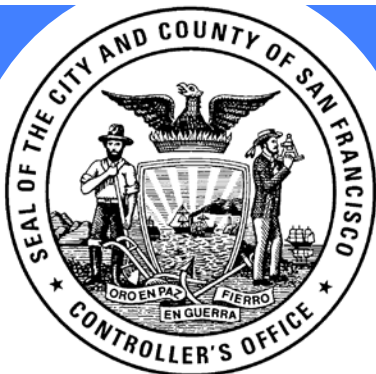


San Francisco Business Tax Reform

Annual Report for 2018



CITY & COUNTY OF SAN FRANCISCO

Office of the Controller

Office of the Treasurer & Tax Collector

03.28.2019

- In 2012, San Francisco voters approved a significant change to the way businesses in the city were taxed.
- Prior to that, most larger businesses in the city paid a tax of 1.5% of their payroll expense. Approximately 10% of the city's registered businesses were subject to the tax. In addition, businesses paid a small registration fee.
- The 2012 ballot measure established and phased-in a new Gross Receipts Tax, established a new Administrative Office Tax, increased the Business Registration Fee, and began to phase-out the Payroll Expense Tax.
- The ballot measure also directed the Controller's Office and Treasurer's Office to produce annual reports on the transition for five years. This report is the fourth in that series, covering tax filing information from 2017.

Details of San Francisco's Business Taxes in 2017

Tax Name	Who Pays It?	How Much Is it?	How Many Businesses Paid It in 2017?
Payroll Expense Tax	Non-exempt businesses with more than \$300,000 in taxable Payroll Expense in San Francisco	0.711% of San Francisco Payroll Expense in 2017, falling to 0.38% in 2018.	9,916
Gross Receipts Tax	Non-exempt businesses with over \$1.09 million in San Francisco Gross Receipts*.	0.075% - 0.650% of San Francisco Gross Receipts, depending on industry and size	14,742
Business Registration Fee	Non-exempt businesses engaged in business in San Francisco†	\$79 - \$37,293, depending on industry and size	79,640
Administrative Office Tax	Certain non-exempt large businesses having more than 50% of their combined San Francisco payroll expense associated with providing administrative or management services exclusively to that business or its related entities.	1.4% of San Francisco payroll expense, in lieu of paying Payroll Expense or Gross Receipts Taxes.	23

*Non-exempt lessors of residential real estate are required to pay the Gross Receipts Tax if they leased out four or more units in any individual building in the city.

† A person receiving rental income in connection with the operation of a cooperative housing corporation, one residential structure consisting of fewer than four units, or one residential condominium is not, by reason of that fact alone, required to pay the business registration fee

Goals of the 2012 Business Tax Reform

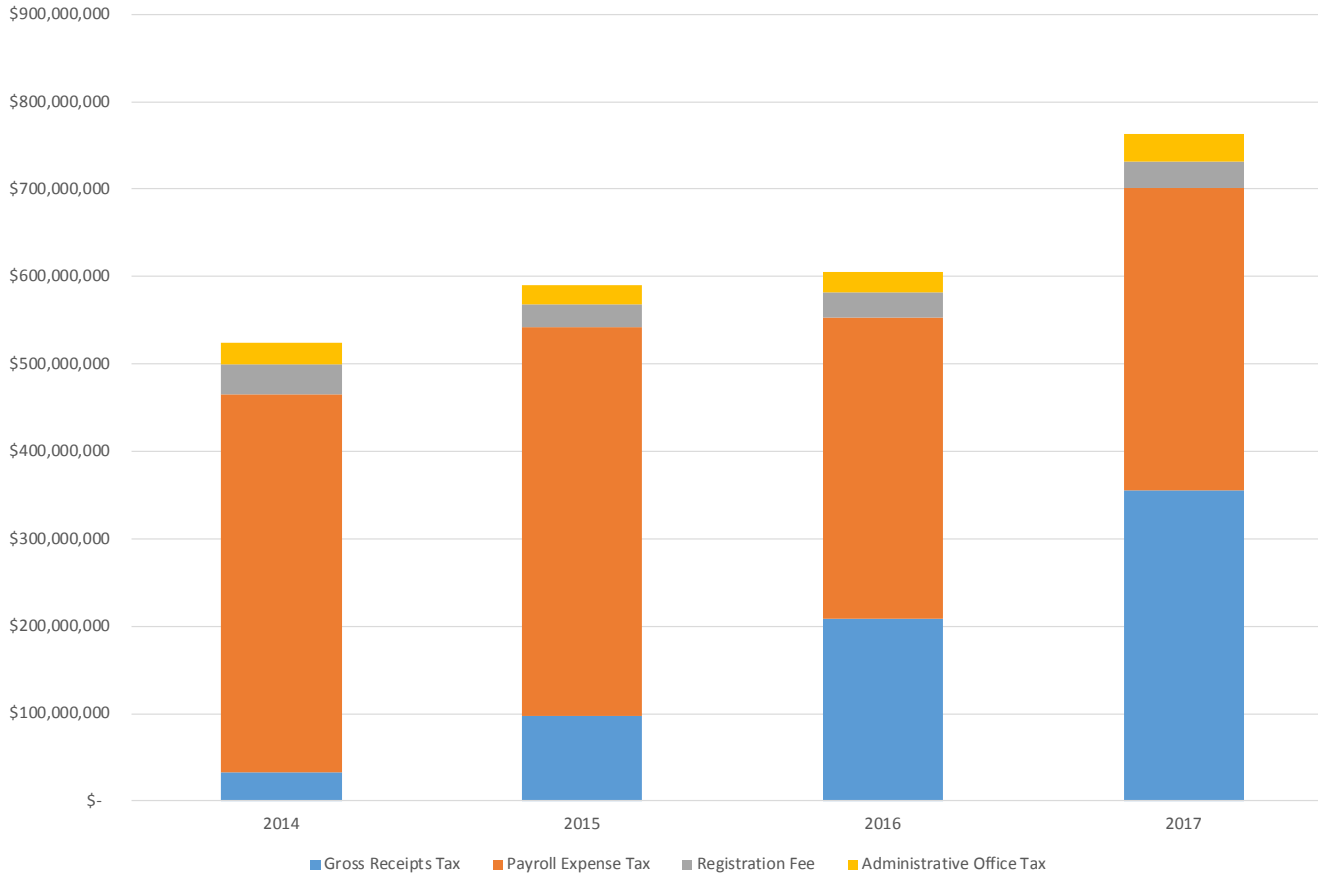
- The 2012 Business Tax Reform effort sought to achieve a variety of objectives:
 - Eliminate the Payroll Expense Tax, which was believed to discourage job creation and economic growth.
 - Adjust the business tax burden across industries, to further incentivize job creation.
 - Improve the equity of the tax, by better matching the tax burden with a business's ability to pay.
 - Stabilize business tax revenue, by broadening the tax base and moving away from a volatile source of revenue (payroll expense).
 - Ensure the transition to the Gross Receipts tax would neither raise nor lower business tax revenue.
- As detailed later in this report, the new business tax system has made progress on several of these goals. However, while the Payroll Expense Tax has been reduced from 1.5% to 0.38% as of tax year 2018, it will not be fully eliminated without further legislative change.

