
San Francisco's new tax - what it means for asset managers

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In brief

Fundamental changes to the San Francisco City Business Tax and Registration Certificate Fee are anticipated to significantly impact asset managers and financial institutions in San Francisco (City).

Asset managers should be aware of the complexities and challenges the City's new Gross Receipts Tax introduces to their business starting in 2014, including: (1) potential increase in tax liability because the tax base shifts from payroll to gross receipts; (2) increased annual business registration certificate fees to as much as \$35,000 (previously capped at \$500) for businesses; (3) determination of the gross receipts tax base; (4) complexities in payroll factor based apportionment for flow-through entities; (5) treatment of carried interest and management fees; (6) complications related to the combined reporting mandate and requirement to include flow-through entities; and (7) other uncertainties generally facing all taxpayers.

For detail regarding tax rates and fees applicable to asset managers, please refer to the appendix at the end of this summary.

Please [click here](#) for our insight into the City's new Gross Receipts Tax and changes to the annual business registration certificate fees (registration fee).

In detail

Gross Receipts Tax phase-in starting in 2014

San Francisco's business tax, which is currently based on *payroll* in the City (Payroll Tax), is being replaced with a tax measured by *gross receipts* attributable to the City (Gross Receipts Tax or 'tax'). Beginning in tax year 2014, the Gross Receipts Tax gradually phases-in over a five-year period (2014: 10%, 2015: 25%, 2016: 50%, 2017: 75%, 2018: 100%), while the Payroll Tax simultaneously

phases-out over the same period of time. The measure also increases the registration fee to as much as \$35,000 for businesses with over \$200 million in gross receipts attributable to San Francisco.

Gross receipts tax base may result in higher tax liabilities for asset managers

Asset managers may begin to see their tax liability increase due to the shift in tax base from payroll in the City to gross receipts attributable to the City

based on application of the new payroll factor apportionment formula. This change means that many asset managers are likely to have an increased tax liability as they will have a much greater tax base under a gross receipts measure than a payroll measure.

New calculation – a payroll apportionment formula

Asset managers will have to calculate a payroll factor to apportion total gross receipts to the City. This payroll factor will be on a combined basis with

related entities and is generally measured on a world-wide basis, with the opportunity for a water's-edge calculation if so elected on the taxpayer's California return (assuming there is a corporate member of the group). Payroll in the City is the total amount paid for 'compensation' in the City by the taxpayer and all its related entities. Asset managers must consider the implications of this provision and how they will determine 'compensation' for entities without employees. To the extent an entity has no employees, 'compensation' includes all taxable income for federal income tax purposes of the owners or proprietors of such entities that are individuals. The new law, however, does not make clear how an asset manager is to apply the mechanics of this treatment.

Gross receipts tax base may create complexities when applied to asset managers

Asset managers will also be faced with nuances regarding which receipts are 'gross receipts' subject to the tax. 'Gross receipts' is broadly defined to include the total amounts received by a taxpayer from whatever source derived and including all amounts that constitute gross income for federal income tax purposes. Provisions that apply to pass-through entities, however, pose a particular challenge in this regard. Failing to understand whether certain pass-through receipts are included or excluded from the tax base could result in underpayment or overpayment of tax. In particular:

- **Investment receipts.** Gross receipts is defined to exclude 'investment receipts,' which includes interest, dividends, capital gains, other amounts received on account of financial instruments, and distributions from business entities to the extent such items are

directly derived exclusively from the investment of capital. However, these receipts will be included in the gross receipts tax base if derived from the sale of non-investment property, or from the provision of services.

- **Tiered entities.** Gross receipts of a pass-through entity that were subject to tax at a lower tier entity are not included in the owner's gross receipts base.

These provisions create unique issues for asset managers when applied to carried interest and management fees.

Carried interest – tax base, pass-through, and apportionment issues

Asset managers receive carried interest (i.e., a right to receive a percentage of fund profits without an obligation to contribute to the capital to the fund) as compensation for their investment expertise in selecting, managing, and disposing of fund assets. Since carried interest is compensation to asset managers earned for providing investment management services, it appears that carried interest is likely to be included in the Gross Receipts Tax base and also used to determine the registration fee. Informal discussions with the City indicate this is likely to be the City's position.

Note, however, that even though a fund manager's carried interest, which is generally received through a General Partner entity, may be subject to the tax and fee at the General Partner level, it will likely not be subject to the tax again at ownership tiers above the General Partner (e.g., at the investor limited partner level) because these receipts are investment receipts derived from the investment of capital and/or an allocation from a pass-through entity unrelated to

services rendered up the ownership chain.

Recall that if an entity has no employees, the payroll factor is determined based on the federal taxable income of the entity's individual owners. As a result, carried interest likely would be apportioned at the General Partner level based on the pass-through taxable income of the partners of the General Partner receiving the carried interest working in the City divided by the flow-through taxable income of all partners.

