2016-17, by June 30, 2016. 2,401 were exempt (as non-profits or short-term rental hosts), and the remainder paid a registration fee ranging from $75 to $35,000, depending on their gross receipts.

15% of the non-exempt businesses reported more than $1 million in San Francisco gross receipts; these businesses will generally be liable to also pay the gross receipts tax. Another 26% of registered businesses reported between $100,000, and $1 million, in San Francisco gross receipts. These businesses paid a fee ranging from $125 to $700, but were mostly exempt from the gross receipts tax and, depending on their payroll expense, from the payroll expense tax as well.

The majority, 59%, reported less than $100,000 in San Francisco gross receipts. These businesses paid a fee of $75 or $90. In the vast majority of cases, these businesses are exempt from both the gross receipts and payroll expense taxes.

Despite the Broader Base, 2016 Data Continues to Suggest that the New System is More Progressive Than the Old Payroll Expense Tax.

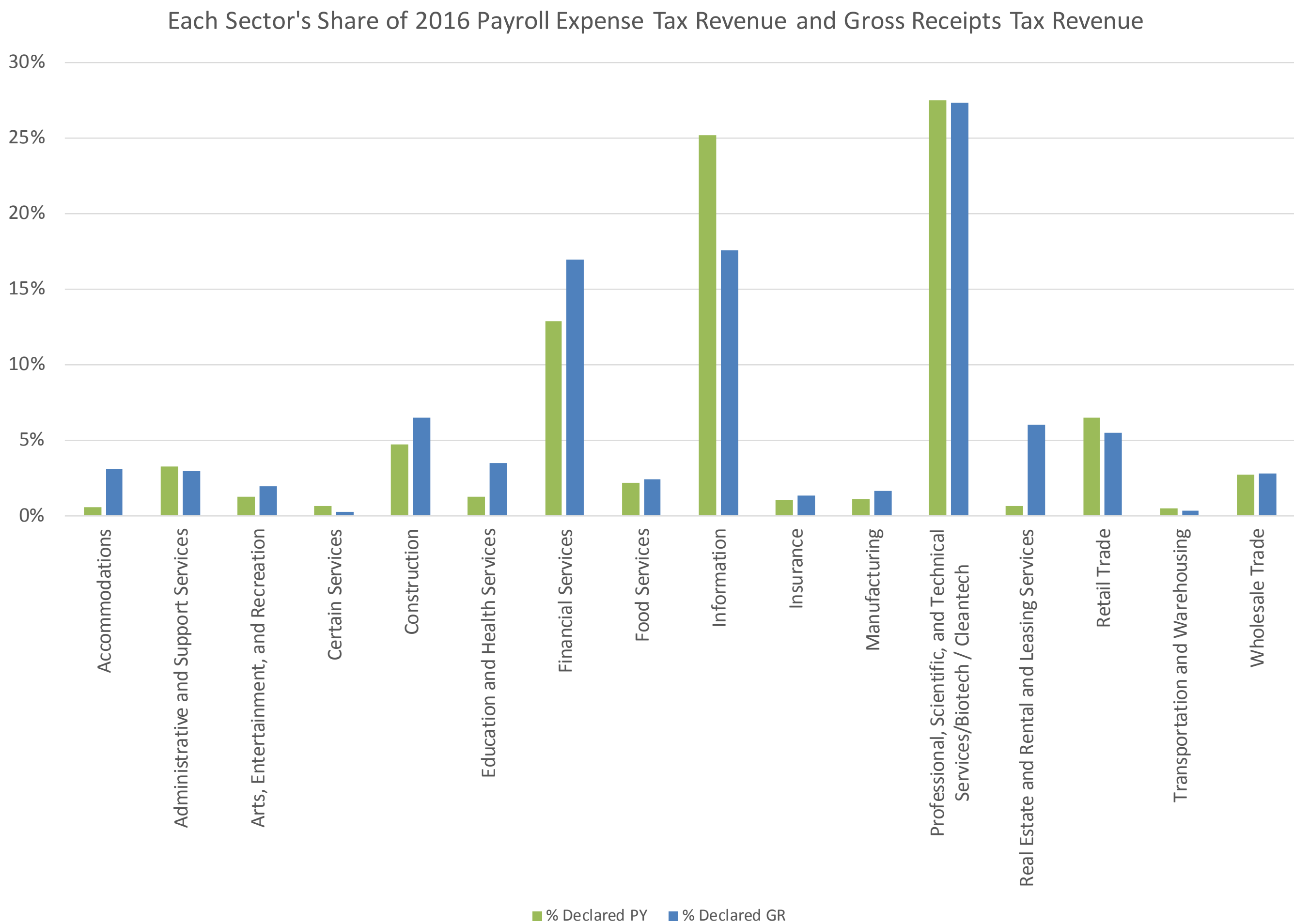


Another one of the base-broadening objectives of the 2012 business tax reform was to improve the equity of the City's business tax system. Under the old system, businesses with more than $250,000 in payroll paid a flat 1.5% rate, and business registration fee revenue was comparatively small.

The new gross receipts tax system introduced a progressive rate structure, and a larger, progressive business registration fee. The overall effect on the progressivity of the tax can be seen here: despite facing higher registration fees, businesses with less than $1 million in gross receipts pay much less than what they paid under the old system, even with higher fees.

Only businesses with above $25 million in gross receipts pay a higher share of revenue under the new system, compared to the old flat payroll expense tax and business registration fees.