Outline of This Report

- Given these objectives, this report reviews 2017 tax filing information that is relevant to the following issues:
 - The trends in business tax payments, 2014-2017
 - Base broadening: the number of payers, and average payments, of the Payroll Expense Tax and Gross Receipts Tax
 - The progressivity of the Payroll Expense Tax and Gross Receipts Taxes
 - Shifts in the business tax burden across industries
 - Overall Business Tax Payments: New System vs. the Old System
 - Progress of the Payroll Expense Tax Phase-Out
 - Administrative Costs

Business Tax and Fee Payment Trend, 2014-17

Growth in San Francisco Business Tax Revenues, 2014-2017
(Based on Filings Received by June 30 of each Calendar Year)



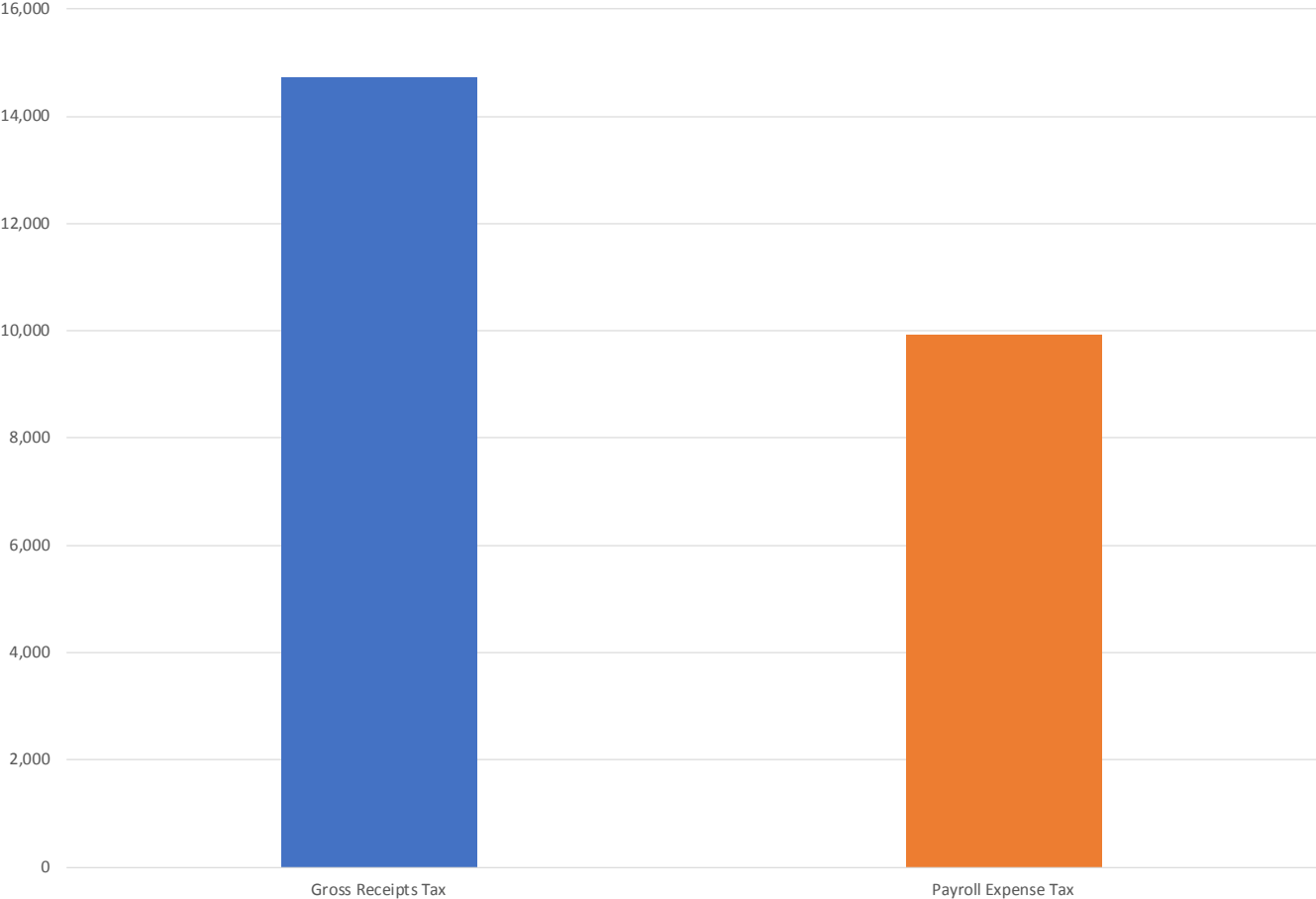
The chart to the left illustrates the growth in City business taxes since the beginning of the phase-in process in 2014. The blue area indicates the growth of Gross Receipts Tax payments, as the new tax's rates were phased in, and as the underlying tax base grew with the strength of the city's economy.

