File No. 120377

Committee Item No. 1
Board Item No. 22

COMMITTEE/BOARD OF SUPERVISORS

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Committee: Government Audit and Oversight **Date** May 31, 2012

Board of Supervisors Meeting **Date** June 12, 2012

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Completed by: Alisa Miller **Date** May 24, 2012
Completed by: Alisa Miller **Date** June 5, 2012

An asterisked item represents the cover sheet to a document that exceeds 25 pages.
The complete document can be found in the file.

[Business and Tax Regulations Code - Payroll Expense Tax Exclusion for Small Business Net New Payroll for 2012 through 2015]

Ordinance amending the San Francisco Business and Tax Regulations Code Article 12-A by adding Section 906.5 to permit a Payroll Expense Tax Exclusion for Small Business Net New Payroll for years 2012 through 2015.

NOTE: Additions are *single-underline italics Times New Roman*; deletions are ~~*strike-through italics Times New Roman*~~. Board amendment additions are double-underlined; Board amendment deletions are ~~strikethrough normal~~.

Be it ordained by the People of the City and County of San Francisco:

Section 1. The San Francisco Business and Tax Regulations Code is hereby amended by adding Section 906.5, to read as follows:

SEC. 906.5. NET NEW PAYROLL EXCLUSION.

(a) The purpose of this Section is to increase the number of jobs within the City and County of San Francisco by providing an incentive for Small Businesses to create new jobs or to relocate existing jobs to the City and County of San Francisco.

(b) Notwithstanding any other provisions of this Article, for purposes of this Section the following terms shall have the meaning set forth below:

(1) "Small Business" means a person whose Base Year Payroll Expense is between $1 and $500,000.

(2) "Base Year" means the 2011 tax year for a person who had Payroll Expense in 2011. If a person did not have Payroll Expense in the 2011 tax year, then the first year that the person incurs Payroll Expense shall be that person's Base Year. If a person is exempt from filing a Payroll Expense Tax return pursuant to Business and Tax Regulations Code 6.9-2 in the first year that the person incurs Payroll Expense, the person's Base Year Payroll Expense shall be $150,000 for the purposes of calculating this exclusion.

(3) "San Francisco Labor Law" means the Health Care Security Ordinance, codified at San Francisco Administrative Code Chapter 14; the Minimum Wage Ordinance, codified at San Francisco Administrative Code Chapter 12R; the Paid Sick Leave Ordinance, codified at San Francisco Administrative Code Chapter 12W; the Minimum Compensation Ordinance, codified at San Francisco Administrative Code Chapter 12P; the Health Care Accountability Ordinance, codified at San Francisco Administrative Code Chapter 12Q; and the prevailing wage requirements, codified at San Francisco Administrative Code Chapter 6.22.

(c) A Small Business may exclude from its Payroll Expense the lesser of $250,000 or the amount of Payroll Expense that is greater than its Base Year Payroll Expense for the 2012, 2013, 2014 and 2015 tax years; provided, however, that in no event shall this exclusion reduce a person's Payroll Expense Tax liability for 2012, 2013, 2014 or 2015 to less than the person's Base Year Payroll Expense Tax liability.

(d) In order to be eligible for the Payroll Expense Tax exclusion authorized under this Section, persons wishing to claim the exclusion must:

(1) Maintain records and documents in a manner acceptable to the Tax Collector. Such records and documents must objectively substantiate any exclusion claimed under this Section and be provided to the Tax Collector upon request.

(2) Timely file with the Tax Collector an annual Payroll Expense Tax return claiming the exclusion provided for in this Section, regardless of the amount of tax liability shown on the return after claiming the exclusion provided for in this Section. All returns shall be filed by the due date set forth in Article 6 of the San Francisco Business and Tax Regulations Code.

(3) If, after the timely filing of a person's Payroll Expense Tax return, it is determined that the person was delinquent in remitting any taxes, fees or penalties owed to the City and County of

San Francisco at the time of filing, that person shall be ineligible to claim the exclusion under this Section for the period covered by the return.

(4) If, prior to or after the timely filing of a person's Payroll Expense Tax return, the San Francisco Office of Labor Standards Enforcement determines that a person violated a San Francisco Labor Law during the period covered by the return, or, in response to an investigation by the San Francisco Office of Labor Standards Enforcement, a person paid, or was required to pay, restitution to former or current employees during the period covered by the return, then such person shall be ineligible to claim the exclusion provided by this Section for the period covered by the return.

(e) A person may not use or claim any unused portion of the exclusion available under this Section after the expiration of this Section.

(f) The San Francisco Office of Labor Standards Enforcement shall, no later than the first of December of each year that the exclusion under this Section is in effect, provide to the Tax Collector a list of all persons it determined to have violated a San Francisco Labor Law, including the year the violation occurred.

(g~~f~~) The Tax Collector shall verify that any exclusion claimed pursuant to this Section is appropriate.

