# Local Small Business Tax Cut Ordinance: Economic Impact Report

Office of the Controller
Office of Economic Analysis

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# Introduction

- A measure that would change the way the City imposes and collects business taxes has qualified for the November 2024 ballot in San Francisco.
- The measure, termed the Local Small Business Tax Cut ordinance, would make a number of changes to the City's Gross Receipts, Homelessness Gross Receipts, and Overpaid Executive Gross Receipts Taxes. The changes would be effective beginning with the 2025 Tax Year.
- Under State law, any ordinance that would raise taxes for any taxpayer must be approved by voters. Because this measure was placed on the ballot through citizen initiative, it will be approved with a simple majority of votes.
- The Office of Economic Analysis has prepared this economic impact report after determining the measure may have a material effect on the city's economy.

# Background

- In July, 2023, a report was released by the Offices of the Controller and the Treasurer/Tax Collector, which highlighted several risks to the City's business tax revenue, in light of recent economic changes relating to remote work.
- The final report, released in February 2024, indicated risks from the City's over-reliance on tax from industries that have adopted remote work, on a small number of very large taxpayers, and on commercial real estate. The report also highlighted the extreme differences in tax liability that some employers face in San Francisco, as compared to other cities in the Bay Area.
- Following that report and pursuant to a request from Mayor Breed and Board President Peskin, City staff developed and published a draft ordinance that reflected the recommendations in the report.
- The draft ordinance subsequently became the basis of this citizen's initiative.

# Details of the Proposal

- The proposed ordinance makes a number of changes to the City's business taxes, including:
  - Change to the Small Business Exemption of the City's Gross Receipts Tax
  - Changes to tax rates, and to scheduled increases to tax rates
  - Changes to gross receipts apportionment rules
  - Changes to implementation
  - Changes to business registration fees
  - Specific tax credits
- As discussed later in more detail, the proposed ordinance is expected to result in less City business tax revenue in the short term, compared to a 2022 baseline, and slightly more in later years.

# Details of the Proposal

## Change to the Small Business Exemption

- The City's Gross Receipts Tax currently allows for an exemption for small businesses. Businesses with gross receipts below the exemption ceiling are exempt from paying the tax. In tax year 2022, the ceiling was $2,090,000.
- The proposed ordinance would raise the ceiling to $5,000,000. Like the current exemption, the proposed exemption ceiling would increase annually in line with inflation.
- As with the other changes in the ordinance, this change would be effective beginning with the 2025 tax year, beginning on January 1, 2025.

# Details of the Proposal

## Change to Tax Rates, and Scheduled Increases

- The Gross Receipts Tax levies different tax rates on different industries (or "business activities")[1].
- The City also imposes a Homelessness Gross Receipts Tax on larger businesses. The proposed ordinance would also change those rates. Overall revenue for the Homelessness Gross Receipts tax is not expected to change.
- The City also imposes an Overpaid Executive Tax. The proposed ordinance would reduce these rates by 80%[2].
- Gross Receipts Tax rates for several business activities are scheduled to increase in Tax Year 2025 and 2026. The proposed ordinance would cancel those increases.
- However, the proposed ordinance would also impose across-the-board increases to Gross Receipts Tax, Administrative Office Tax, and Overpaid Executive Tax rates, of 4% in 2027 and of an additional 3% in 2028.

1 – See Business Tax Reform: Final Proposal, pp. 16-22.
2 – Ibid., p. 24.

# Details of the Proposal

## Change to Apportionment Rules

- The City may only tax gross receipts that can be fairly apportioned to San Francisco. The Gross Receipts Tax currently defines three methods used by different business activities to determine how much of a taxpayer's total gross receipts may be taxed by the City.
- The proposed ordinance would consolidate apportionment rules to two methods. For the business activities of Real Estate, Accommodation, Construction, Facilities Support Services, Services to Buildings and Dwellings, and Parking Lots and Garages, taxable gross receipts would entirely be based on gross receipts derived from or related to real properties located within the city. For every other business activity, taxable gross receipts would be 75% based on gross receipts allocated to the city and 25% based on the proportion of payroll expense in the city.
- Overall, these changes would reduce the importance of local employment and payroll determining business tax liability, and increase the importance of local sales.