While the Payroll Expense Tax rate declined significantly during this period, the decline in Payroll Expense Tax payments was moderated by the rapid growth in the tax base. Overall, payments from the four revenue sources grew by 57% over the three years.

This data is based on the Calendar Year tax filings of San Francisco businesses, as of June 30th of the following year. These number will not match City tax revenues, which are reported on a fiscal-year basis.

More Businesses Pay the Gross Receipts Tax

Number of Companies Paying Gross Receipts or Payroll Expense Tax, 2017



In 2017, 14,742 businesses paid some Gross Receipts Tax, while 9,916 paid the Payroll Tax. Many of those paid both taxes. Additionally, 23 businesses paid only the Administrative Office Tax.

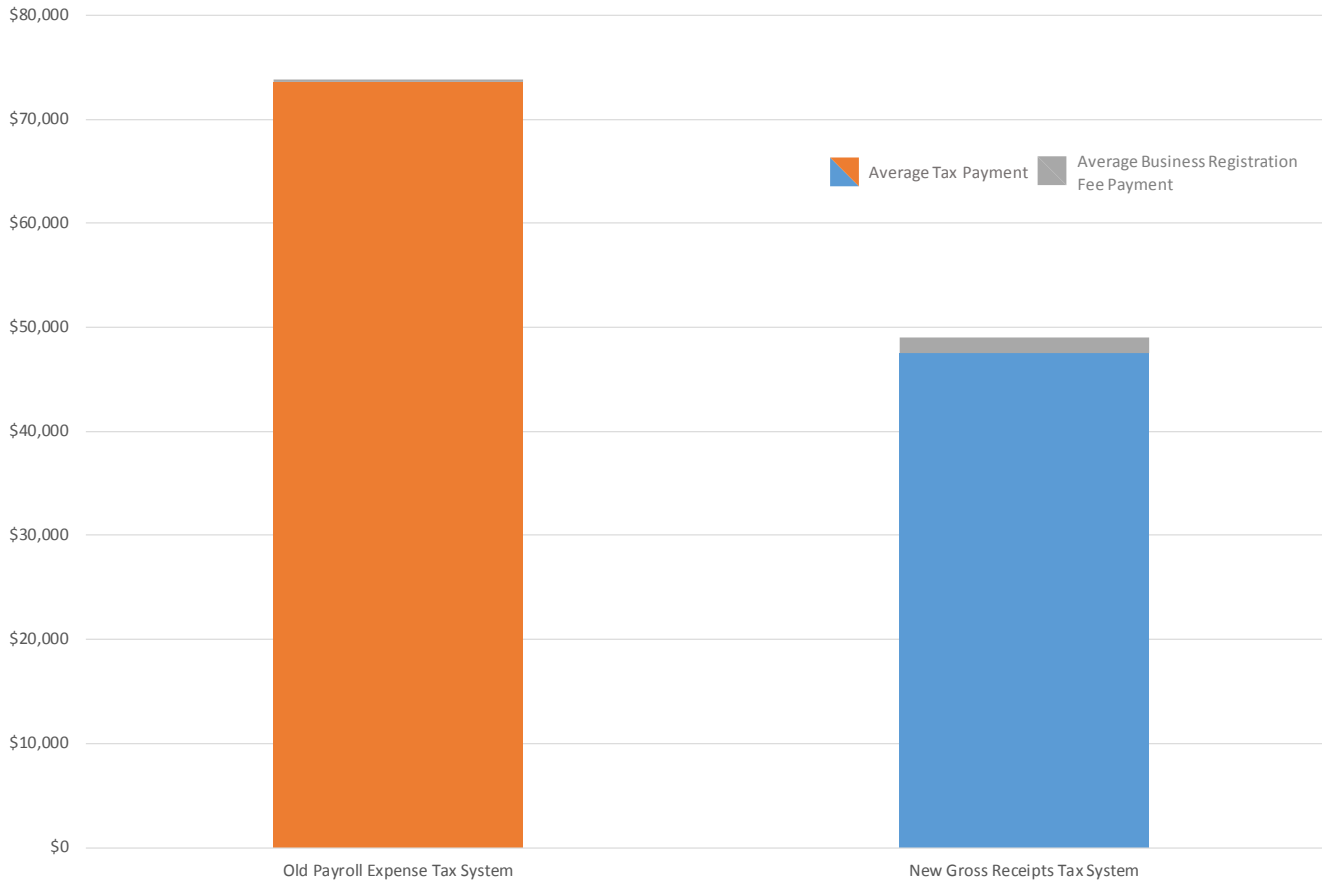
There are two main reasons why more businesses pay the Gross Receipts Tax than the Payroll Tax.