(h~~g~~) A misrepresentation or misstatement by any person regarding eligibility for the exclusion authorized under this Section that results in the underpayment or underreporting of the Payroll Expense Tax shall be subject to penalties and interest.

(i~~h~~) The Office of the Treasurer and Tax Collector may adopt rules and regulations regarding the exclusion provided under this Section.

(j~~i~~) The exclusion provided by this Section may not be claimed concurrently with any other Payroll Expense Tax exclusion.

(~~k~~j) The Tax Collector shall submit an annual report to the Board of Supervisors for each year for which the exclusion authorized under this Section is available. The report shall set forth aggregate information on the dollar value of the exclusions taken each year and the number of persons claiming this exclusion.

(~~l~~k) The exclusion set forth in this Section shall expire by operation of law on December 31, 2015, and the City Attorney shall cause it to be removed from future editions of the Business and Tax Regulations Code unless the Board of Supervisors or the voters extend the exclusion prior to December 31, 2015. Alternatively, should the voters of the City and County of San Francisco pass a gross receipts tax prior to December 31, 2015, the exclusion under this Section shall terminate upon the effective date of such gross receipts tax.

Section 2. Effective Date. The exclusion set forth in this Section shall become effective 30 days from the date of passage.

Section 3. This Section is uncodified. In enacting this Ordinance, the Board intends to amend only those words, phrases, paragraphs, subsections, sections, articles, numbers, punctuation, charts, diagrams, or any other constituent part of the Business and Tax Regulations Code that are explicitly shown in this legislation as additions, deletions, Board amendment additions, and Board amendment deletions in accordance with the "Note" that appears under the official title of the legislation.

APPROVED AS TO FORM:
DENNIS J. HERRERA, City Attorney

By: _____
STEPHANIE PROFITT
Deputy City Attorney

Supervisors Farrell, Campos, Chu, Cohen, Elsbernd, Mar, Wiener
BOARD OF SUPERVISORS

FILE NO. 120377

REVISED LEGISLATIVE DIGEST

(5/24/2012, Amended in Committee)

[Business and Tax Regulations Code - Payroll Expense Tax Exclusion for Small Business Net New Payroll for 2012 through 2015]

Ordinance amending the San Francisco Business and Tax Regulations Code Article 12-A by adding Section 906.5 to permit a Payroll Expense Tax Exclusion for Small Business Net New Payroll for years 2012 through 2015.

Existing Law

San Francisco imposes a Payroll Expense Tax on business entities based on the compensation they pay to employees and others for work or services performed in San Francisco. (Business and Tax Regulations Code Section 901 et seq.) The tax rate is 1.5% of taxable Payroll Expense. This tax is determined each year based on the Payroll Expense of the entity.

Amendments to Current Law

The proposed amendment would amend Section 906 to establish an exclusion for net new Payroll Expense incurred by a Small Business in years 2012 through 2015. The amount a Small Business may exclude is the lesser of $250,000 or the amount of Payroll Expense that is greater than the Small Business' Base Year Payroll Expense. The exclusion cannot reduce a person's Payroll Expense Tax liability to less than the person's Base Year Payroll Expense Tax liability. The Net New Payroll Expense Tax exclusion is available for years 2012 through 2015.

Background

The purpose of this legislation is to increase the number of jobs within the City and County of San Francisco by providing an incentive for Small Businesses to create new jobs or to relocate existing jobs to the City and County of San Francisco.

SMALL BUSINESS COMMISSION
OFFICE OF SMALL BUSINESS

CITY AND COUNTY OF SAN FRANCISCO
EDWIN M. LEE, MAYOR

May 18, 2012

Ms. Angela Calvillo, Clerk of the Board
Board of Supervisors
City Hall room 244
1 Carlton B. Goodlett Place
San Francisco, CA 94102-4694

Re: File No. 120377 [Business and Tax Regulations Code - Payroll Expense Tax Exclusion for Small Business Net New Payroll - 2012 through 2015]

Small Business Commission Recommendation: **Approval**

Dear Ms. Calvillo:

On May 7, 2012 the Small Business Commission met and recommended 6-0 that the Board of Supervisors approve BOS File No. 120377.

The Commission determined that this ordinance will lead to job creation at our small businesses which have payrolls of less than $500,000.

The SBC noted that the potential impact to the general fund, estimated by Supervisor Farrell to be $1.8 million at the time of the presentation, was justifiable, pending the outcome of job creation estimates by the City's economist. The Commission noted that while previous tax exclusions have targeted business sectors or geographic areas, this ordinance will target job creation at all qualified small businesses, which will be spread throughout many business sectors of the economy and throughout the entire city. Small Businesses benefiting from this exclusion will be diverse and positive job creation will be seen in areas that are currently not benefiting from existing programs. Additionally, the Commission noted that the exclusion will apply automatically to qualified small businesses and that it will come at a minimum administrative cost to the Tax and Treasurers Office.

