



# San Francisco's Experience With Business Tax Reform

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## A Bit of History

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- 1970s – San Francisco institutes a hybrid, Gross Receipts/Payroll tax system for businesses, Los Angeles adopts something similar.
- 1990s – Los Angeles loses a lawsuit and is forced to abandon its payroll tax.
- San Francisco – fearing the same outcome – unilaterally drops its gross receipts tax.
- 2002, 2004, 2010 – Proposed ballot measures to either replace lost gross receipts revenue, or reinstitute the gross receipts tax.
- 2004 – explicit inclusion of stock options in the payroll tax.
- 2004 – payroll tax incentive for biotechnology.
- 2011 – payroll tax incentives for locating in the Central Market St. area, and for pre-IPO tech companies.
- 2012 – ballot measure to:
  - phase-out the payroll tax
  - phase-in a gross receipts tax in a revenue-neutral way.
  - raise business registration fees to replace lost revenue from the old gross receipts tax.

# Criteria for Effective Tax Systems

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- 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 was 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

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"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

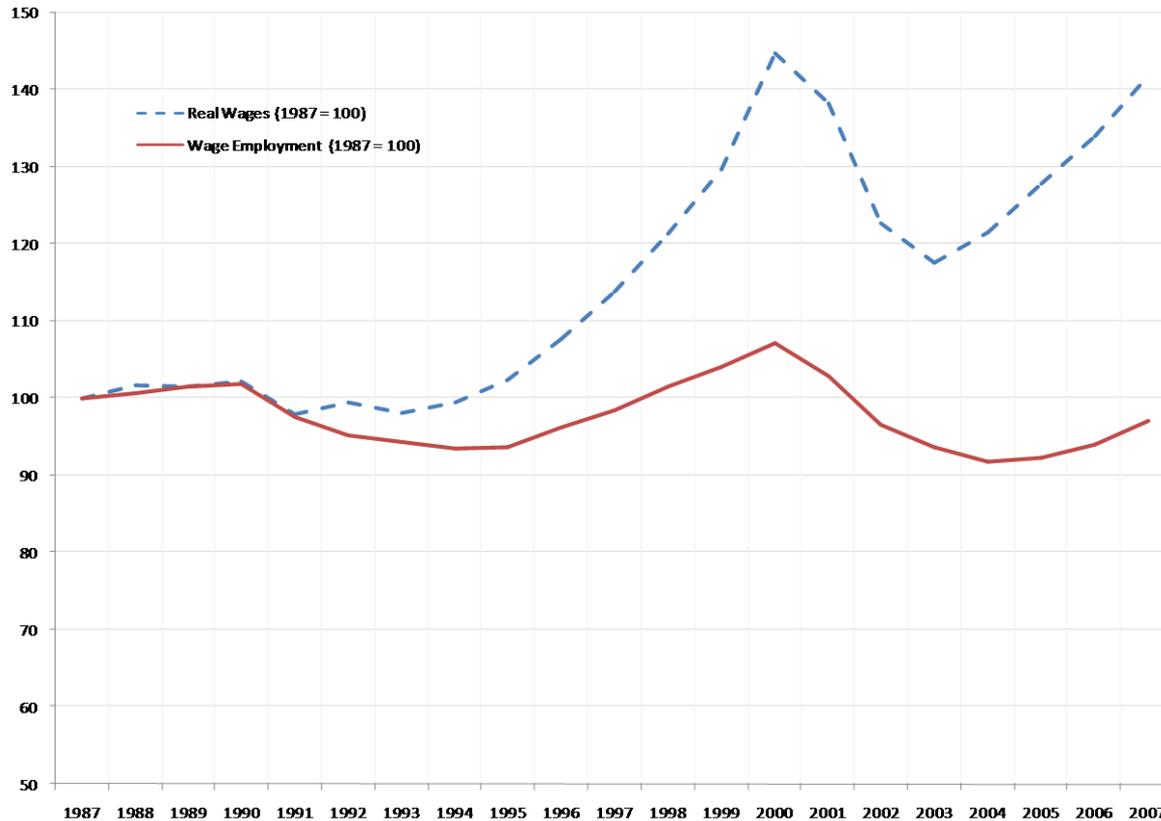
"A payroll tax may also have particularly strong negative effects on employment...It is probably true that gross receipts taxes have less of a direct, negative impact on payrolls through wages and employment levels than do payroll taxes."