The Gross Receipts Tax incorporates companies with more than \$1.09 million in San Francisco gross receipts, but with little or no payroll. Many real estate businesses, as well as larger partnerships and sole proprietorships would fall into this category.

Secondly, the Gross Receipts Tax permits the City to tax businesses in the Presidio and other Federal enclaves in San Francisco. Because of Federal law, these businesses may not be subjected to a Payroll Expense tax, but can be charged a Gross Receipts Tax.

The Broader Base Has Lowered Average Payments

Average Business Tax and Business Registration Fee Payment per Taxpayer, Old and New Systems, Based on 2017 Filings



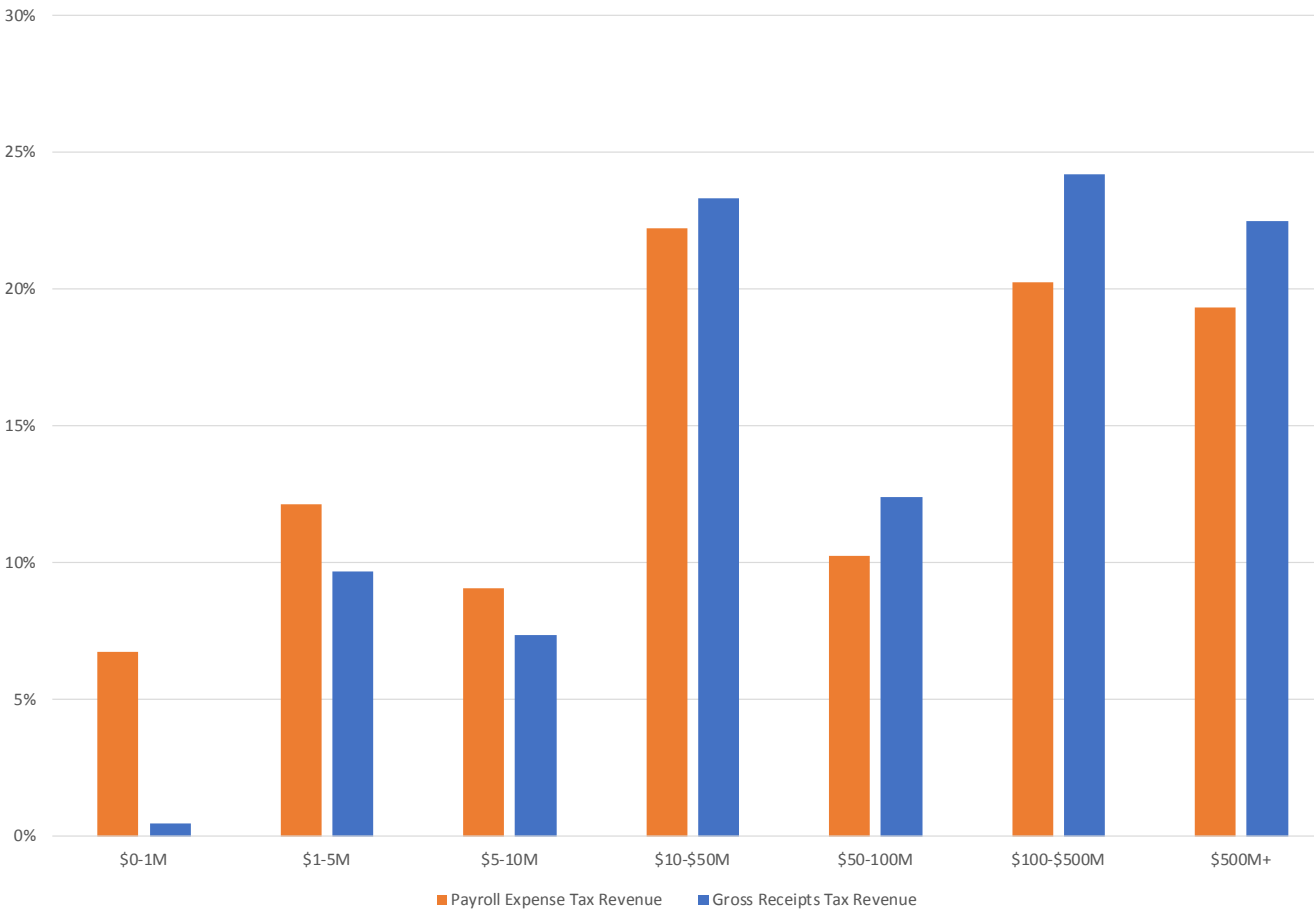
Because of the larger base of payers, the average tax and fee payment under the new system is significantly below what it would have been under the old 1.5% Payroll Expense Tax: \$48,979 under the new system, and \$73,862 under the old system.

