



June 13, 2012

Ted Egan, Ph.D.
Office of the Controller
City and County of San Francisco
City Hall, Room 316
1 Dr. Carlton B. Goodlett Pl.
San Francisco, CA 94102

Re: San Francisco's Business Tax Proposals

Dear Dr. Egan:

This letter discusses San Francisco's two business tax reform proposals in light of the city's current Payroll Expense Tax. We believe that the gross receipts proposal would benefit the San Francisco business community more than the revised payroll proposal, but that either proposal constitutes an improvement over the current Payroll Expense Tax.

Both proposals are revenue-neutral. As a result, the goal of excluding small businesses from the tax (by requiring a small number of large firms pay relatively more) conflicts with the goal of attracting large-scale businesses (by spreading some tax responsibility to smaller businesses). While revenue-generating businesses would pay more under the gross receipts proposal than the revised payroll proposal, both proposals generally lower the tax for large entities. Your office's April 18 report found that the gross receipts proposal would increase the payor group from about 8% to 35%, and the revised payroll proposal would lower business tax payments for all current taxpaying businesses (by broadening the base). Small businesses would generally pay more under either proposal than under the current law. The gross receipts proposal stands to benefit pre-revenue generating businesses the most, whereas the revised payroll tax proposal stands to benefit large businesses the most.

Neither proposal geographically expands the "Twitter tax break" exception, as some businesses locked into leases outside economically depressed areas have urged. The lack of such expansion is probably not a missed opportunity to stop businesses from leaving San Francisco precisely because such leases exist. When their leases end, so do the firms' inabilities to take advantage of "Twitter tax breaks." However, each proposal alters the debate. The gross receipts proposal shifts the tax away from payroll entirely. The revised payroll proposal makes permanent the Pre-IPO Stock-Based Compensation Exclusion, which allows businesses to exclude stock-based compensation above \$750,000 or their 2010 stock-based compensation levels, whichever is higher, from their payrolls.

The two proposals take different approaches to taxing companies with large payrolls and little or no revenue (e.g., startups). The gross receipts proposal would assuage or eliminate tax burdens in startups' pre-revenue phases. This proposal would bring San

Francisco into closer parity with other cities; over thirty of the largest cities in California use gross receipts to determine business tax liability, whereas San Francisco is the only city to use payroll size. Parity tends to stabilize tax revenue because it removes an incentive for companies to relocate. The revised payroll proposal would retain the incentive for startups to relocate to cities with gross receipts taxes (which would exert less pressure on them during pre-revenue phases). While the revised payroll proposal's "payroll tax holiday" for a startup's first year in business would encourage formation in San Francisco, pre-revenue startups past their first year that could not or would not avail themselves of "Twitter tax breaks" would still benefit from minimizing their employee presence in San Francisco.

Both proposals close the sole proprietor / partnership loophole. Under the current system, sole proprietors and partnerships without employees (and thus without payrolls) pay no Payroll Expense Tax regardless of earnings. Both proposals explicitly state that sole proprietor and partner compensation constitutes "payroll" for purposes of the tax. Closure of this loophole would remove a disparity between partnerships and other entities.

Both proposals establish a marginal tax rate (\$100,000 for the gross receipts proposal and \$250,000 for the revised payroll proposal). Under either proposal, unlike current law, a company that crosses the initial threshold would only be liable for tax on the amount by which its gross receipts or payroll exceeds the threshold. Marginal rate structures generally result in more accurate taxation.

Both proposals constitute improvements over the current system because they close the sole proprietor / partnership loophole and establish progressive and marginal systems, removing growth disincentives. Between the two proposals, the gross receipts proposal more sufficiently addresses the incentive for high-payroll, low-revenue companies (i.e., growth companies) to minimize their employee presence in San Francisco. Beyond these differences, the gross receipts proposal is the best choice if San Francisco wishes to "grow" local business by bolstering entities in the pre-revenue phase. The revised payroll proposal is the best choice if San Francisco wants to relax the tax burden on large entities, encouraging the residence of already-established companies in the city.

Thank you for giving us the opportunity to comment. We are happy to discuss the proposals further if so desired.

Sincerely,

Roger Royse
Attorney
Royse Law Firm, PC

CC: Steven Lee