The SBC, which supports a transition to a gross receipts business tax, recognizes that this exclusion will expire should a gross receipts tax take place. However, due to the immediate stimulus that will take place should this proposal pass, the Commission recommends that this ordinance be approved promptly and remain in effect until such time that the voters of the City and County of San Francisco pass a gross receipts tax or until the expiration of the ordinance.

Sincerely,

Regina Dick-Endrizzi
Director, Office of Small Business

cc. Jason Elliott, Mayors Office
Supervisors Farrell, Campos, Chu, Cohen, Elbernd, Mar, Wiener

Item 1 File 12-0377 *(Continued from May 24, 2012)*	Department(s): Treasurer/Tax Collector

EXECUTIVE SUMMARY

Legislative Objectives

- The proposed ordinance would amend the City's Business and Tax Regulations Code to establish a four-year Payroll Expense Tax exclusion for small businesses' new payroll expenses. The intent of the proposed ordinance is to encourage small businesses to create new jobs in San Francisco or relocate existing jobs to San Francisco.

Key Points

- Businesses that have annual payroll expenses of more than $250,000 currently pay annual Payroll Expense Taxes to the City of 1.5 percent of total payroll expense.
- Under the proposed ordinance, a small business is defined as a business with annual payroll expenses between $1 and $500,000 in the base year. The proposed Payroll Expense Tax exclusion would be available to eligible small businesses in Tax Years 2012 through 2015.
- Under the proposed ordinance, a small business would be able to exclude from its annual payroll expense whichever is less, either (a) $250,000 or (b) the amount of payroll expense that is greater than its base year payroll expense. This exclusion would be available for small businesses for Tax Years 2012 through 2015[1].

Fiscal Impacts

- The Treasurer/Tax Collector's Office would incur one-time General Fund costs of an estimated $150,000 for professional services to revise their Payroll Expense Tax documents and program their computer system.
- The Controller's Office estimates reduced Payroll Expense Tax revenues to the City of an estimated $2,000,000 annually, or a total reduction in City revenues of approximately $8,000,000 over the four-year effective term of the proposed ordinance. Based on the proposed maximum annual Payroll Expense Tax exclusion of $250,000 and the City's current Payroll Expense Tax of 1.5%, the maximum savings to eligible businesses would be $3,750 per business per year.

Policy Considerations

- Although the stated purpose of the proposed Payroll Tax Exclusion is to create new jobs in San Francisco or to relocate existing jobs to San Francisco, the proposed exclusion of up to $250,000 of annual payroll expenses in Tax Years 2012 through 2015 would also be available to businesses whose annual payroll expenses increase as a result of (a) increased number of hours for existing employees, or (b) higher salaries for existing employees.
- In addition, the City will not be able to verify whether any new and relocated jobs resulted from the proposed ordinance or whether such new and relocated jobs would have otherwise occurred.

[1] A "Tax Year" is a calendar year.

- The proposed maximum Payroll Expense Tax exclusion of $250,000 would be available to businesses regardless of how much the businesses' annual payroll expenses increase beyond the base year. This raises the question of whether there should be a maximum annual payroll expense threshold in order to only target small businesses for the proposed Payroll Expense Tax exclusion or whether the proposed Payroll Expense Tax exclusion is intended to assist all businesses.
- On May 10, 2012, the Controller's Office issued a report on possible alternatives to the City's current business tax, including replacing the City's existing Payroll Expense Tax with a potential Gross Receipts Tax. The proposed Gross Receipts Tax would be subject to San Francisco voter approval. The subject ordinance states that if San Francisco voters approve a Gross Receipts Tax measure prior to December 31, 2015, the proposed Payroll Expense Tax exclusion would terminate when such new Gross Receipts Tax becomes effective.

Recommendation

- Approval of the proposed ordinance is a policy decision for the Board of Supervisors.

MANDATE STATEMENT

Charter Section 2.105 provides that all legislative acts in San Francisco be by ordinance, and be subject to approval by a majority of the Board of Supervisors.

In accordance with the City's Business and Tax Regulations Code Section 902, every business entity, including sole proprietors with no employees, that conducts business in San Francisco must obtain a valid annual business registration certificate and pay business registration fees to the Office of the Treasurer and Tax Collector. In addition, the City's Business and Tax Regulations Codes provides that (a) businesses that have annual payroll expenses of $150,000 or more are required to file annual Payroll Expense Tax statements with the Office of the Treasurer and Tax Collector, and (b) businesses that have over $250,000 in annual payroll expenses are subject to the City's 1.5% annual Payroll Expense Tax. Under Business and Tax Regulations Code Section 905-A, San Francisco businesses with annual payroll expenses of $250,000 or less are exempt from Payroll Expense Taxes.