The New Tax System Has Changed the Tax Burden Among Industries

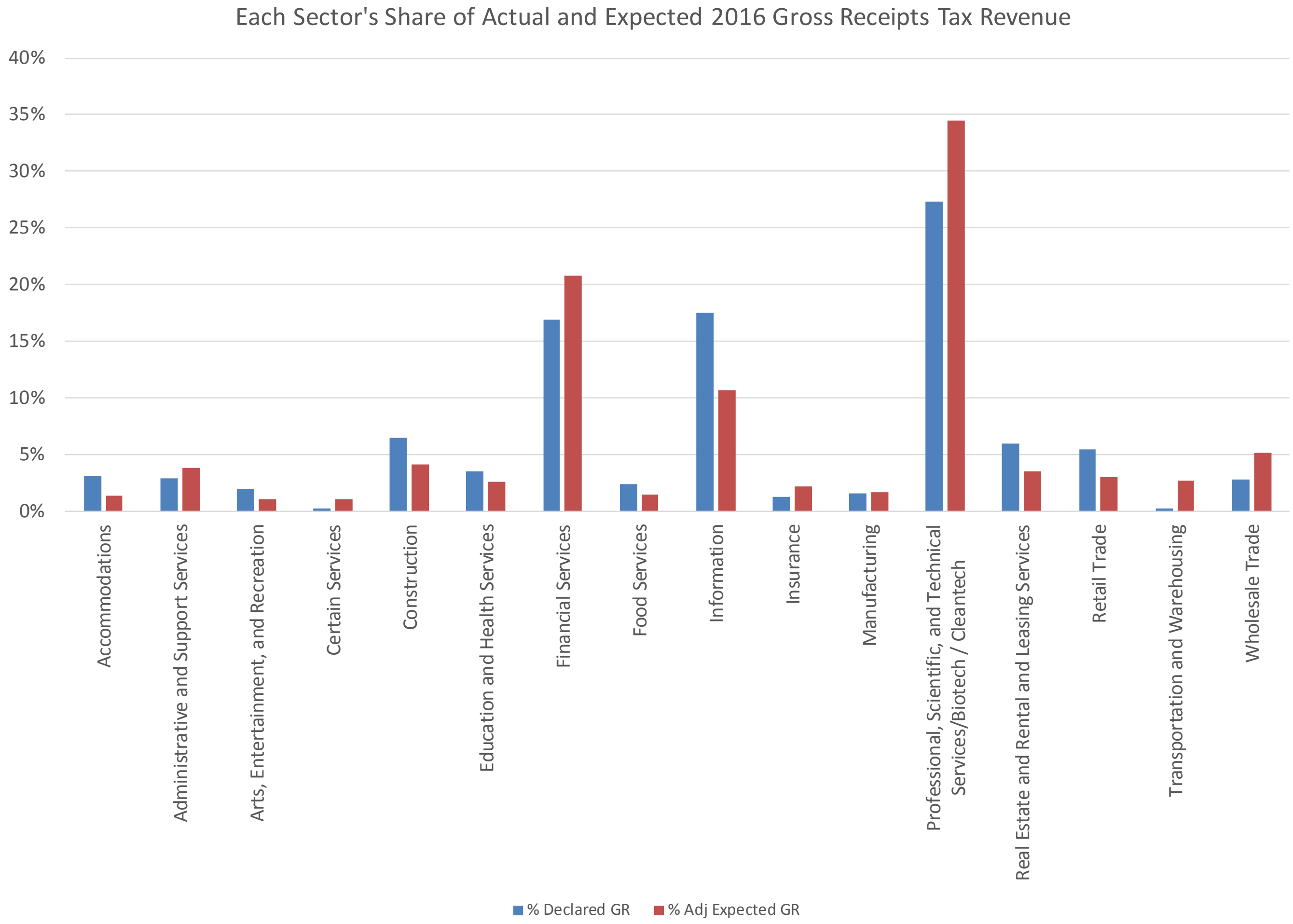


The chart to the left illustrates how the gross receipts tax is changing the tax burden across industry sectors in the city. The bars show how 2016 payroll expense and gross receipts tax payments are distributed, based on the industry sectors that businesses declare in their filing. If the blue bar is lower than the green bar, the industry is facing a lower overall tax burden as the City transitions to the new system.

For example, businesses declaring themselves in the Information sector are paying 25% of the City's payroll expense tax, but only 17% of the gross receipts tax. These businesses therefore have a lower tax burden than they would under the old 1.5% payroll expense tax.

Conversely, businesses in sectors such as Financial Services, Real Estate, and Accommodations are paying a higher percentage of the gross receipts tax than of the payroll expense tax, indicating a rising tax burden during the transition.

While Some Sectors' Gross Receipts Tax Burdens Are In Line With Expectations, Others Are Not