# Details of the Proposal

## Change to Implementation

- The proposed ordinance would also make several changes to the implementation of the City’s business taxes. These changes include:
    - directing the Tax Collector to lead a public process and promulgate regulations about the sourcing of Gross Receipts;
    - directing the Tax Collector to create a process for taxpayers to request and receive advance determinations, by June 30th, 2025;
    - better aligning the City’s business tax deadlines with those for State tax filings;
    - eliminating complex rules for businesses engaged in multiple business activities.

# Details of the Proposal

## Change to Business Registration Fees

- In addition to the taxes already mentioned, the City also imposes business registration fees. The proposed ordinance would restructure and modify these fees[1].
- These fees currently increase annually in line with inflation, and that would remain the case under the new fees established by the proposed ordinance.

1 –Business Tax Reform: Final Proposal, p. 15.

# Details of the Proposal

## Specific Tax Credits

- The proposed ordinance contains a tax credit for Supermarkets and other Grocery Retailers. The credit is equivalent to 0.5% of an eligible business's San Francisco Gross Receipts from those business activities, up to a maximum of $4 million.
- The proposed ordinance also contains a tax credit for businesses that pay the City's Stadium Operator Admissions Tax, or substantially similar taxes in other jurisdictions. The tax is paid by operators of athletic contests, exhibitions and other special events. The credit is equivalent to 50% of its payment of such taxes.
- The proposed ordinance also contains a credit for first lessees of space in certain qualified buildings who require at least 100 employees to occupy that space. The credit is equal to the lesser of the taxpayer's Gross Receipts Tax liability and $4 million, and is available for the length of the lease or 15 years, whichever is less. Construction on the qualified building must begin within a 5-year period beginning November 5, 2024, and the qualified building must have at least 450,000 square feet and meet several other financial and physical criteria.

# Economic Impact Factors

By changing business tax liabilities, the proposed ordinance will change the incentives that businesses face when deciding to operate, employ people, and sell in San Francisco. It will also affect City revenues. There are three primary economic impact factors:

1. The shift in apportionment rules away from payroll expense in the city, and towards sales in the city, will reduce the tax disincentive for creating and maintaining jobs in the city, while increasing the tax disincentive on selling in the city.
2. At an industry level, some industries will face a lower tax burden, while others will face a higher tax burden. Industries differ in how their growth or contraction affects the rest of the local economy, through their multiplier effects. Thus, the change in industry tax burdens will have broader economic implications.
3. Finally, the changes in overall tax revenue, vs. the current system, will affect City spending, and also lead to other multiplier effects in the local economy.

# Economic Impact Factors

## Changing Apportionment Rules

- As noted earlier, the City's Gross Receipts Tax contains industry-specific rules for how a business's total gross receipts are to be apportioned to San Francisco. The other taxes that would be changed by this measure, the Homelessness Gross Receipts Tax and the Overpaid Executive Tax, also rely on the same apportionment rules.
- In the current system, taxpayers in most industries use apportionment rules that are fully or partly dependent on their payroll expense in the city. If a business increases its local payroll, its tax liability increases, all other things being equal.
- Under the proposed system, most industries would use an apportionment formula that is 75% weighted to gross receipts allocated to San Francisco, and the remaining industries would use 100% gross receipts allocated to San Francisco.
- These changes in rules effectively make the tax less dependent on payroll within the city, and more dependent on sales within the city. This will reduce the discentive that the tax imposes on job creation in the city, at the cost of raising prices throughout the economy.

# Economic Impact Factors

## Changing Tax Burden by Industry

- The change in tax rates, together with the change in apportionment rules, is expected to change the amount of business tax paid by different industries in the City.
- The table on the next page illustrates the difference, based on 2022 tax filings, between what industries actually owed, and what they would have owed had this proposal been in effect in that year[1].
- In addition to the industry impacts, the tables also account for the specific tax credits described earlier, plus $10 million for future business license fee reductions, although these fee reductions are not part of the proposed measure.

1 – The table refers to two business activities called "Financial Services for Select NAICS Activities". For details of the individual industries in those two groups, see Business Tax Reform: Final Proposal, p. 12-13. "Financial Services for Select NAICS Activities – 1" is in Category 6, and "Financial Services for Select NAICS Activities – 2" is in Category 5.