---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.

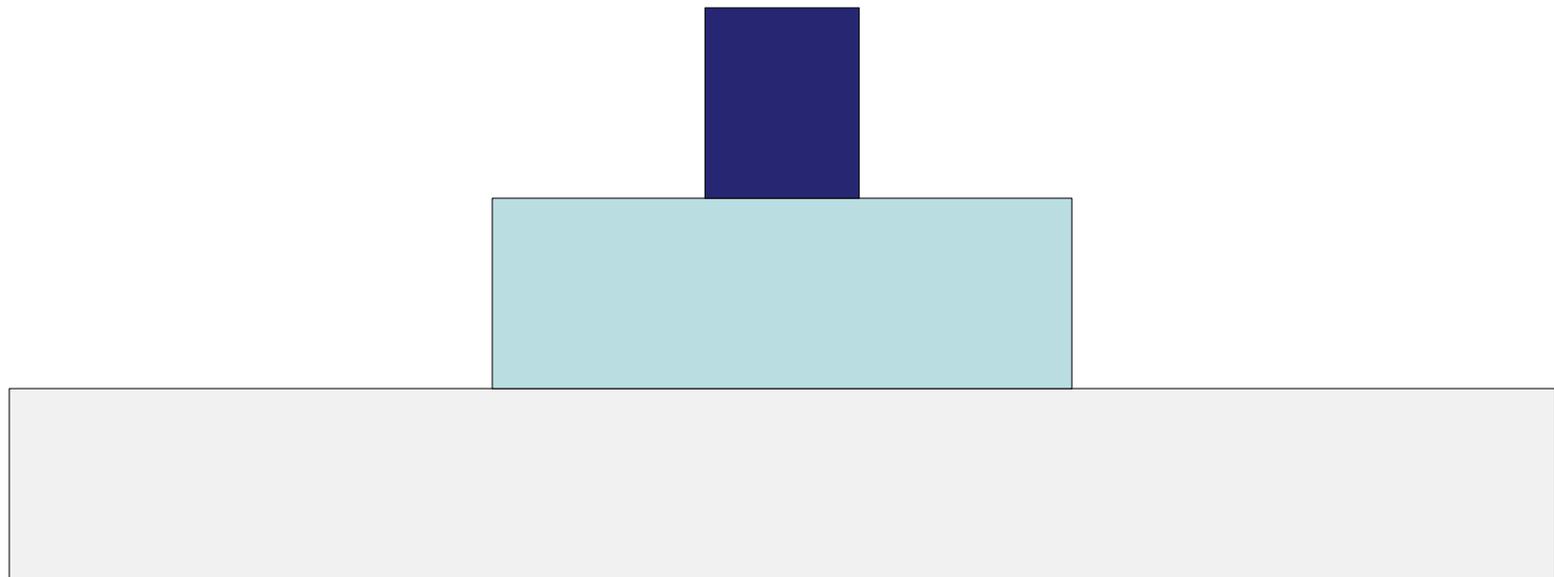
In recent years, payroll tax revenue has both increased and decreased by over 10% per year.