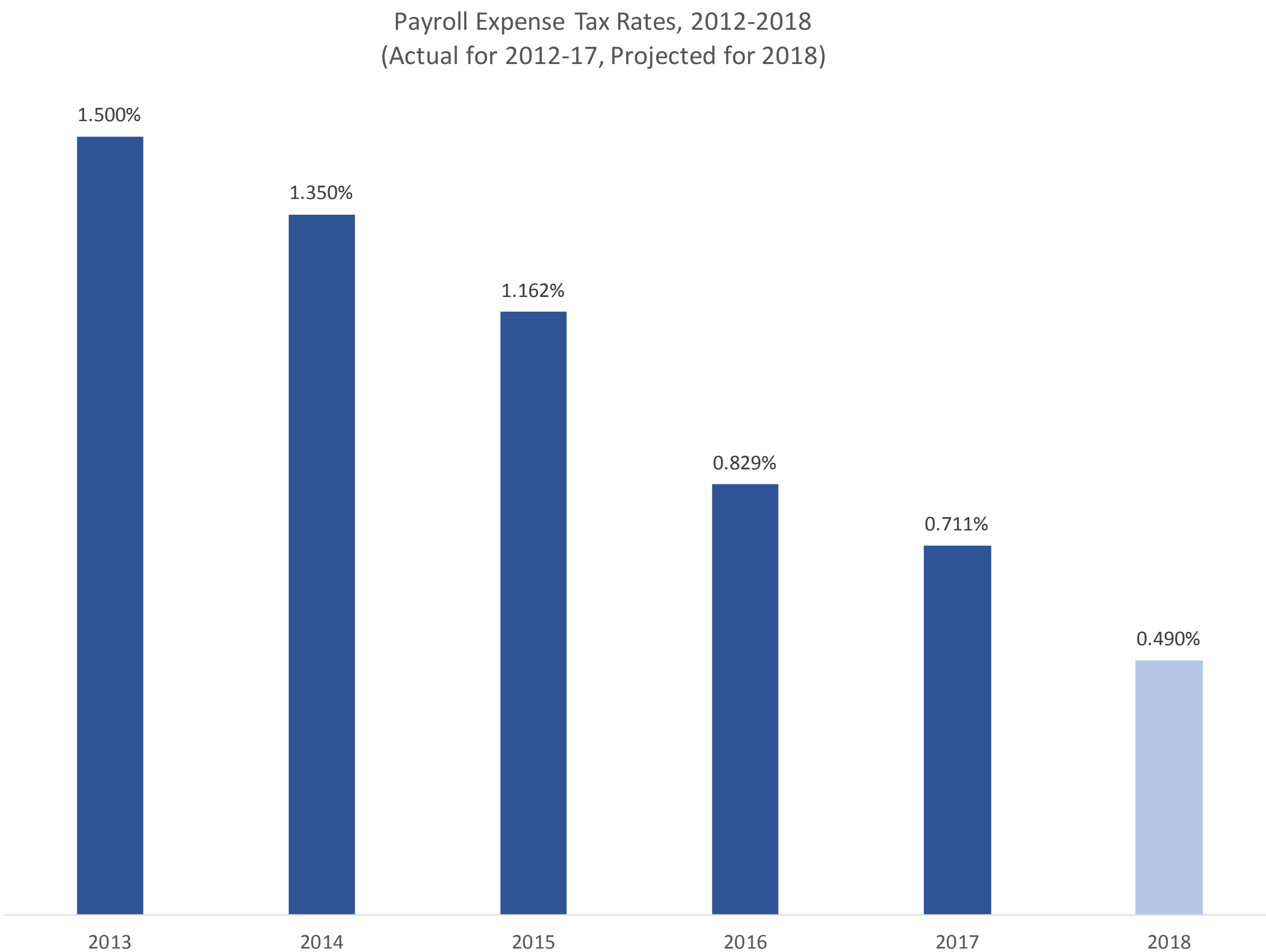
Some of these changes in the tax burden across sectors was anticipated when the gross receipts tax was being designed in 2012, while others were not.

The chart to the left shows the differences between the actual gross receipts tax burden, and what was expected in 2012. The expected burden (red bars) has been adjusted to reflect changes in the economy since 2012. Differences between the red and blue bars reflect our errors in estimating tax revenue 5 years ago, as well as businesses filing in unexpected sectors.

The gross receipts tax burden on the Real Estate and Accommodations sector, discussed on the previous page, is higher than was expected, while Transportation/Warehousing and Certain Services are paying less than expected.

The Information sector is a special case. Businesses in that sector benefit from the switch, but gross receipts taxes are higher than expected. This may be because businesses are filing in that sector instead of Professional Services, which has much less gross receipts tax revenue than expected.

Payroll Expense Tax Rates, 2013-17, With a Projection for 2018



The 2012 Gross Receipts Tax Ordinance set the new tax to phase in gradually over time. In 2014, gross receipts rates were 10% of the voter-approved maximum, rising to 25% in 2015, 50% in 2016, 75% in 2017, and finally 100% in 2018.