# Changing Business Tax Burden by Business Activity

| Business Activity (in Current System) | Total – Policy | Total - Baseline | Difference | Pct Diff |
|---|---:|---:|---:|---:|
| Accommodation | $10.9 | $12.5 | -$1.6 | -13% |
| Administrative and Support Services | $19.0 | $26.9 | -$7.9 | -29% |
| Arts, Entertainment, and Recreation | $1.7 | $8.5 | -$6.8 | -80% |
| Biotechnology | $9.0 | $7.6 | $1.4 | 18% |
| Certain Services | $0.6 | $0.4 | $0.2 | 37% |
| Clean Technology | $0.2 | $0.4 | -$0.2 | -59% |
| Construction | $36.7 | $34.3 | $2.4 | 7% |
| Financial Services for Select NAICS Activities - 1 | $175.1 | $148.7 | $26.4 | 18% |
| Food Services and Drinking Places | $6.2 | $11.2 | -$5.0 | -45% |
| Information | $441.4 | $438.8 | $2.5 | 1% |
| Insurance Carriers | $4.1 | $7.2 | -$3.1 | -43% |
| Manufacturing | $39.9 | $54.7 | -$14.8 | -27% |
| Educational Services and Healthcare Services | $19.8 | $28.2 | -$8.3 | -30% |
| Professional, Scientific, and Technical Services | $149.3 | $158.4 | -$9.0 | -6% |
| Real Estate | $236.3 | $240.6 | -$4.3 | -2% |
| Retail Trade | $92.3 | $79.3 | $13.0 | 16% |
| Transportation and Warehousing | $54.5 | $57.6 | -$3.1 | -5% |
| Utilities | $19.2 | $12.0 | $7.1 | 59% |
| Wholesale Trade | $33.1 | $26.1 | $7.1 | 27% |
| Activity not listed above | $15.1 | $18.2 | -$3.1 | -17% |
| Financial Services for Select NAICS Activities - 2 | $9.3 | $24.9 | -$15.6 | -63% |
| Specific Tax Credits & License Fee Reduction | -$20.0 | | -$20.0 | |
| TOTAL | $1,353.7 | $1,396.5 | -$42.7 | -3.1% |

# Economic Impact Factors

## Changes in Overall Business Tax Revenue and City Spending

- The difference in industry payments under the current tax system, along with other policy changes, will affect City revenue in the future. These changes are complex, because rate increases that are currently scheduled for tax years 2025 and 2026 do not feature in the proposal, but would contribute to revenue growth with the current system.
- The tables on the next page show projected business tax revenue, by specific tax, under the current system, the proposed system, and the difference between them.
- The final table shows that City tax revenue will be moderately reduced in the first three fiscal years, before increasing in FY27-28, and beyond, because of the scheduled across-the-board tax increases. Homelessness Gross Receipts Tax revenue is projected to remain the same as it would be under the current system.
- The reported revenue impact is slightly different than the industry impacts presented on page 14, because those were static impacts of what the measure’s impact would have been if enacted for tax year 2022, and these are fiscal year-based estimates of the differences between future revenue forecasts.

# Forecast Changes in Overall Business Tax Revenue

| Current System by Tax | FY22-23 (Actual) | FY23-24 | FY24-25 | FY25-26 | FY26-27 | FY27-28 | FY28-29 |
|---|---|---|---|---|---|---|---|
| Homelessness gross receipts tax | $248 | $255 | $274 | $280 | $296 | $303 | $312 |
| Gross receipts tax | $803 | $785 | $839 | $906 | $932 | $963 | $992 |
| Overpaid executive tax | $140 | $133 | $140 | $140 | $140 | $140 | $144 |
| Business registration fees | $48 | $40 | $44 | $48 | $48 | $48 | $49 |
| Other fees and charges | $48 | $51 | $41 | $51 | $51 | $51 | $53 |
| **Total** | **$1,287** | **$1,264** | **$1,338** | **$1,425** | **$1,467** | **$1,505** | **$1,550** |