Source: Controller's Office REMI model

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

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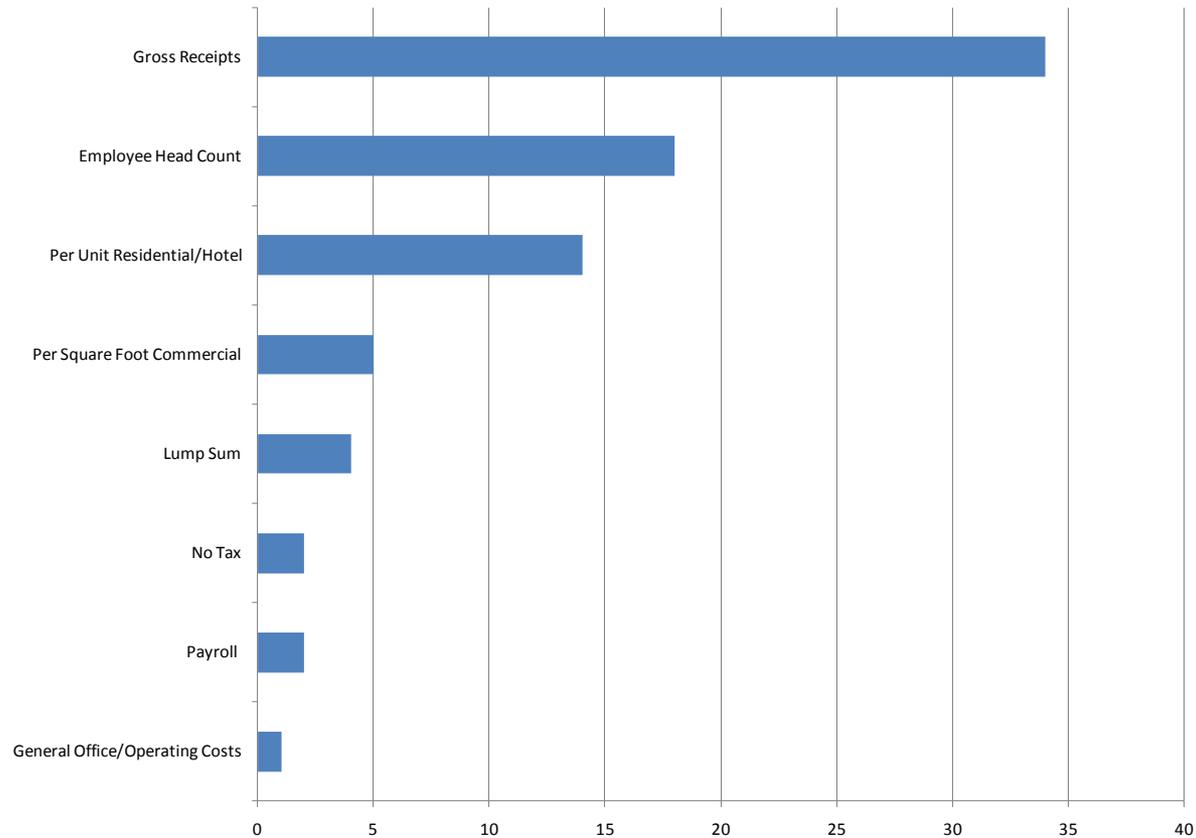
- 7,500 payroll tax payers
- 30,000 under the Small Business Exclusion (\$250k in Payroll)
- 96,000 registered businesses – including sole proprietors and partnerships



Source: Office of the Treasurer / Tax Collector

# Most Large Cities in California Use a Gross Receipts Tax

Types of Tax Used by the 50 Largest California Cities



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 the 2012 Proposal

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- Multiple Progressive, Marginal Rate Schedules for Different Industries
- Small Business and Other Exemptions
- Treatment of Administrative Offices
- Phase-In of Gross Receipts Tax Rates
- Phase-Out of Payroll Expense Tax Rate
- Existing Payroll Expense Tax Exclusions
- Establishment of New Registration Fees

**SPUR Forum**

**San José**

**Business Tax Modernization**

**August 10, 2016**

# **Current Business Tax**

**Structure**

**History**

**Comparisons**

**Council Direction**

**Principles**

# Current Business Tax Structure & Rates

Types of Business	Annual Tax	Additional Tax Increments	Not to Exceed	Number of Registered Businesses	Annual Tax Revenue
Most Businesses	\$150 up to 8 employees	\$18 per employee over 8	\$25,000 <sup>(1)</sup>	67,000	\$10.5 M
Commercial Landlords	\$150 up to 15,000 sq. ft.	\$.01 per sq. ft. over 15,000	\$5,000 <sup>(2)</sup>	3,600	\$1.3 M
Residential Landlords	\$150 up to 30 units	\$5 per unit over 30	\$5,000 <sup>(2)</sup>	3,800	\$0.8 M
Mobile Home Parks	\$150 up to 30 units	\$5 per lot over 30	\$5,000	50	\$0.05 M
<b>Totals</b>				<b>74,450<sup>(3)</sup></b>	<b>\$12.7 M</b>

<sup>(1)</sup> 12 registered businesses are at the \$25,000 cap

<sup>(2)</sup> 24 registered landlords are at the \$5,000 cap

<sup>(3)</sup> Total count includes approximately 13,000 exempt businesses, but does not include approximately 11,000 branch locations

