

LEGISLATIVE DIGEST

[Payroll Expense Tax]

Ordinance submitting to the voters an ordinance amending the Business and Tax Regulations Code by (1) amending Section 902.1 and adding Section 902.2 to clarify the tax liability of "pass through entities" under the Payroll Expense Tax Ordinance, including partnerships, Subchapter S corporations, limited liability companies, limited liability partnerships and other persons or entities not subject to federal income tax or which are allowed a deduction in computing such tax for distributions to the owners or beneficiaries of such persons or entities and specifying safe harbor measure of taxable payroll expense for owners of pass through entity (200% of compensation for its most highly paid quartile of employees, provided entity has at least 4 employees); and (2) amending Section 905-A to increase the Small Business Tax Exemption to include all taxpayers whose taxable payroll expense is \$250,000 or less.

Existing Law

The City and County of San Francisco currently imposes a tax on the payroll expense of persons who conduct business in the City. The payroll expense tax rate is 1.5%. Taxable payroll includes all compensation paid to employees for services and distributions by way of salary to owners of associations, which include partnerships, LLPs, LLCs and other forms of unincorporated entities that engage in business in the City. If an employee or owner of an association who receives a salary performs work or renders services within and outside the City, the taxpayer must allocate the compensation between his or her in-City and out-of-City work and services to determine the amount of taxable payroll expense that is attributable to the City. The ordinance exempts "small business enterprises" from the payroll expense tax. The ordinance defines "small business enterprise" as a taxpayer who filed a timely return the preceding tax year and whose payroll expense tax liability would not exceed \$2,500.

Amendments to Current Law

Clarification of treatment of payments to owners of pass through entities for their services.

This Ordinance amends the existing Payroll Expense Tax imposed under Article 12-A to clarify that taxable payroll expense includes all compensation for services paid to partners and owners of trusts, limited liability companies, Subchapter S corporations, and other "pass through" legal entities that are not subject to federal income tax or otherwise allowed a deduction for distributions to their owners. Payments from pass-through entities to their owners are included in the pass-through entity's payroll expense.

The owners of some pass through entities may include professional corporations and single member limited liability companies. In this situation, payments from the pass through entity to its PC/LLC owner for services will be included in the pass through entity's payroll expense, but the PC/LLC's payment to its owner for the same services will not be included in the PC/LLC's payroll expense.

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Example 1: X Corp pays Law Partnership for legal services. That payment is not included in X Corp's taxable payroll expense. But when Law Partnership pays its partners and employees for their work on X Corp's legal matters, Law Partnership's payments are included in Law Partnership's taxable payroll expense.

Example 2: Law Partnership pays its partners A and B, a professional corporation ("B PC"), for their services. Both payments are included in Law Partnership's taxable payroll. B PC's payment to B is not included in B PC's payroll expense because it has already been taxed.

The Ordinance also explains how a pass through entity should calculate the amount of the compensation it has paid its owners for their services. The entity's payments may represent both compensation for services, which is part of taxable payroll expense, and a return on or of the owner's investment, which the City does not intend to tax. The entity may presume that the compensation it has paid its owners for their services is the sum of any amounts reported on W-2 forms plus, for each owner, two hundred percent (200%) of the average annual compensation for its most highly paid quartile of in-City employees (provided the employer has at least 20 4 in-City employees). The entity also has the option to provide the City with information establishing a lesser amount of compensation paid to its owners for their services.

Increased Small Business Tax Exemption.

Effective January 1, 2009, for the 2009 and following tax years, taxpayers whose taxable payroll expense is \$250,000 or less will qualify for the Small Business Tax Exemption. The City will increase this ceiling every 2 years, starting with the 2011 tax year, to reflect increases in the consumer price index during the preceding two years.

Background Information