| Proposed System by Tax | FY22-23* | FY23-24 | FY24-25 | FY25-26 | FY26-27 | FY27-28 | FY28-29 |
|---|---|---|---|---|---|---|---|
| Homelessness gross receipts tax | $248 | $255 | $274 | $280 | $296 | $303 | $312 |
| Gross receipts tax | $803 | $785 | $883 | $966 | $993 | $1,090 | $1,163 |
| Overpaid executive tax | $140 | $133 | $84 | $28 | $28 | $28 | $29 |
| Business registration fees | $48 | $40 | $46 | $53 | $53 | $53 | $54 |
| Other fees and charges | $48 | $51 | $36 | $41 | $41 | $41 | $43 |
| **Total** | **$1,287** | **$1,264** | **$1,323** | **$1,368** | **$1,411** | **$1,515** | **$1,601** |

| Difference by Tax | FY22-23* | FY23-24 | FY24-25 | FY25-26 | FY26-27 | FY27-28 | FY28-29 |
|---|---|---|---|---|---|---|---|
| Homelessness gross receipts tax | $0 | $0 | $0 | $0 | $0 | $0 | $0 |
| Gross receipts tax | $0 | $0 | $44 | $60 | $61 | $127 | $171 |
| Overpaid executive tax | $0 | $0 | ($56) | ($112) | ($112) | ($112) | ($115) |
| Business registration fees | $0 | $0 | $2 | $5 | $5 | $5 | $5 |
| Other fees and charges | $0 | $0 | ($5) | ($10) | ($10) | ($10) | ($10) |
| **Total** | **$0** | **$0** | **($15)** | **($57)** | **($56)** | **$10** | **$51** |

# Risk Assessment

- As noted on page 3, the 2023 Controller/Treasurer report highlighted several risks to the City's revenue, in light of new economic trends related to remote office work.
- One of the risks – a high reliance on advanced services industries that have widely adopted remote work – is only slightly mitigated by the proposal. Financial Services, Information, and Professional, Technical, and Scientific Services owed 56% of business taxes in 2022, and would have owed 55% under the proposal.
- A second risk – a high reliance on commercial real estate rent and sales – is unaffected by the proposal, which does not modify the City's Commercial Rents Tax nor its Real Property Transfer Tax.
- A third risk – a high reliance on a small number of large payers, who would face a much smaller tax burden in other Bay Area cities – is modestly mitigated by the proposal. As noted on the next pages, the percentage of business tax revenue coming from the five largest payers would be reduced, from 28% of the total to 23% of the total.

# Impact on Concentration Risk

| Business Tax Revenue (Gross Receipts Tax, Homelessness Gross Receipts Tax, Overpaid Executive Tax) | % of Total Tax Revenue, Current System | % of Total Tax Revenue, Proposed System |
|---|---:|---:|
| From 5 Largest Taxpayers | 28% | 23% |
| From 10 Largest Taxpayers | 37% | 32% |
| From 100 Largest Taxpayers | 65% | 63% |
| From All Remaining Taxpayers | 35% | 37% |

# Economic Impact Assessment

- The Office of Economic Analysis uses the REMI model to estimate the economic impact of major policy changes in the city.
- Using REMI, we modeled the three economic impact factors discussed earlier: the shift in taxation away from payroll and towards sales, the redistribution of the business tax burden across industries, and the near-term decline, followed by an increase, in City tax revenue.
- Over a twenty-year period, we forecast that the proposal would have a positive impact on the city's economy, leading to average increase of over 1,900 jobs over twenty years, and a $338 million increase to GDP.
- Job increases are expected in every major sector of the city's economy, with the exception of utilities, for which a minor decrease is expected.
- As noted earlier, the shift of the tax basis away from payroll on to sales is expected to put upward pressure on prices, but, according to REMI, the effect is expected to be minor – a 0.03% increase in consumer prices in the city, on average over the next 20 years.

# Conclusions

- The persistence of remote work after the pandemic has had significant effects on San Francisco's economy and business tax base, and created new risks for the City.
- The proposed measure is anticipated to reduce some of these risks by improving simplicity, administrability, equity, and by limiting the City's over-reliance on a handful of large taxpayers.
- The measure is expected to have a notably beneficial impact on the city's economy, beyond its impacts on the city's financial risks. It is expected to spur job creation across nearly every sector of the economy, by shifting the basis of business taxation away from payroll and towards sales.
- While there is expected to be some impact on local prices, the increase (0.03%) is roughly equivalent to one-tenth of a quarter-point sales tax increase.

# Staff Contacts

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