Business and Tax Regulations Code Section 902.1(a) specifically defines Payroll Expense as compensation paid to individuals including shareholders of a professional corporation or a Limited Liability Company (LLC), for salaries, wages, bonuses, commissions, property issued or transferred in exchange for the performance of services (including but not limited to stock options), compensation for services to owners of pass-through entities, and any other form of compensation, who during any tax year, perform work or render services, in whole or in part in the City.

In addition, the following provisions of the Business and Tax Regulations Code provide specific additional Payroll Expense Tax exclusions:

- Sections 906.1 and 906.2 provide Payroll Expense Tax exclusions for businesses engaged in certain biotechnology enterprises and clean energy technology, respectively.

- Section 906.3 provides a Payroll Expense Tax exclusion for certain businesses that are located in or relocate to the Central Market Street and Tenderloin Area, expiring May 20, 2019.

- Section 906.4 provides a Payroll Expense Tax exclusion for that portion of an eligible person's payroll expense that is attributable to Stock-Based Compensation, expiring December, 31, 2017.

The City's FY 2011-12 budget includes $390,613,000 of Business Registration and Payroll Expense Tax revenues.

According to Mr. Greg Kato, Policy and Legislative Manager with the Treasurer/Tax Collector's Office, there are approximately 80,000 business entities with current business registration certificates in San Francisco, including sole proprietors and businesses that have no payroll expenses. Of the approximately 80,000 businesses currently registered with the City, 11,864 or 14.8 percent of all registered businesses filed Payroll Expense Tax statements for Tax Year 2011 indicating annual payroll expenses of $150,000 or more, as shown in Table 1 below.

Table 1
Payroll Expense Tax Statement Filings for Tax Year 2011

Annual Payroll Expenses	Number of Businesses
$150,000 to $250,000	4,570
$250,001 to $500,000	2,314
Greater than $500,000	4,980
Total	**11,864**

Source: Treasurer and Tax Collector

DETAILS OF PROPOSED LEGISLATION

The proposed ordinance would amend Article 12-A of the City's Business and Tax Regulations Code by adding Section 906.5 to establish a four-year Payroll Expense Tax exclusion for small businesses' new payroll expenses. Under the proposed ordinance, a small business would be defined as a business with annual payroll expenses between $1 and $500,000 in the base year. The proposed new Payroll Expense Tax exclusion would be effective for four tax years, commencing on January 1, 2012 and expiring on December 31, 2015, unless extended by the Board of Supervisors or the voters before December 31, 2015. In addition, if San Francisco voters approve a gross receipts tax prior to December 31, 2015, the proposed Payroll Expense Tax exclusion would terminate when such new gross receipts tax becomes effective.

The proposed ordinance establishes a base year of (a) 2011 for those businesses that had payroll expenses in 2011, or (b) the first year a business has payroll expenses for those businesses that did not have payroll expenses in 2011. In accordance with the proposed ordinance, a small business would be able to exclude annual payroll expenses (a) that are greater than the businesses' base year payroll expenses in Tax Years 2012 through 2015, or (b) $250,000 in Tax Years 2012 through 2015, whichever is less. If the small business is exempt from filing a Payroll

Expense Tax return in the first year that the small business incurs the payroll expenses, the small business' base year payroll expense is calculated as $150,000 for the purpose of calculating the exclusion. However, the proposed ordinance also provides that the subject Payroll Expense Tax exclusion cannot reduce a business' annual Payroll Expense Tax liability for Tax Years 2012 through 2015 to less than the business' base year Payroll Expense Tax liability.

In addition to the above requirements, in order to qualify for the proposed new Payroll Expense Tax exclusion, each business must: (a) maintain records and documents that objectively substantiate that the exclusions claimed that are acceptable and provided to the Tax Collector, (b) timely file annual Payroll Expense Tax returns with the Tax Collector, (c) timely remit any taxes, fees or penalties owed to the City and County of San Francisco, and (d) not claim any other Payroll Expense Tax exclusions.

Under the proposed ordinance, small businesses that are delinquent in paying taxes, fees or penalties that are owed to the City are not eligible to claim the Payroll Expense Tax exclusion for the period in which they were delinquent in paying the taxes, fees or penalties. Also, small businesses that have been determined by the Office of Labor Standards Enforcement (OLSE) to have violated the City's labor regulations[2] are not eligible to claim the Payroll Expense Tax exclusion for the period for which they were determined to have violated the City's labor regulations and for the period for which they were required by the OLSE to pay restitution to workers whose rights were violated.

In accordance with the proposed ordinance, the Office of the Treasurer and Tax Collector (a) would be responsible for verifying each Payroll Tax Expense exclusion claimed by individual businesses, (b) may adopt rules and regulations to implement the proposed ordinance, and (c) must submit an annual report to the Board of Supervisors, including aggregate information on the number of persons and the dollar value of the exclusions approved each year that the proposed Payroll Expense Tax exclusion is in effect.

