

**ARTICLE:**

**THE NEW SAN FRANCISCO GROSS RECEIPTS ORDINANCE: TAXING COMMERCIAL PROPERTY OWNERS TO FUND EARLY CHILD CARE AND EDUCATION**

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**I. Introduction**

On June 5, 2018, San Francisco voters passed Proposition C, which imposes a new gross receipts tax of 1 percent on revenues a business receives from leasing warehouse space in San Francisco and 3.5 percent on revenues a business receives from leasing certain qualifying commercial spaces in San Francisco.<sup>1</sup> Proposition C becomes operative on January 1, 2019.<sup>2</sup> The proceeds of these taxes will fund quality early care and education for young children and other public purposes.<sup>3</sup> The new gross receipts tax imposed by Proposition C is in addition to the gross receipts tax payable by businesses under the existing San Francisco Gross Receipts Tax Ordinance enacted by the voters under Proposition C in 2012 (the “Existing GRT Ordinance”).<sup>4</sup> Despite the seemingly broad net cast by Proposition C (and the ordinance it authorized, commonly known as the Early Care and Education Commercial Rents Tax Ordinance (the “New GRT Ordinance”)), it would appear to place the greatest burden on owners of commercial property that is leased for office use or retail use by a retailer with a larger regional, national, or international presence.

**II. Purpose of the New GRT Ordinance**

San Francisco found success and has been a national leader in early care and education through its 2004 Preschool for All program, including expanding access for families to quality preschool programs to prepare children for kindergarten and beyond.<sup>5</sup> However, San Francisco found that infants and toddlers under four years old were not afforded the same opportunities and that the waitlist for publicly funded and subsidized early care had over 2,400 applicants, with two-thirds of those applicants under the age of three.<sup>6</sup> San Francisco was also concerned that, without the ability to have such publicly funded or subsidized early care, parents and other care givers would leave the workforce in order to provide care for the child and ultimately would find a

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hard or near impossible path back to the work force once the child entered school.<sup>7</sup> Further, even if a parent or caregiver found the path back, their earning power or opportunities for promotion may have suffered due to having left to provide care for a child.<sup>8</sup> Implementation of the New GRT Ordinance is designed to help ensure that such early care and education is well funded, that children have the best possibility to succeed in school, and that working families have support from San Francisco.<sup>9</sup>

### III. Who is Subject to the Existing GRT Ordinance and the New GRT Ordinance?

The Existing GRT Ordinance, enacted in November 2012, had the stated purpose of amending San Francisco's business tax system to include a gross receipts tax to promote revenue stability by diversifying the tax base while phasing out and potentially eliminating the existing payroll-based tax within a five-year period between 2014 and 2019.<sup>10</sup>

At present, any person engaging in business within San Francisco is subject to the gross receipts tax under the Existing GRT Ordinance.<sup>11</sup> Among other examples, a person is considered "engaging in business" in San Francisco if that person (or any employee, representative, or agent of that person) conducts any activity related to owning, renting, or leasing real or personal property in San Francisco for a business purpose.<sup>12</sup>

"Gross receipts" means the total amounts received or accrued by a person from whatever source derived, including, but not limited to, amounts derived from . . . dealings in property, rent, . . . and distributed amounts from other business entities. [G]ross receipts includes but is not limited to all amounts that constitute gross income for federal income tax purposes.<sup>13</sup> Furthermore, "[g]ross receipts" with respect to any lease or rental includes payment for any services that are part of the lease or rental, whether received in money or otherwise, that are paid to, on behalf of, or for the benefit of, the lessor, and all receipts, cash, credits, property of any kind or character and the fair market value of services so paid or rendered by the lessee.<sup>14</sup>