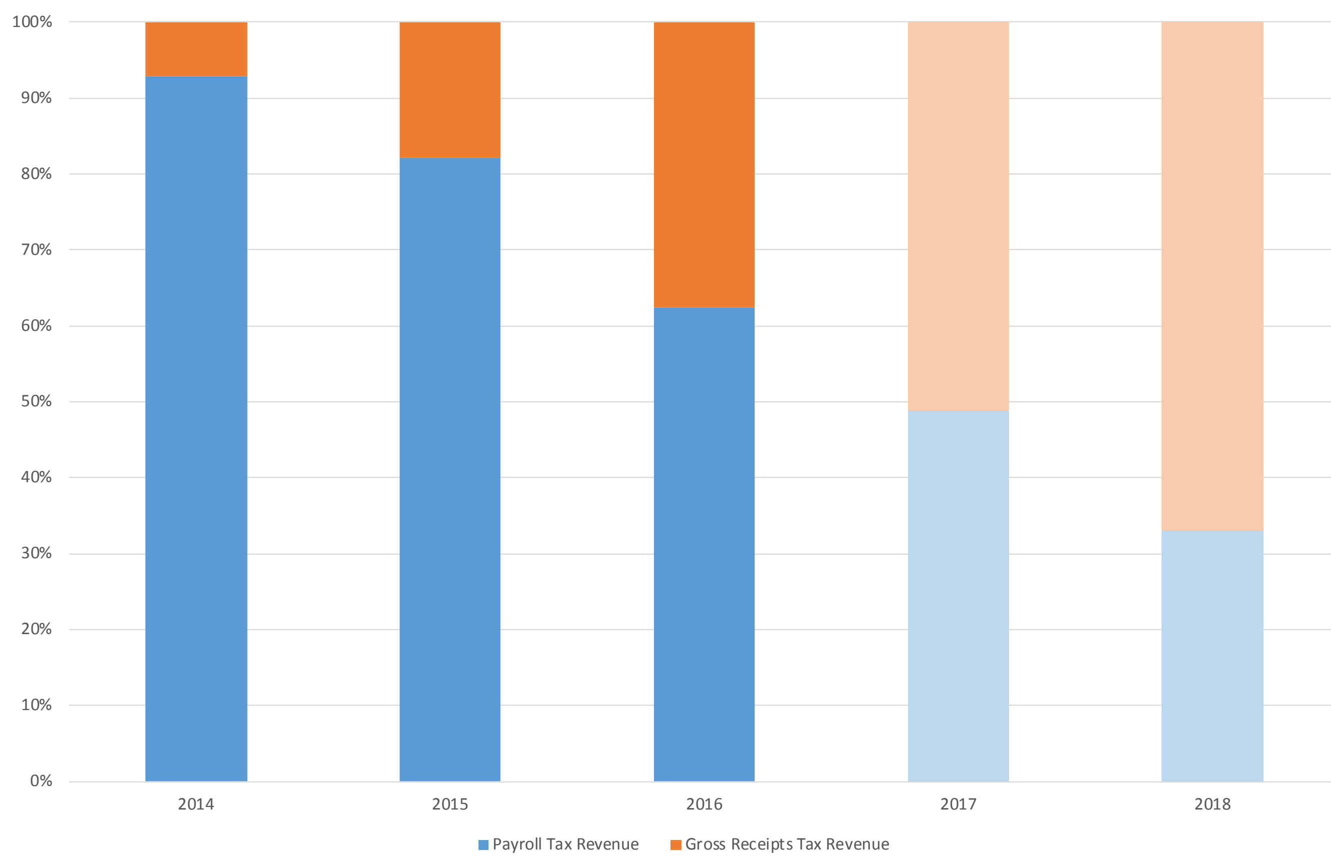
The tax change was designed to be revenue-neutral: revenue raised by the new gross receipts tax would be used to retire the payroll expense tax.

The Controller's Office is directed to compute the payroll expense tax rate during the phase-in period, using formulas in the ordinance. The rates through 2017, and the projected rate for 2018, are shown in the chart to the left. In 2018, the final year of the phase-in period, we project the payroll expense tax rate to be approximately 0.5%.

The basic reason for the remaining payroll expense tax rate in 2018, after the gross receipts tax has fully phased in, is that gross receipts tax revenue has been less than expected.