The reduction in average tax and fee payment has occurred despite the increase in the average Business Registration Fee payment. Business Registration Fee revenue is a small portion of overall business tax revenue.

The Gross Receipts Tax is More Progressive

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Distribution of 2017 Gross Receipts and Payroll Expense Tax Revenue by Business Size



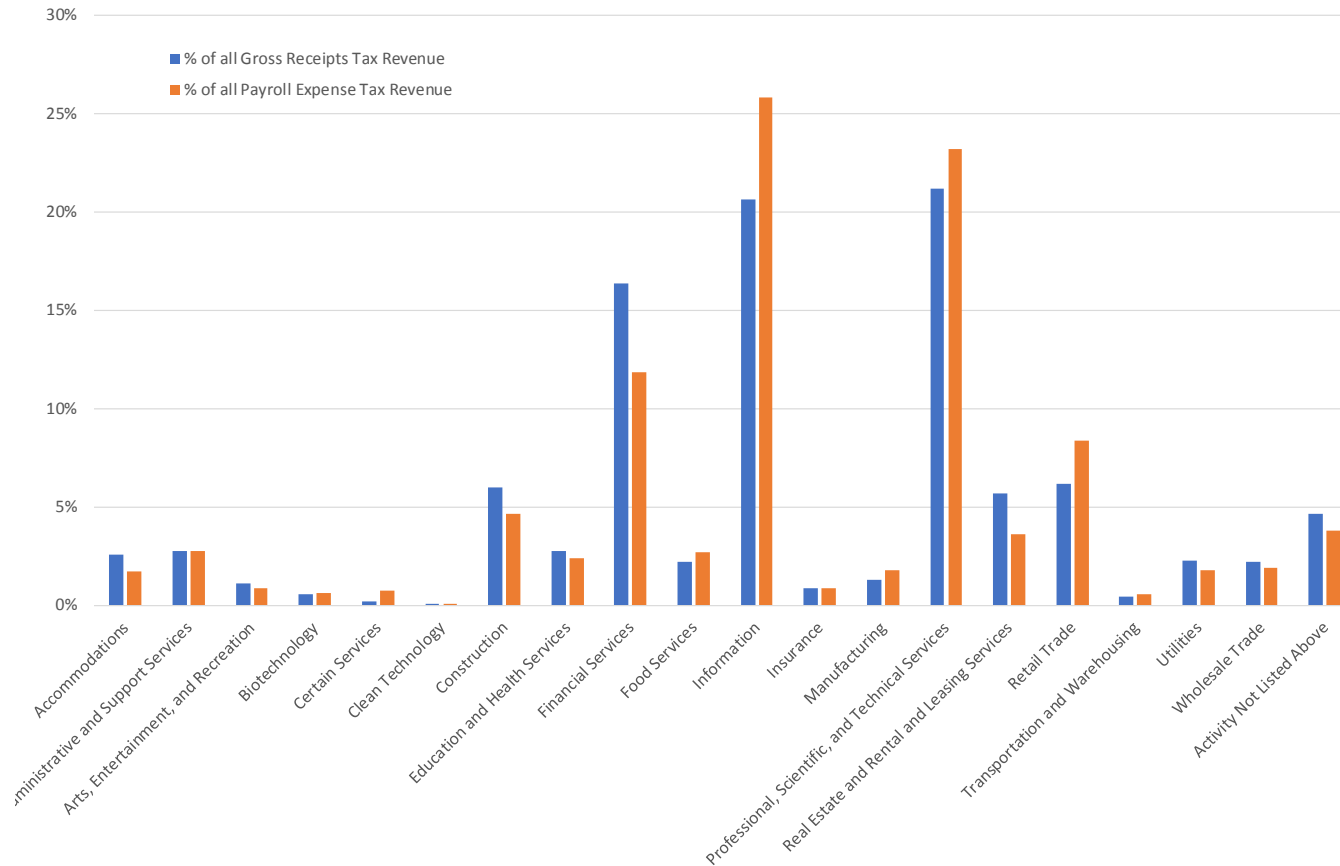
Despite the lower average payment, large businesses pay a greater share of the Gross Receipts Tax than they do of the Payroll Expense Tax. Businesses with over \$50 million in San Francisco gross receipts pay less than 50% of the Payroll Expense Tax, but nearly 60% of the Gross Receipts Tax. Businesses with less than \$10 million in gross receipts pay 28% of the Payroll Expense Tax, but only 18% of the Gross Receipts Tax.

This suggests that the phase-out of the Payroll Expense Tax has tended to shift the City's business tax burden from smaller on to larger businesses.

The primary reason for this is the progressive rate structure of the Gross Receipts Tax. Within each rate schedule, the tax has four tiers, with higher rates for larger businesses. In contrast, affected businesses of all sizes pay the same Payroll Expense Tax rate.

The Tax Burden Among Industries is Changing

Distribution of Gross Receipts Tax and Payroll Expense Tax Revenue by Industry Sector, 2017



The shift from Payroll Expense to Gross Receipts taxation has not only shifted the business tax burden away from small and towards larger businesses, but it has shifted the burden among industries in the city.