As a result of the enactment of Proposition C, in addition to the general gross receipts tax payable under the Existing GRT Ordinance, any person engaging in the business of leasing commercial space or warehouse space in San Francisco will now also be subject to a tax under the New GRT Ordinance.<sup>15</sup> Under this ordinance, "Commercial Space" is any building or structure (or portion thereof)

that is *not* “residential real estate” (i.e. property where the primary use is for dwelling, sleeping, or lodging other than as part of the business activity of accommodations).<sup>16</sup> “Commercial Space” does not include (1) any space used for an industrial use (i.e. light or heavy manufacturing, metal working, agricultural or beverage processing, junkyard, etc.); (2) arts activities (performances, exhibitions, rehearsals of activities like dance, music, dramatic art, film and so forth, but excludes movie theaters, amusement enterprises, adult entertainment or any establishment where liquor is customarily sold during performances such as a night club, stadium or sports arena); and (3) retail or services that are not “formula retail.”<sup>17</sup> “Warehouse space” is commercial space that is used for commercial storage (i.e. a space that stores contractors’ equipment, building materials, or goods or materials used by other businesses at other locations), volatile materials storage, wholesale storage (i.e. wholesale merchandise and including cold storage facilities), or as a storage yard.<sup>18</sup>

One effect of the foregoing definitions is that the New GRT Ordinance excludes the gross receipts received by a property owner from any retail or service activity that is *not* defined as “formula retail.” “Formula retail” is defined as a retail sales or service activity or establishment that has eleven or more other retail sales establishments in operation, or with local land use or permit entitlements already approved, located anywhere in the world, and that maintains two or more of the following features: a standardized array of merchandise, a standardized facade, a standardized decor and color scheme, uniform apparel, standardized signage, or a trademark or a servicemark.<sup>19</sup> Gross receipts from formula retail would include, by way of example only, rents from retailers such as Starbucks or Pottery Barn.

In addition to the non-formula retail exclusion, the other exemptions or exclusions from the New GRT Ordinance include:

- (a) A small business enterprise. A “small business enterprise” is any person or combined group, except for a lessor of residential real estate, whose gross receipts within the City for the preceding tax year did not exceed \$1,000,000, adjusted annually in accordance with the increase in the Consumer Price Index: All Urban Consumers for the San Francisco/Oakland/San Jose Area for All Items as reported by the United States Bureau of Labor Statistics, or any successor to that index, as of December 31 of the preceding year, beginning with December 31, 2014.<sup>20</sup>
- (b) Any organization or business that qualifies as a “non-profit” under either

the California Revenue and Taxation Code or the Internal Revenue Code of 1986.<sup>21</sup>

- (c) Gross receipts from (i) any lease for a commercial space to either (A) a non-profit organization described above in (b); and (B) any federal, state or local government; or (ii) any business activity if San Francisco is prohibited from taxing such gross receipts under the Constitution or the laws of California or the United States.<sup>22</sup>

While the section of the New GRT Ordinance imposing the tax refers to each “person” engaged in business receiving gross receipts from the lease of commercial space, the section of the New GRT Ordinance providing guidance on the calculation of the tax provides that the tax applies to “the person or the combined group’s gross receipts.”<sup>23</sup> The San Francisco Treasurer & Tax Collector views a “combined group” as persons and their related entities. A person is a related entity of the taxpayer if either (a) they are permitted or required to file a combined tax return for California Franchise or Income Tax purposes; or (b) they derive all their gross receipts solely within California or if their business activities are conducted such that they would be required to file a combined report for California Franchise or Income Tax purposes.<sup>24</sup> Using this methodology, if a commercial space is owned by a single purpose entity that is part of an affiliated ownership group that files a single return, then all members of the affiliated group that collect gross receipts for commercial space subject to the New GRT Ordinance would likely be a combined payor.

#### IV. Leases for Office, Retail, or Warehouse Use; Effects of the New Tax

In many commercial leases, included in a tenant’s obligation to pay operating expenses and taxes is the obligation to pay or reimburse the landlord for taxes on any rent payable under the lease, which often includes any gross income tax or gross receipts tax or excise tax levied by any governmental entity on the receipt of such rent. This obligation regarding taxes on rent or gross income or receipts taxes is often found in office, retail, and industrial leases.