In accordance with Section 906.5(a) of the proposed ordinance, the purpose of this proposed new Payroll Tax Exclusion is to provide small businesses with an incentive to create new jobs in San Francisco or to relocate existing jobs to San Francisco.

FISCAL ANALYSIS

Prospective Payroll Expense Tax Impact

Under the proposed ordinance, businesses with between $1 and $500,000 in annual payroll expenses in their base year would be eligible for the subject Payroll Expense Tax exclusion over the four Tax Years 2012, 2013, 2014 and 2015. As noted above, businesses that currently have annual payroll expenses greater than $250,000 are required to pay Payroll Expense Taxes of 1.5% of their annual payroll expenses to the City. Therefore, the proposed ordinance provides a maximum Payroll Expense Tax exclusion of $250,000. Based on the current Payroll Expense Tax of 1.5%, the proposed a maximum annual Payroll Expense Tax savings would be $3,750 per business per year.

[2] Labor regulations include minimum wage, prevailing wage, health care and paid sick leave requirements.

According to Mr. Ted Egan, Chief Economist in the Controller' Office, in Tax Year 2010, a total of 29,589 businesses had payroll expenses between $1 and $500,000. If the number of businesses with between $1 and $500,000 in payroll expenses in Tax Year 2011 is comparable to Tax Year 2010, then up to 30,000 businesses would be potentially eligible for the proposed Payroll Expense Tax exclusion, although it is likely that many of these businesses had payroll of $250,000 or less.

In addition, an unknown number of other businesses from the approximately 80,000 businesses with current business registration certificates that had no payroll expenses in 2011 would also be potentially eligible for the proposed Payroll Tax Expense exclusion, if these businesses' annual payroll expenses increase to more than $250,000 in Tax Years 2012 through 2015. Additionally, businesses that did not exist in Tax Year 2011 could also eventually become eligible for the proposed Payroll Expense Tax exclusion if these new businesses' annual payroll expenses are more than $250,000 in Tax Years 2012 through 2015.

Assuming continued economic recovery, Mr. Egan estimates that the proposed Payroll Expense Tax exclusion would reduce the City's Payroll Expense Tax revenue to the General Fund by approximately $2,000,000 annually, or a total reduction in City revenues of approximately $8,000,000 for the four Tax Years under the proposed ordinance.

Administrative Impacts and Costs

According to Mr. Kato, the Treasurer/Tax Collector's Office would incur an initial one-time General Fund cost of approximately $150,000 for professional services to conduct the necessary revisions to the Treasurer/Tax Collector's Office's existing Payroll Expense Tax documents and to program the Tax Collector's Payroll Tax computer system. According to Mr. Kato, the Treasurer and Tax Collector does not anticipate any additional ongoing costs to implement the proposed ordinance.

POLICY CONSIDERATIONS

Number of Jobs Created or Relocated to San Francisco

As noted above, the purpose of the proposed new Payroll Tax Exclusion is to provide small businesses with an incentive to create new jobs in San Francisco or to relocate existing jobs to San Francisco. However, the Budget and Legislative Analyst notes that the proposed exclusion of up to $250,000 of annual payroll expenses in Tax Years 2012 through 2015 would also be available to businesses whose annual payroll expenses increase as a result of (a) increased number of hours for existing employees, or (b) higher salaries for existing employees.

In addition, the Budget and Legislative Analyst notes that even if new jobs are created or relocated to San Francisco during the term of the proposed ordinance, the City will not be able to verify whether these new and relocated jobs resulted from the proposed ordinance or whether such new and relocated jobs would have otherwise been occurred.

Maximum Annual Payroll Expense Threshold

Under the proposed ordinance, small businesses would be able to exclude annual payroll expenses (a) that are greater than the businesses' base year payroll expenses in Tax Years 2012 through 2015, or (b) a maximum of $250,000 in Tax Years 2012 through 2015, whichever is less. However, the Budget and Legislative Analyst notes that, the proposed maximum Payroll Expense Tax exclusion of $250,000 would be available to businesses regardless of how much the businesses' annual payroll expenses increase beyond the base year in which the proposed ordinance would be in effect. In other words, a business that initially has an annual payroll expense of less than $500,000 in 2011 could take advantage of the proposed maximum $250,000 Payroll Expense Tax exclusion, even if the businesses' annual payroll expenses increase beyond $500,000 and regardless of how much beyond $500,000 such a businesses' payroll expenses grow in Tax Years 2012 through 2015.

The Budget and Legislative Analyst therefore questions whether there should be a maximum annual payroll expense threshold in order to only target small businesses for the proposed Payroll Expense Tax exclusion or whether the proposed Payroll Expense Tax exclusion is intended to assist all businesses.