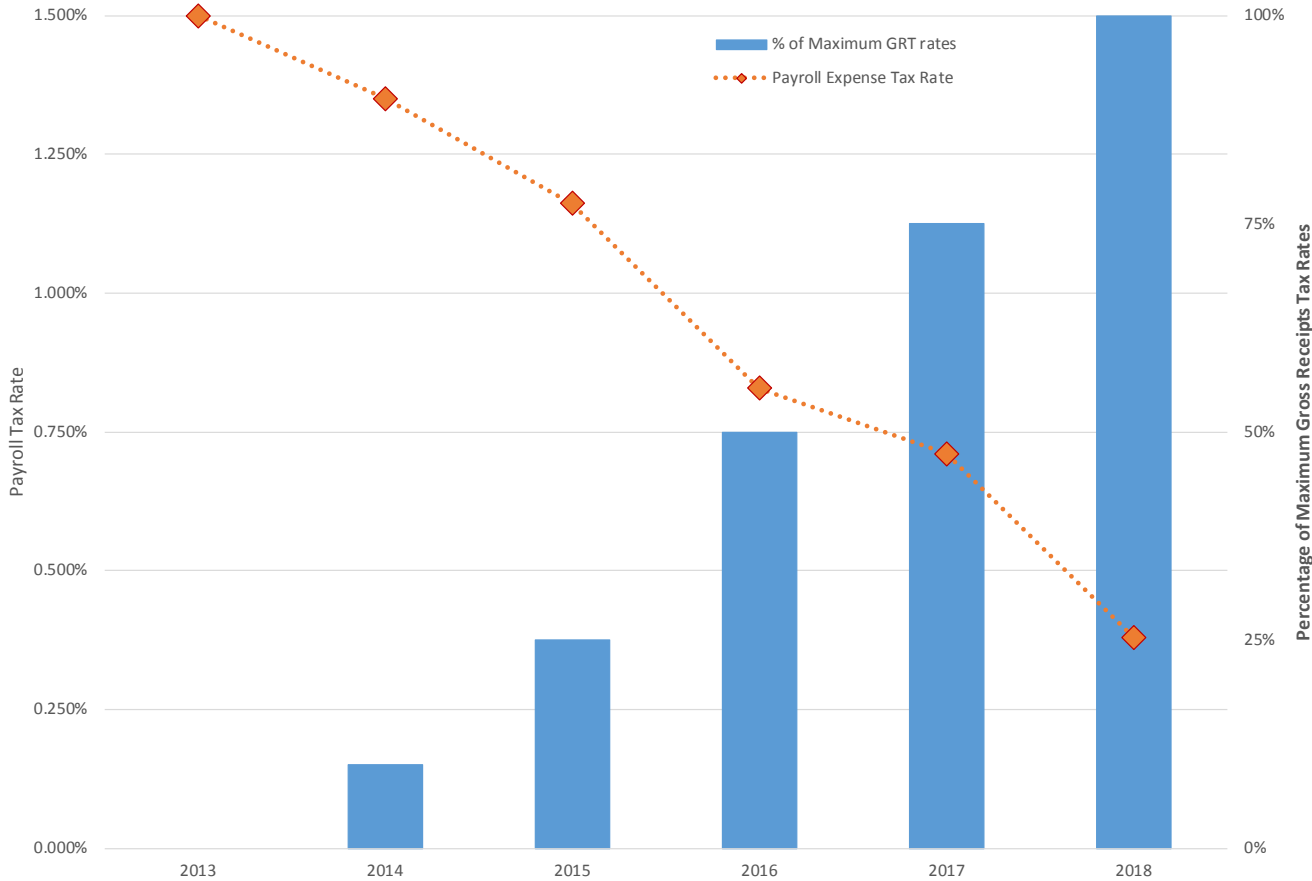
This can be seen by comparing the percentage of both taxes that each industry pays. As the chart to the left shows, industries like Information, Retail Trade, and Professional Services pay a lower share of the Gross Receipts Tax than they do of the Payroll Expense Tax, so the phase-out has benefitted them. Conversely, industries such as Financial Services, Real Estate, and Construction pay more.

To some extent, these shifts were anticipated when the Gross Receipts Tax was designed in 2012.

Note: Only businesses that report Gross Receipts across the different industry sectors are included, and businesses operating in more than one sector are assigned to the one that accounts for the most of their San Francisco gross receipts.