Under the Existing GRT Ordinance, the gross receipts tax applicable to the business activities of real estate and rental and leasing services is approximately:

- 0.285 percent (e.g., \$2.85 per \$1,000) for gross receipts between \$0 and \$1,000,000;

- 0.285 percent (e.g., \$2.85 per \$1,000) for gross receipts between \$1,000,001 and \$5,000,000;
- 0.300 percent (e.g., \$3.00 per \$1,000) for gross receipts between \$5,000,001 and \$25,000,000; and
- 0.300 percent (e.g., \$3.00 per \$1,000) for gross receipts over \$25,000,000.<sup>25</sup>

Following the January 2019 implementation of the New GRT Ordinance, a person leasing “Commercial Space” (such as office or formula retail) in San Francisco will face an aggregate gross receipts tax (i.e., payable under both ordinances) ranging from 3.785 percent to 3.8 percent, which is a significant increase. To put it in dollar amounts, an owner of office space with annual gross receipts in San Francisco of \$1,500,000 would have an annual gross receipts tax of \$4,275.00 prior to the implementation of the New GRT Ordinance. Following implementation of the ordinance, that annual gross receipts tax (payable under both ordinances) will increase to \$56,775.00.

The San Francisco City Controller estimated that the Early Care and Education Commercial Rents Tax would generate an additional net annual revenue to San Francisco of approximately \$146,000,000 and that approximately 80 percent of commercial rents paid in San Francisco would be subject to the tax.<sup>26</sup>

As points of comparison:

- The gross receipts tax rate for office and commercial building rental activities in the City of Los Angeles is 0.132 percent for the 2017 Tax Year; the only rate above 1.0 percent in the City of Los Angeles is for medical marijuana collectives which pay a 6.0 percent gross receipts tax for the 2017 tax year.<sup>27</sup>
- The City of San Jose assesses a tax on every person in San Jose engaged in the business of renting or leasing any nonresidential real estate based on the square footage of space held for rental which tax is a base of \$197.90 plus \$0.02575 per square foot and with an aggregate cap on the tax of \$154,500.00;<sup>28</sup>
- The City of Oakland assesses a gross receipts tax of 1.395 percent for office and commercial building rental activities, which rate is the second highest in the city after the rate of 2.40 percent on firearms dealers.<sup>29</sup>

- Berkeley, Palo Alto, and Mountain View do not assess a gross receipts tax or any similar tax upon businesses.

However, while the City of Berkeley may not have a gross receipts tax on commercial real estate similar to the New GRT Ordinance, in 2016 it passed Measure U1, which imposed an increased gross receipts tax on residential landlords of 2.88 percent.<sup>30</sup> While this tax does not apply to all residential landlords and also includes a 12-year exemption for any new construction, this measure explicitly stated that landlords are not permitted to pass along the tax to any existing tenant in any manner, including as a rent increase.<sup>31</sup> Similarly, East Palo Alto also passed a tax of 1.5 percent on the gross receipts from the rental of five or more residential rental units and, like Berkeley, the measure explicitly stated that landlords are not permitted to pass along the tax to any existing tenant in any manner, including as a rent increase.<sup>32</sup> The New GRT Ordinance does not include a similar limitation on property owners' ability to pass through the tax in any manner.

## V. Conclusions

While it is too early to determine the impact of this new tax on the leasing of office, warehouse, and certain retail properties in San Francisco, this new tax likely will be felt in direct as well as subtle ways across all tenant and rental property profiles in San Francisco (including small retail and non-profit tenants). Since the New GRT Ordinance remains silent on whether property owners must pay the tax themselves or whether they can pass it through to the tenant of the leased space, the resulting consequences could reach beyond a straightforward pass-through of such increased costs. Also, unlike the Berkeley and East Palo Alto residential property gross receipts ordinances, the New GRT Ordinance does not exempt any new construction from the tax. The magnitude of the tax will likely cause all parties involved in these types of transactions to closely evaluate the increased cost of doing business in San Francisco.

Leases that clearly and specifically state which party is responsible for the taxes payable under the New GRT Ordinance should not lead to disputes over this issue. Leases that are silent on who is responsible for this obligation could easily result in a dispute between the landlord and tenant, which might be resolved by a sharing arrangement instead of one party assuming the entire obligation.