Controllers Report on Possible Gross Receipts Tax Replacement of Payroll Tax

In response to the Mayor and the President of the Board of Supervisors request, on May 10, 2012, the Controller's Office issued a report on possible alternatives to the City's current business tax, including replacing the City's existing Payroll Expense Tax with a potential Gross Receipts Tax. The proposed Gross Receipts Tax alternative would be phased-in over time as the current Payroll Expense Tax is phased-out and is proposed to generate as much revenue as the existing Payroll Expense Tax. The proposed Gross Receipts Tax alternative would assign businesses in San Francisco to one of six progressive rate schedules based on the types of business. The proposed Gross Receipts Tax would be subject to San Francisco voter approval. The subject ordinance states that if San Francisco voters approve a Gross Receipts Tax measure prior to December 31, 2015, the proposed Payroll Expense Tax exclusion would terminate when such new Gross Receipts Tax becomes effective.

RECOMMENDATION

Approval of the proposed ordinance is policy decision for the Board of Supervisors.

Item 2 File 12-0377	Department(s): Treasurer/Tax Collector

EXECUTIVE SUMMARY

Legislative Objectives

- The proposed ordinance would amend the City's Business and Tax Regulations Code to establish a four-year Payroll Expense Tax exclusion for small businesses' new payroll expenses. The intent of the proposed ordinance is to encourage small businesses to create new jobs in San Francisco or relocate existing jobs to San Francisco.

Key Points

- Businesses that have annual payroll expenses of more than $250,000 currently pay annual Payroll Expense Taxes to the City of 1.5 percent of total payroll expense.
- Under the proposed ordinance, a small business is defined as a business with annual payroll expenses between $1 and $500,000 in the base year. The proposed Payroll Expense Tax exclusion would be available to eligible small businesses in Tax Years 2012 through 2015.
- Under the proposed ordinance, a small business would be able to exclude from its annual payroll expense whichever is less, either (a) $250,000 or (b) the amount of payroll expense that is greater than its base year payroll expense. This exclusion would be available for small businesses for Tax Years 2012 through 2015[1].

Fiscal Impacts

- The Treasurer/Tax Collector's Office would incur one-time General Fund costs of an estimated $150,000 for professional services to revise their Payroll Expense Tax documents and program their computer system.
- The Controller's Office estimates reduced Payroll Expense Tax revenues to the City of an estimated $2,000,000 annually, or a total reduction in City revenues of approximately $8,000,000 over the four-year effective term of the proposed ordinance. Based on the proposed maximum annual Payroll Expense Tax exclusion of $250,000 and the City's current Payroll Expense Tax of 1.5%, the maximum savings to eligible businesses would be $3,750 per business per year.

Policy Considerations

- Although the stated purpose of the proposed Payroll Tax Exclusion is to create new jobs in San Francisco or to relocate existing jobs to San Francisco, the proposed exclusion of up to $250,000 of annual payroll expenses in Tax Years 2012 through 2015 would also be available to businesses whose annual payroll expenses increase as a result of (a) increased number of hours for existing employees, or (b) higher salaries for existing employees.
- In addition, the City will not be able to verify whether any new and relocated jobs resulted from the proposed ordinance or whether such new and relocated jobs would have otherwise occurred.

[1] A "Tax Year" is a calendar year.

- The proposed maximum Payroll Expense Tax exclusion of $250,000 would be available to businesses regardless of how much the businesses' annual payroll expenses increase beyond the base year. This raises the question of whether there should be a maximum annual payroll expense threshold in order to only target small businesses for the proposed Payroll Expense Tax exclusion or whether the proposed Payroll Expense Tax exclusion is intended to assist all businesses.
- On May 10, 2012, the Controller's Office issued a report on possible alternatives to the City's current business tax, including replacing the City's existing Payroll Expense Tax with a potential Gross Receipts Tax. The proposed Gross Receipts Tax would be subject to San Francisco voter approval. The subject ordinance states that if San Francisco voters approve a Gross Receipts Tax measure prior to December 31, 2015, the proposed Payroll Expense Tax exclusion would terminate when such new Gross Receipts Tax becomes effective.

Recommendation

- Approval of the proposed ordinance is a policy decision for the Board of Supervisors.

MANDATE STATEMENT

Charter Section 2.105 provides that all legislative acts in San Francisco be by ordinance, and be subject to approval by a majority of the Board of Supervisors.

In accordance with the City's Business and Tax Regulations Code Section 902, every business entity, including sole proprietors with no employees, that conducts business in San Francisco must obtain a valid annual business registration certificate and pay business registration fees to the Office of the Treasurer and Tax Collector. In addition, the City's Business and Tax Regulations Codes provides that (a) businesses that have annual payroll expenses of $150,000 or more are required to file annual Payroll Expense Tax statements with the Office of the Treasurer and Tax Collector, and (b) businesses that have over $250,000 in annual payroll expenses are subject to the City's 1.5% annual Payroll Expense Tax. Under Business and Tax Regulations Code Section 905-A, San Francisco businesses with annual payroll expenses of $250,000 or less are exempt from Payroll Expense Taxes.