A Gap in Gross Receipts Tax Revenue Means the Payroll Expense Tax Comprises About a Third of Business Tax Revenue After 2018

Payroll Expense Tax and Gross Receipts Tax Share of Combined Business Tax Revenue, 2014-18
(2017 and 2018 Projected based on 2015-16 Growth Rates)

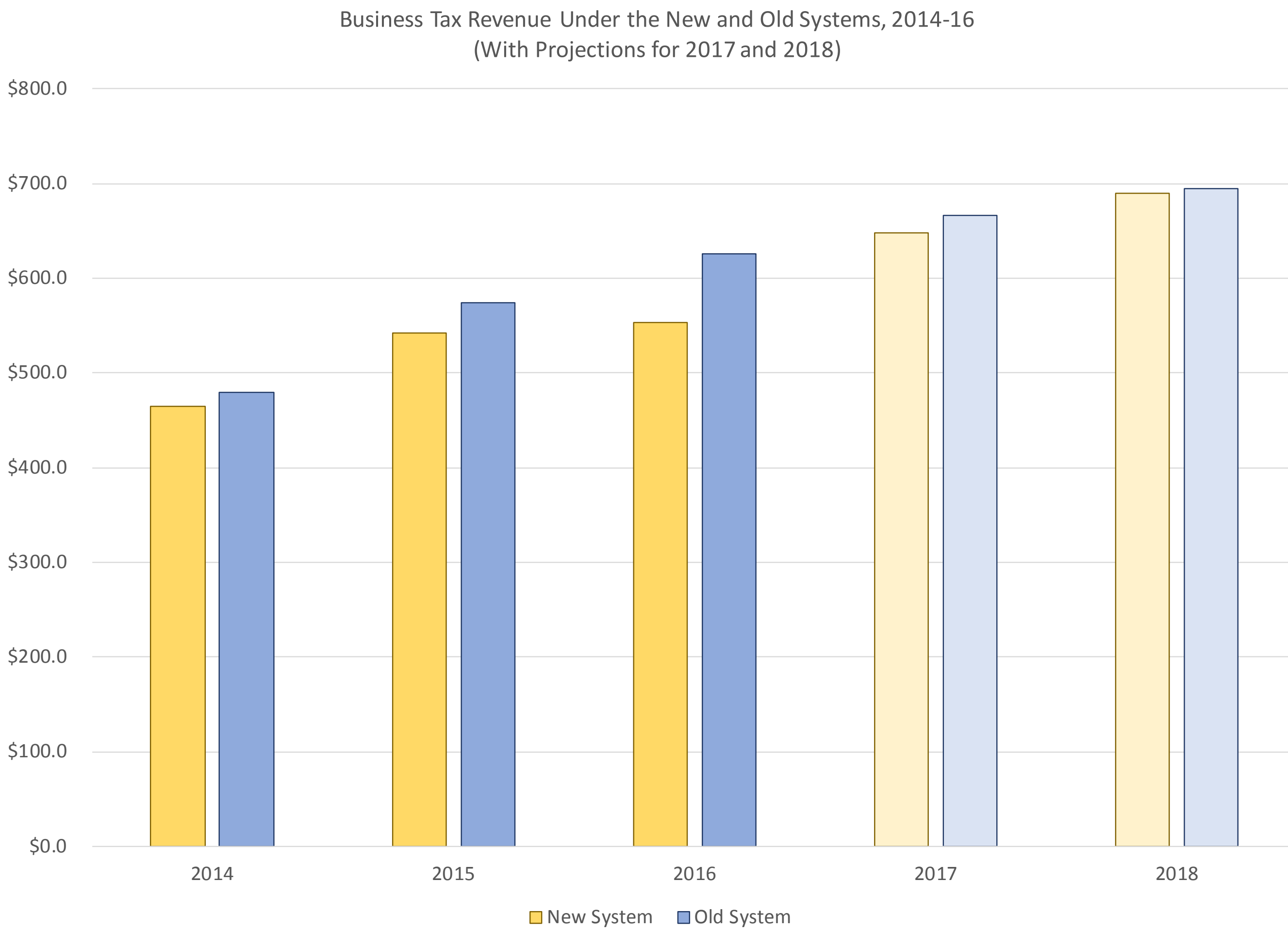


The chart to the left shows the split in actual business tax revenue between payroll expense and gross receipts taxes from 2014 to 2016. Projections are shown for tax years 2017 and 2018, based on current Controller's Office revenue projections for those years.