# History of San José Business Tax

- **Adopted in 1964**
- **Council last modified 30 years ago**
  - **1984-Base rate increased from \$30 to \$75**
  - **1986-Base rate increased from \$75 to \$150**
- **Voters rejected an inflationary adjustment in 1998**

# Recent History

- **Recommendation of General Fund Structural Deficit Elimination Plan Stakeholder Group (2008):**
  - “Restructure Business Tax rates to modernize and reflect current business profile”
- **Recommendation of Fiscal Reform Plan (2011) as one of four Revenue Strategies to pursue after implementation of other fiscal reforms**
- **Tested high-level concept in Community Budget Priorities Surveys 2008 to 2012; results varied**

# Bay Area Large City Comparison

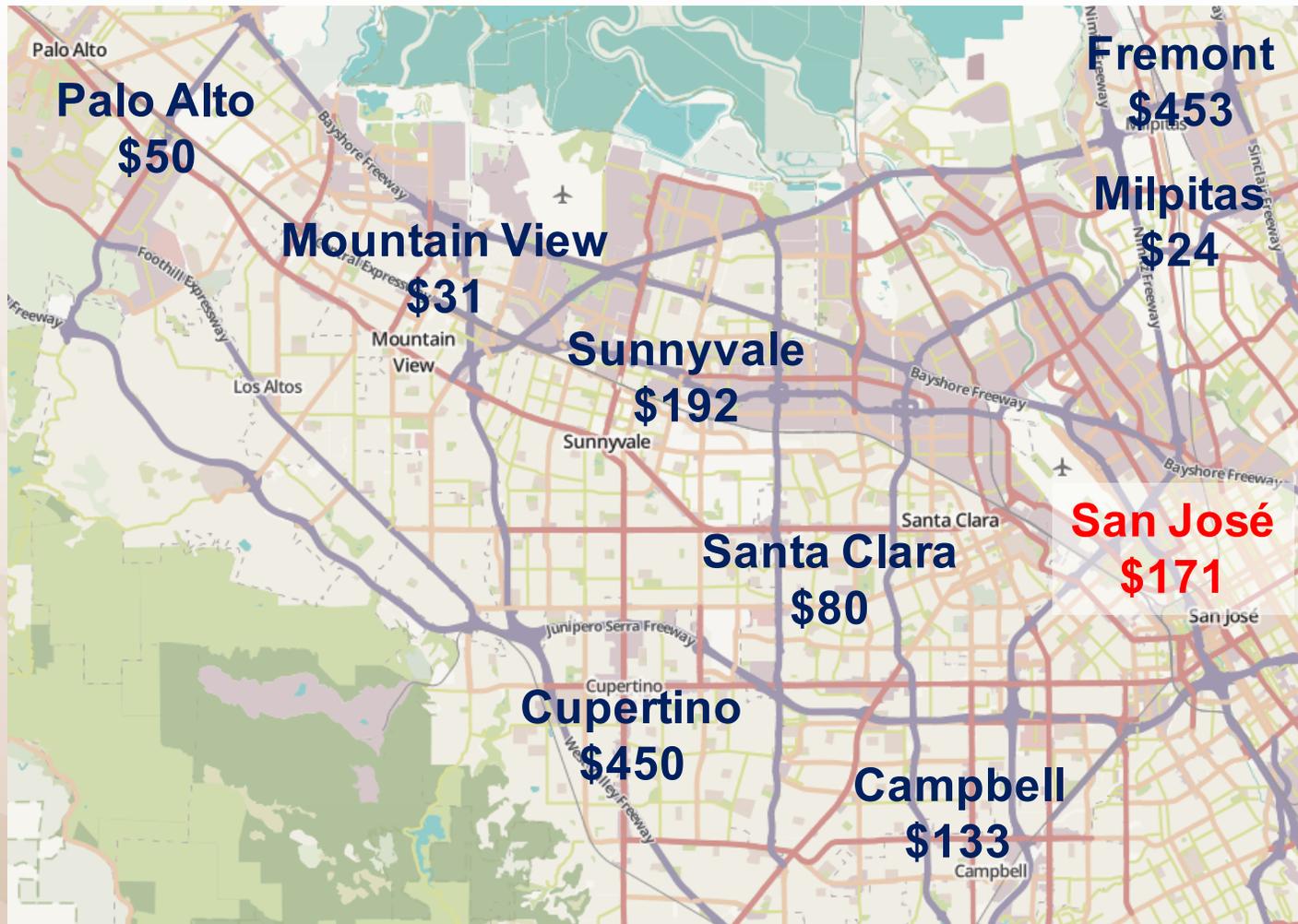
	San José	San Francisco	Oakland
<b>Tax Basis</b>	Per Employee	Gross Receipts	Gross Receipts
<b>Tax Revenue Generated</b>	\$12.7 M	\$600 M	\$70M
<b>Average Tax Per Business</b>	\$171	\$6,000	\$1,077