Management fees

Since management fees are earned by the management company as compensation for management services, they should be considered gross receipts subject to the tax. Additionally, the management fee should be apportioned to the City according to the compensation paid by the management company in the City over compensation everywhere (the payroll factor). Compensation includes the wages, salaries, commissions, and other forms of remuneration paid to the management company employees for their services.

Uncertain application of combined reporting for asset managers

Another new concept to the Gross Receipts Tax that was absent in the Payroll Tax is the requirement of combined reporting. Generally, a 'person' engaged in business in the City must file a combined Gross Receipts Tax return that includes all entities included in its California combined group. Additionally, a partnership is included in the definition of a taxable 'person.'

Asset managers will have to answer many reporting questions that aren't clear in the City's new law. Are partnerships and other pass-through

entities included in a combined group? Or, must partnerships and other pass-through entities file separate City returns? How will complex structures that include many pass-through entities and corporations be addressed? There remain significant open issues for asset managers to consider when determining their Gross Receipts Tax filing obligations and liability.

This uncertainty regarding the combined group has important implications. To the extent there are multiple filing groups, each group would be liable for a separate registration fee, which could result in a higher overall liability. In addition, gross receipts received from related entities (e.g., entities in the same filing group) are typically eliminated from the gross receipts tax base. As such, intercompany receipts between entities in different filing groups would not be eliminated thereby increasing the amount of gross receipts subject to tax.

Other issues for consideration

Apportionment methodology:

California generally applies a single

sales factor apportionment methodology, which sources sales other than the sale of tangible personal property to California to the extent the customer receives the benefit of the service in the state. This methodology differs from the payroll factor apportionment methodology applicable to asset managers and may lead to situations where a taxpayer has significant Gross Receipts Tax liability but a relatively lower income and franchise tax liability. This may create inequities for asset managers that choose to establish a business in the City.

City guidance: It is anticipated that it may take some time for audit staff to identify and provide guidance relating to the Gross Receipts Tax. During the phase-in period asset managers should monitor official guidance issued by the City to ensure the tax is being properly applied to their unique facts.

Tax Collector authorized to determine gross receipts: The Gross Receipts Tax allows the tax collector the discretion to ‘independently establish’ a person’s gross receipts within City. Additionally, the tax collector may

establish or reallocate gross receipts between related entities in order to fairly reflect gross receipts in the City. It is unclear the extent to which the tax collector will exercise this broad granting of authority.

The takeaway

Both the Gross Receipts Tax and the registration fee present unique issues and challenges for asset managers. Combined reporting, determining the tax base, and calculating the proper apportionment factor are just a few of the challenges asset managers must resolve when the new tax is effective in January 2014. For asset managers with a presence in San Francisco, the transition from the Payroll Tax to the Gross Receipts Tax could have a significant impact on their liability and, therefore, they should develop a strong understanding of the tax and how it applies to their unique circumstances to ensure they are not misstating their liability.

Let’s talk

For more information on the new San Francisco Gross Receipts Tax, please contact:

State and Local Tax Services

Brian Rebhun
Partner, New York Metro
+1 (646) 471-4024
brian.rebhun@us.pwc.com

Rakhal Bhalla
Manager, Los Angeles
+1 (213) 217-3728
rakhal.bhalla@us.pwc.com

Sam Melehani
Partner, Los Angeles
+1 (213) 356-6900
sam.melehani@us.pwc.com

Robert Salas
Manager, San Francisco
+1 (415) 498-6313
robert.p.salas@us.pwc.com

Eran Liron
Partner, San Jose
+1 (408) 817-3937
eran.j.liron@us.pwc.com

Gross receipts tax rates and registration fee tables

Asset managers are subject to the second highest Gross Receipts Tax rate range topping out at 0.560%. Additionally, Proposition E significantly increases the maximum annual registration certificate fee from \$500 to as much as \$35,000.

Base Tax Rate for Financial Services

The financial services industry is subject to one of the highest rate tables as follows:

Gross Receipts	Base Tax Rate
Between \$0 and \$1,000,000	.400%
Between \$1,000,001 and \$2,500,000	.460%
Between \$2,500,001 and \$25,000,000	.510%
Over \$25,000,000	.560%

Registration Fee Applicable to Financial Services

The base for the registration fee varies based on tax year as the Gross Receipts Tax is phased in. Below is a summary of the highest applicable fees:

	Base to Determine Registration Fee	The Amount of the Applicable Base	Annual Registration Fee
Prior to 6/30/2014	Payroll Expense Tax for the Immediately Preceding Tax Year	More than \$50,000	\$500
Between 7/1/14 - 6/30/2015	Payroll Expense for the Immediately Preceding Tax Year	\$40,000,001 or more	\$35,000
After to 6/30/2015	Gross Receipts for the Immediately Preceding Tax Year	\$200,000,001 and over	\$35,000