Business and Tax Regulations Code Section 902.1(a) specifically defines Payroll Expense as compensation paid to individuals including shareholders of a professional corporation or a Limited Liability Company (LLC), for salaries, wages, bonuses, commissions, property issued or transferred in exchange for the performance of services (including but not limited to stock options), compensation for services to owners of pass-through entities, and any other form of compensation, who during any tax year, perform work or render services, in whole or in part in the City.

In addition, the following provisions of the Business and Tax Regulations Code provide specific additional Payroll Expense Tax exclusions:

- Sections 906.1 and 906.2 provide Payroll Expense Tax exclusions for businesses engaged in certain biotechnology enterprises and clean energy technology, respectively.

- Section 906.3 provides a Payroll Expense Tax exclusion for certain businesses that are located in or relocate to the Central Market Street and Tenderloin Area, expiring May 20, 2019.

- Section 906.4 provides a Payroll Expense Tax exclusion for that portion of an eligible person's payroll expense that is attributable to Stock-Based Compensation, expiring December, 31, 2017.

The City's FY 2011-12 budget includes $390,613,000 of Business Registration and Payroll Expense Tax revenues.

According to Mr. Greg Kato, Policy and Legislative Manager with the Treasurer/Tax Collector's Office, there are approximately 80,000 business entities with current business registration certificates in San Francisco, including sole proprietors and businesses that have no payroll expenses. Of the approximately 80,000 businesses currently registered with the City, 11,864 or 14.8 percent of all registered businesses filed Payroll Expense Tax statements for Tax Year 2011 indicating annual payroll expenses of $150,000 or more, as shown in Table 1 below.

Table 1
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Total	**11,864**

Source: Treasurer and Tax Collector

DETAILS OF PROPOSED LEGISLATION

The proposed ordinance would amend Article 12-A of the City's Business and Tax Regulations Code by adding Section 906.5 to establish a four-year Payroll Expense Tax exclusion for small businesses' new payroll expenses. Under the proposed ordinance, a small business would be defined as a business with annual payroll expenses between $1 and $500,000 in the base year. The proposed new Payroll Expense Tax exclusion would be effective for four tax years, commencing on January 1, 2012 and expiring on December 31, 2015, unless extended by the Board of Supervisors or the voters before December 31, 2015. In addition, if San Francisco voters approve a gross receipts tax prior to December 31, 2015, the proposed Payroll Expense Tax exclusion would terminate when such new gross receipts tax becomes effective.

The proposed ordinance establishes a base year of (a) 2011 for those businesses that had payroll expenses in 2011, or (b) the first year a business has payroll expenses for those businesses that did not have payroll expenses in 2011. In accordance with the proposed ordinance, a small business would be able to exclude annual payroll expenses (a) that are greater than the businesses' base year payroll expenses in Tax Years 2012 through 2015, or (b) $250,000 in Tax Years 2012 through 2015, whichever is less. However, the proposed ordinance also provides that

the subject Payroll Expense Tax exclusion cannot reduce a business' annual Payroll Expense Tax liability for Tax Years 2012 through 2015 to less than the business' base year Payroll Expense Tax liability.

In addition to the above requirements, in order to qualify for the proposed new Payroll Expense Tax exclusion, each business must: (a) maintain records and documents that objectively substantiate that the exclusions claimed that are acceptable and provided to the Tax Collector, (b) timely file annual Payroll Expense Tax returns with the Tax Collector, (c) timely remit any taxes, fees or penalties owed to the City and County of San Francisco, and (d) not claim any other Payroll Expense Tax exclusions.

In accordance with the proposed ordinance, the Office of the Treasurer and Tax Collector (a) would be responsible for verifying each Payroll Tax Expense exclusion claimed by individual businesses, (b) may adopt rules and regulations to implement the proposed ordinance, and (c) must submit an annual report to the Board of Supervisors, including aggregate information on the number of persons and the dollar value of the exclusions approved each year that the proposed Payroll Expense Tax exclusion is in effect.

In accordance with Section 906.5(a) of the proposed ordinance, the purpose of this proposed new Payroll Tax Exclusion is to provide small businesses with an incentive to create new jobs in San Francisco or to relocate existing jobs to San Francisco.

FISCAL ANALYSIS

Prospective Payroll Expense Tax Impact

Under the proposed ordinance, businesses with between $1 and $500,000 in annual payroll expenses in their base year would be eligible for the subject Payroll Expense Tax exclusion over the four Tax Years 2012, 2013, 2014 and 2015. As noted above, businesses that currently have annual payroll expenses greater than $250,000 are required to pay Payroll Expense Taxes of 1.5% of their annual payroll expenses to the City. Therefore, the proposed ordinance provides a maximum Payroll Expense Tax exclusion of $250,000. Based on the current Payroll Expense Tax of 1.5%, the proposed a maximum annual Payroll Expense Tax savings would be $3,750 per business per year.