**Gross Receipts Tax Ballot Initiative: \$40 million add'l revenue**

**Companies with 11-500 employees: 8x increase**

**Companies with 500+ employees: 17x increase**

# South Bay Region Comparison: Average Business Tax Per Business



# South Bay Region Comparison (cont.): Tax Basis and Other Detail

City	Tax Basis	Admin Fee	Annual Revenue Generated	Number of Businesses	Average Tax Revenue Per Business
<b>San José</b>	<b>Unit</b>	<b>No</b>	<b>\$12.7 M</b>	<b>74,450</b>	<b>\$171</b>
Campbell	Unit	No	\$0.7 M	5,000	\$133
Cupertino	Flat Rate	No	\$0.9 M	2,000	\$450
Fremont	Gross Receipts	\$30	\$8.6 M	19,000	\$453
Los Gatos	Unit	\$25	\$1.3 M	4,000	\$313
Milpitas	Unit	\$50	\$0.7 M	2,800	\$24
Morgan Hill	Unit	\$60	\$0.2 M	3,200	\$57
Mountain View	Flat Rate	No	\$0.2 M	6,500	\$31
Santa Clara	Unit	No	\$1.0 M	12,000	\$80
Sunnyvale	Unit	No	\$1.5 M	7,800	\$192

## Notes

- (1) Unit taxation is driven by number of employees, apartments, lots, square footage, etc. – or some combination thereof
- (2) Flat Rate taxation is a single tax amount applied to all businesses regardless of size
- (3) Gross Receipts taxation is driven by top line revenue of each business

## **Council Direction – March 2016**

- Double the annual revenues from the tax without unduly influencing business location decisions**
- Protect small businesses while making the existing tax structure more progressive**
- Expand the current maximum per-firm caps**
- Include Cost of Living Adjustment (COLA)**
- Ensure businesses can obtain tax certificates online**
- Engage the business community and stakeholders in reviewing the proposed revisions**
- Plan for November 2016 Ballot Measure**

# Underlying Principles for Business Tax Change

*These principles were presented by City staff at the February 13, 2012 Budget Study Session*

- a) Generate revenue to support services without unduly influencing business location decisions**
- b) Align tax with service demand**
- c) Minimize administration costs for City and compliance costs for taxpayers**
- d) “Fair” sharing of solutions** (employees, residents, businesses)
- e) Ensure revenue can grow over time as economy expands and City operating costs rise**

# **Proposed Business Tax**

**Levers  
Proposals and Revenue  
Summary  
Reflections**

# Levers for Updating Business Tax

## Levers

- 1. Increase the base tax rate**
- 2. Increase the incremental tax rates (progressive)**
- 3. Increase the cap**
- 4. Update tax applications in municipal code**
- 5. Establish inflation-based adjustments over time**

# Increase Per Employee Rates

	<b>Current Rates</b>	<b>Proposed Rates</b>
<b>Base Rate</b>	\$150	\$195
<b>Employee Rate (1-2)</b>	\$0	\$0
<b>Employee Rate (3-35)</b>	\$18 (9+)	\$30
<b>Employee Rate (36-100)</b>	\$18	\$40
<b>Employee Rate (101-500)</b>	\$18	\$50
<b>Employee Rate (501+)</b>	\$18	\$60