The charts illustrate the gross receipts gap: in 2014, gross receipts tax was expected to be 10% of combined tax revenue but was only 8%. In 2015, it was expected to be 25%, but was only 18%. In 2016, it was expected to be 50% of total revenue, but in reality comprised only 38%.

Unless there are significant changes to the gross receipts tax base in the next 18 months, payroll expense tax revenue will still make up about one-third of combined business tax revenue in 2018. This will be necessary to maintain revenue neutrality, and reflects a projected payroll expense tax rate for 2018 of 0.49%, about one-third of the original rate.

Based on Current Projections, in 2018, Combined Business Tax Revenue Will Be Within 1% of Revenue Under the Old System



Revenue-neutrality means the new business tax system should produce the same amount of business tax revenue for the City as the system it replaced.

The chart to the left compares combined business tax revenue under the new system—gross receipts and payroll expense tax--to what the City would have collected under the original 1.5% payroll expense tax.

The gross receipts gap discussed earlier, and the rapid rate of economic growth in the city, has contributed to a lag between the new system and the target.

However, the payroll expense tax formula will act to close this gap in 2017 and 2018. If business taxes grow in line with Controller's Office projections, combined business tax revenue will be within 1% of the target in tax year 2018.

2017 Implementation Highlights

- The Office of the Treasurer & Tax Collector (TTX) implemented legislative changes to reduce tax penalties on small businesses and quarterly installment payments to enhance faster compliance without collection actions, and conform quarterly installment payment to align with federal and state estimated tax payment practices.
- Online business registration and the rapid adoption of independent contractor models to certain industries has led to a higher volume of openings and closures of San Francisco businesses.
- TTX publishes data about businesses to the DataSF portal, including business activity information.
- TTX has continued its outreach campaign including online videos, community presentations, and enhanced taxpayer assistance resources with filing assistance resources for specific taxpayer groups, such as landlords.
- TTX continues to review and enhance its systems and forms to improve tax compliance and enhance the taxpayer filing experience.

Conclusions

- The 2012 business tax reform process had many goals:
  - Replace the payroll expense tax
  - Broaden the tax base
  - Improve equity
  - Encourage economic growth
  - Maintain revenue neutrality
- Most of these goals are on track. The tax base is broader and the business tax is more progressive. Revenue under the new system is expected to closely match what revenue would have been under the old system, meaning the switch has been close to revenue neutral. It is too soon to tell how much of the city's recent economic growth is attributable to the tax switch, and if the gross receipts tax will be a more stable revenue source.
- However, it is clear that the goal of fully replacing the payroll expense tax with new gross receipts tax revenue will not be met. Further adjustments will be required to be approved by the voters to complete the shift to a single tax structure, if desired.

Policy Options

- If, as expected, one-third of the payroll expense tax will remain in 2018, it could be replaced all at once with an across-the-board increase in gross receipts rates to maintain revenue neutrality. To some extent, the gross receipts gap was caused by our limited information in 2012, on the gross receipts tax base. We can now more confidently estimate that approximately a 50% increase in current maximum gross receipts tax rates would be required, which would raise about $225 million in new gross receipts tax revenue.
- However, tax compliance issues also contribute to the gross receipts gap. In 2012, we anticipated that the five-year phase-in period would be a sufficient time to ensure that most businesses fully understood how to comply with the new law, and most significant controversies would be addressed or adjudicated. In retrospect, this was too optimistic. Raising rates in 2018 to eliminate the payroll expense tax may not result in revenue neutrality over the longer term.
- The policy choice to further reduce or eliminate the payroll expense tax can, of course, be combined with, or treated separately from, any other policy effort to adjust tax rates or revenue targets.