According to Mr. Ted Egan, Chief Economist in the Controller' Office, in Tax Year 2010, a total of 29,589 businesses had payroll expenses between $1 and $500,000. If the number of businesses with between $1 and $500,000 in payroll expenses in Tax Year 2011 is comparable to Tax Year 2010, then up to 30,000 businesses would be potentially eligible for the proposed Payroll Expense Tax exclusion, although it is likely that many of these businesses had payroll of $250,000 or less.

In addition, an unknown number of other businesses from the approximately 80,000 businesses with current business registration certificates that had no payroll expenses in 2011 would also be potentially eligible for the proposed Payroll Tax Expense exclusion, if these businesses' annual payroll expenses increase to more than $250,000 in Tax Years 2012 through 2015. Additionally, businesses that did not exist in Tax Year 2011 could also eventually become eligible for the

proposed Payroll Expense Tax exclusion if these new businesses' annual payroll expenses are more than $250,000 in Tax Years 2012 through 2015.

Assuming continued economic recovery, Mr. Egan estimates that the proposed Payroll Expense Tax exclusion would reduce the City's Payroll Expense Tax revenue to the General Fund by approximately $2,000,000 annually, or a total reduction in City revenues of approximately $8,000,000 for the four Tax Years under the proposed ordinance.

Administrative Impacts and Costs

According to Mr. Kato, the Treasurer/Tax Collector's Office would incur an initial one-time General Fund cost of approximately $150,000 for professional services to conduct the necessary revisions to the Treasurer/Tax Collector's Office's existing Payroll Expense Tax documents and to program the Tax Collector's Payroll Tax computer system. According to Mr. Kato, the Treasurer and Tax Collector does not anticipate any additional ongoing costs to implement the proposed ordinance.

POLICY CONSIDERATIONS

Number of Jobs Created or Relocated to San Francisco

As noted above, the purpose of the proposed new Payroll Tax Exclusion is to provide small businesses with an incentive to create new jobs in San Francisco or to relocate existing jobs to San Francisco. However, the Budget and Legislative Analyst notes that the proposed exclusion of up to $250,000 of annual payroll expenses in Tax Years 2012 through 2015 would also be available to businesses whose annual payroll expenses increase as a result of (a) increased number of hours for existing employees, or (b) higher salaries for existing employees.

In addition, the Budget and Legislative Analyst notes that even if new jobs are created or relocated to San Francisco during the term of the proposed ordinance, the City will not be able to verify whether these new and relocated jobs resulted from the proposed ordinance or whether such new and relocated jobs would have otherwise been occurred.

Maximum Annual Payroll Expense Threshold

Under the proposed ordinance, small businesses would be able to exclude annual payroll expenses (a) that are greater than the businesses' base year payroll expenses in Tax Years 2012 through 2015, or (b) a maximum of $250,000 in Tax Years 2012 through 2015, whichever is less. However, the Budget and Legislative Analyst notes that, the proposed maximum Payroll Expense Tax exclusion of $250,000 would be available to businesses regardless of how much the businesses' annual payroll expenses increase beyond the base year in which the proposed ordinance would be in effect. In other words, a business that initially has an annual payroll expense of less than $500,000 in 2011 could take advantage of the proposed maximum $250,000 Payroll Expense Tax exclusion, even if the businesses' annual payroll expenses increase beyond $500,000 and regardless of how much beyond $500,000 such a businesses' payroll expenses grow in Tax Years 2012 through 2015.

The Budget and Legislative Analyst therefore questions whether there should be a maximum annual payroll expense threshold in order to only target small businesses for the proposed Payroll Expense Tax exclusion or whether the proposed Payroll Expense Tax exclusion is intended to assist all businesses.

Controllers Report on Possible Gross Receipts Tax Replacement of Payroll Tax

In response to the Mayor and the President of the Board of Supervisors request, on May 10, 2012, the Controller's Office issued a report on possible alternatives to the City's current business tax, including replacing the City's existing Payroll Expense Tax with a potential Gross Receipts Tax. The proposed Gross Receipts Tax alternative would be phased-in over time as the current Payroll Expense Tax is phased-out and is proposed to generate as much revenue as the existing Payroll Expense Tax. The proposed Gross Receipts Tax alternative would assign businesses in San Francisco to one of six progressive rate schedules based on the types of business. The proposed Gross Receipts Tax would be subject to San Francisco voter approval. The subject ordinance states that if San Francisco voters approve a Gross Receipts Tax measure prior to December 31, 2015, the proposed Payroll Expense Tax exclusion would terminate when such new Gross Receipts Tax becomes effective.

RECOMMENDATION

Approval of the proposed ordinance is policy decision for the Board of Supervisors.