**Additional annual revenue generation: \$8.3M**

# Increase Per Residential Rental Property Unit Rates

	Current Rates	Proposed Rates
<b>Base Rate</b>	\$150	\$195
<b>Unit Rate (1-2)</b>	N/A	\$0
<b>Unit Rate (3-35)</b>	\$5 (31+)	\$10
<b>Unit Rate (36-100)</b>	\$5	\$15
<b>Unit Rate (101-500)</b>	\$5	\$20
<b>Unit Rate (501+)</b>	\$5	\$25

**Note 1: Proposed application of base tax begins at unit 1 instead of unit 3**

**Note 2: Non-profit owned rental housing remains exempt in proposal**

**Additional annual revenue generation: \$2.1M**

# Increase Per Non-Residential Rental Property Square Foot Rate

	Current Rate	Proposed Rate
<b>Base Rate</b>	\$150	\$195
<b>Per Square Foot Rate</b>	\$.01 over 15,000 square feet	\$.025

**Additional annual revenue generation: \$2.25M**

# Increase Per Mobile Home Park Lot Rate

	<b>Current Rate</b>	<b>Proposed Rate</b>
<b>Base Rate</b>	\$150	\$195
<b>Per Lot Rate</b>	\$5 (31+)	\$10 (3+)

**Additional annual revenue generation: \$0.05M**

# Increase Per Water Metered Connection Rate

- **Two water companies pay business tax based on the number of water metered connections**
  - **First company pays roughly \$0.30 per connection**
  - **Second company pays roughly \$0.10 per connection**
- **Proposal to increase the rate to \$1.00 per connection regardless of the number of connections**

**Additional annual revenue generation: \$0.2M**

# Increase the Cap

<b>Business Type</b>	<b>Current Cap</b>	<b>Proposed Cap</b>
<b>Employee Based</b>	\$25,000	\$150,000
<b>Residential Rental Property</b>	\$5,000	\$150,000
<b>Mobile Home Park</b>	\$5,000	\$150,000
<b>Non-Residential Rental Property</b>	\$5,000	\$150,000
<b>Water Company</b>	\$20,000	\$150,000

# Update the Application of the Tax

- **Employee Based Business**
  - Continue to allow businesses to choose between calculating the number of employees based on Full-Time Equivalent (“FTE”) or based on the number of employees that employers report to the California Employment Development Department (“EDD”)
- **Residential Rental Units**
  - Removing the base tax exemption for 1 and 2 unit residential landlords; can apply for hardship if applicable
- **Combined Rental Property Tax Calculation**
  - Determine tax based on rental property type; remove square footage equivalency calculation
- **Business Tax Exemptions**
  - Delete the minor and transient marketer exemptions as they qualify for the low-revenue generating exemption

# Establish Annual Cost of Living Adjustment

<b>Tax Rate</b>	<b>Proposed COLA</b>
<b>Base (50%)</b>	Up to 1.5%
<b>Per Employee</b>	Up to 3%
<b>Per Unit</b>	Up to 3%
<b>Per Lot</b>	Up to 3%
<b>Per Square Foot</b>	Up to 3%
<b>Per Water Connection</b>	Up to 3%
<b>Cap of \$150,000</b>	Up to 3%

# Revenue Summary

<b>Tax Revenue (\$ millions)</b>	<b>Current</b>	<b>Additional</b>	<b>New Total</b>
<b>Per Employee</b>	<b>10.50</b>	<b>8.30</b>	<b>18.80</b>
<b>Per Residential Rental Property Unit</b>	<b>0.80</b>	<b>2.10</b>	<b>2.90</b>
<b>Per Commercial Rental Property Unit</b>	<b>1.30</b>	<b>2.25</b>	<b>3.55</b>
<b>Per Mobile Home Park Lot</b>	<b>0.05</b>	<b>0.05</b>	<b>0.10</b>
<b>Per Water Metered Connection</b>	<b>0.05</b>	<b>0.20</b>	<b>0.25</b>
<b>Additional exemption (4X poverty rate) for household adjusted gross income</b>	<b>N/A</b>	<b>(0.60)</b>	<b>(0.60)</b>
<b>Estimated Total Tax Revenue</b>	<b>12.70</b>	<b>12.30</b>	<b>25.00</b>

Note: The proposed Household Exemption is additive to the existing business exemptions. The City has made a rough estimate that approximately 3,000 businesses will fall under the new exemption - representing a tax revenue loss of approximately \$600K.