The Payroll Expense Tax Rate Phase-Out

Phase-In of Gross Receipts Tax, Phase-Out of Payroll Expense Tax: 2013-2018



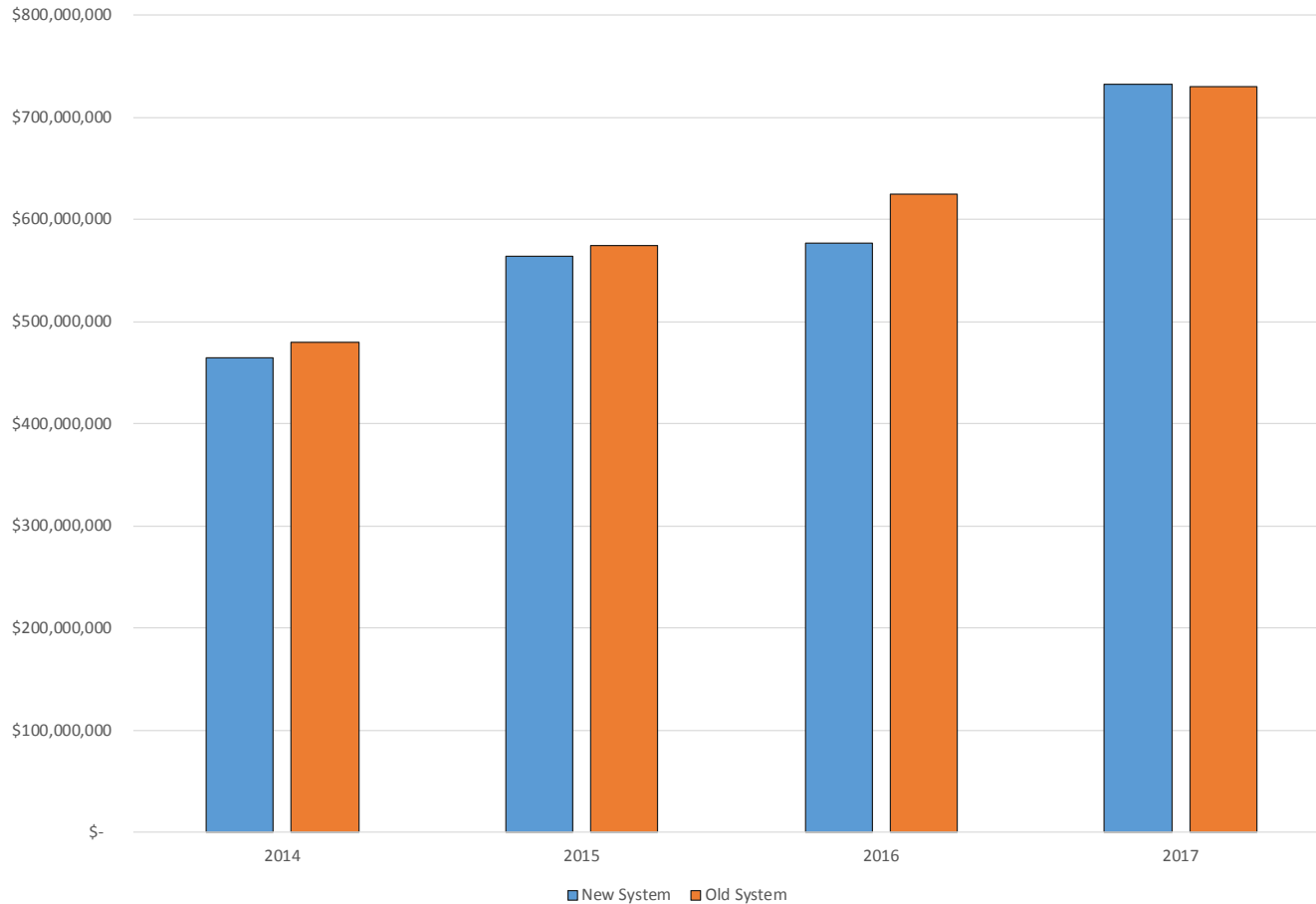
The phase-in of the Gross Receipts Tax was designed to happen in a revenue-neutral way, without significantly raising or lowering the amount of combined business tax that businesses would pay to the City.

This was accomplished by using a mathematical formula to set the Payroll Expense Tax rate for 2015-18, which reflects the difference between how much business tax revenue the City collected in the previous year, and how much it would have collected under the old 1.5% Payroll Expense Tax.

Because Gross Receipts Tax collections have been less than projected, the Payroll Expense Tax will not be fully phased-out. The chart indicates that in tax year 2018, with the full phase-in of 100% of the maximum gross receipts rates, the Payroll Expense Tax rate was set at 0.38%. It will remain at that rate unless changed by later legislation.

Revenue Neutrality of The Phase-Out

Business Tax Revenue Under the New and Old Systems



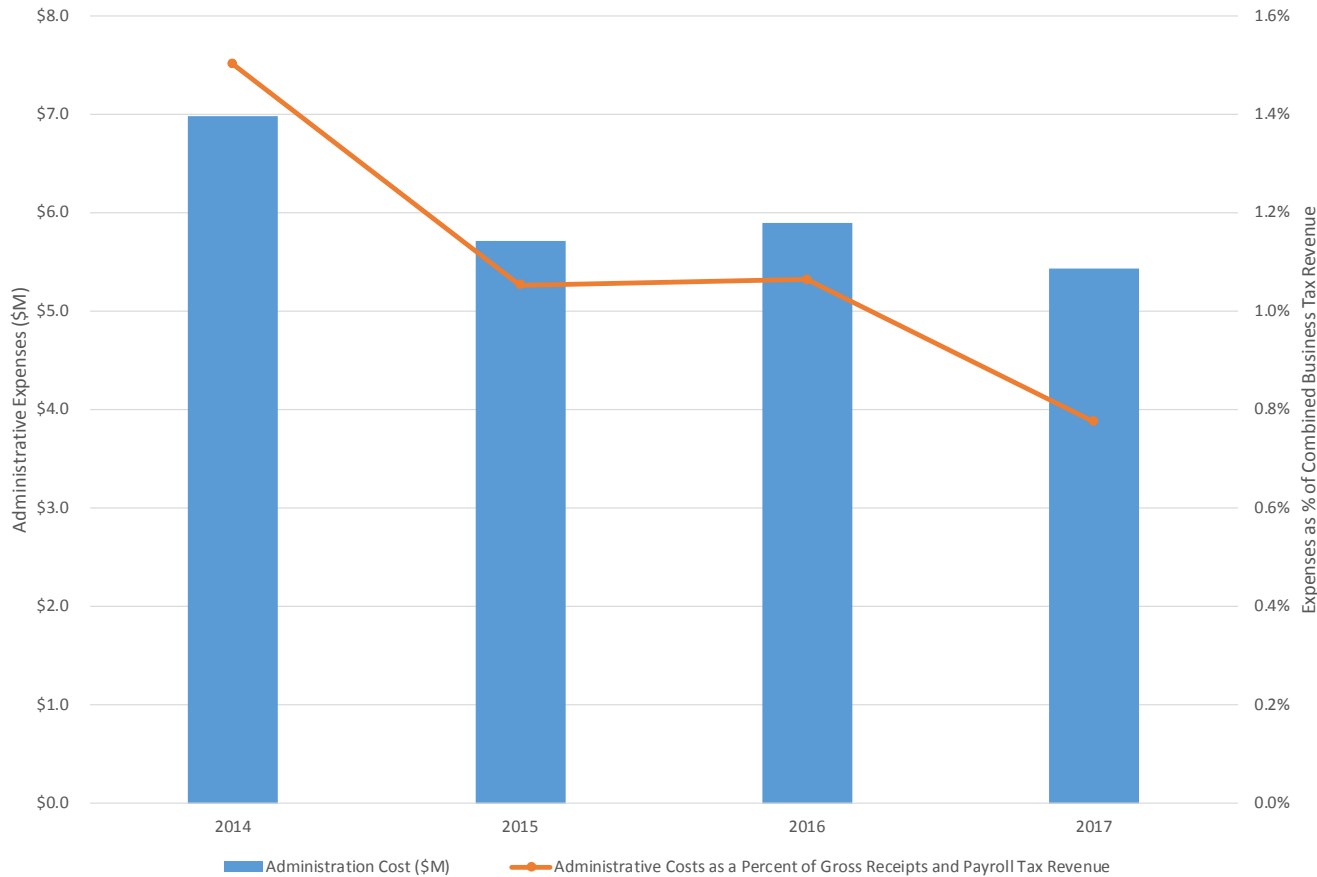
The intent of the Payroll Expense Tax rate formula was to protect the City, and business taxpayers, from uncertainty in the 2012 revenue projections for the new Gross Receipts tax.

While absolute revenue neutrality is difficult to accomplish because of annual growth in the tax base, the new tax system is, as intended, closely tracking the revenue the City would have received under the old 1.5% Payroll Expense Tax.

Based on 2017 tax filings, overall business tax revenue (Gross Receipts Tax, Payroll Expense Tax, and Administrative Office Tax) under the new system was 0.4% higher than it would have been under the old system.

Gross Receipts Administrative Costs, 2014-2017

Additional City Administrative Costs Associated with Gross Receipts Tax Implementation, 2014-17



Given its complexity, the implementation of the new Gross Receipts Tax has been a major undertaking for the City. While the Gross Receipts Tax was believed to be more efficient, stable, and equitable than the Payroll Expense Tax, it is more complex. This has led to higher administrative costs.

The City's administrative costs related to the tax are tracked separately, and are reimbursed through the Payroll Expense Tax rate formula, up to 2% of combined business tax revenue.

In 2017, these administrative costs were approximately \$5.4 million, or 0.8% of combined business tax revenue.

2018 Implementation Highlights

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- The Office of the Treasurer & Tax Collector (TTX) made a number of administrative changes to speed up collection from delinquent taxpayers, resulting in a doubling of principal collected within 90 days since FY 15-16.
- San Francisco voters approved the sugary drinks tax (2016), which became effective in 2018. Voters also passed the commercial rents tax, homelessness gross receipts tax, and cannabis tax in 2018. All taxes are being implemented by TTX leveraging the infrastructure built for GR/PY, with no new headcount.
- While most tax compliance actions are confidential, there have been public reports indicating significant audit activity, particularly around classification disputes. These disputes could have significant revenue impact.
- 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.

- This review of the 2017 tax filings information has largely confirmed the findings of earlier annual reports on the business tax transition.
- As intended, the Gross Receipts Tax is more progressive than the Payroll Expense Tax. It also incorporates more payers, from a wider area, resulting in a lower average business tax payment.
- The tax shift has changed the business tax burden across industries, in ways that were largely anticipated.
- There is, as of yet, insufficient data to determine if the Gross Receipts Tax will be more stable, or more conducive to economic growth, than the Payroll Expense Tax has been.
- While the scheduled five-year phasing-out of the Payroll Expense Tax was necessary to achieve the goal of a revenue-neutral transition, it has led to a situation in which that tax will remain, albeit at a significantly reduced rate.
- The full replacement of the Payroll Expense Tax remains the primary unmet objective of the 2012 business tax reform effort.