More subtle changes resulting from the tax payable under the New GRT

Ordinance could possibly affect tenants that the New GRT Ordinance purportedly intends to exclude. For example, property owners assuming responsibility for 100 percent of the increased tax may decide to recoup that expense through increased rental rates for tenants whose rents are otherwise excluded from the tax (such as small retail or non-profits). This approach would not likely affect the property owner's calculation of gross receipts tax liability under the New GRT Ordinance given the exclusions outlined in the ordinance. For a tenant whose rents are subject to the New GRT Ordinance and who does not have bargaining power in the San Francisco leasing market, its lease costs are likely to increase, whether in connection with the next amendment of its lease, its next lease renewal, or its next lease for other space in San Francisco. Depending on the circumstances, a business may simply elect to leave San Francisco if the burden of the increased tax is considered too great.

In addition to evaluating the effect on each party, property owners and tenants may try to be creative with respect to how a property is used and classified. For instance, a business seeking office space in San Francisco could look for space within a warehouse to use for office purposes in order to potentially save 2.5 percent in gross receipts taxes because the space is technically classified as a warehouse under the New GRT Ordinance despite the office component. However, as "Warehouse Space" is currently defined in the ordinance, such an interpretation would not be without risk.

Although San Francisco's change in 2012 on the taxation of businesses operating in the City could be viewed as a material factor in the City's subsequent growth, the increased gross receipt taxes payable under the New GRT Ordinance may ultimately contribute a slowdown in that growth.

#### **ENDNOTES:**

<sup>1</sup>San Francisco Department of Elections, June 5, 2018 Election Results—Summary @ <https://sfelections.sfgov.org/june-5-2018-election-results-summary>.

<sup>2</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2104(c) and Universal Childcare For San Francisco Families Initiative, section 5.

<sup>3</sup>San Francisco Department of Elections, June 5, 2018 Election Results—Summary @ <https://sfelections.sfgov.org/june-5-2018-election-results-summary>.

<sup>4</sup>Proposition C amends the San Francisco Business and Tax Regulations

Code by adding a new Article 21 thereto rather than amending the existing Gross Receipts Tax Ordinance contained within Article 12-A-1 of the San Francisco Business and Tax Regulations Code.

<sup>5</sup>See San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2101.

<sup>6</sup>See San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2101.

<sup>7</sup>See San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2101.

<sup>8</sup>See San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2101.

<sup>9</sup>See San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2101.

<sup>10</sup>See San Francisco Gross Receipts Tax Ordinance, section 950.

<sup>11</sup>San Francisco Gross Receipts Tax Ordinance, section 953(a).

<sup>12</sup>San Francisco Business and Tax Regulations Code, Article 6, section 6.2-12(c).

<sup>13</sup>San Francisco Gross Receipts Tax Ordinance, section 952.3(a).

<sup>14</sup>San Francisco Gross Receipts Tax Ordinance, section 952.3(b).

<sup>15</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2104(a).

<sup>16</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2103(b) and San Francisco Gross Receipts Tax Ordinance, section 954.1(c).

<sup>17</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2103(b).

<sup>18</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2103(b).

<sup>19</sup>San Francisco Planning Code, section 303.1(b).

<sup>20</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2106 and San Francisco Gross Receipts Tax Ordinance, section 954.1. Note that a lessor of residential real estate is considered a “small business enterprise” if and only if the lessor leases fewer than four units in any individual building.

<sup>21</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2105.

<sup>22</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, sections 2105(b) and 2105(c).

<sup>23</sup>San Francisco Early Care and Education Commercial Rents Tax Ordinance, section 2104(b).

<sup>24</sup>See generally the San Francisco Treasurer & Tax Collector website at <https://sftreasurer.org/gross-receipts-combined-groups>.

<sup>25</sup>See San Francisco Gross Receipts Tax Ordinance, section 953.7.

<sup>26</sup>See the Local Ballot Measure description for Proposition C contained in the San Francisco Voter Information Pamphlet & Sample Ballot for the June 5, 2018 Election.

<sup>27</sup>See the Los Angeles Office of Finance website [finance.lacity.org](http://finance.lacity.org) and Los Angeles Municipal Code, chapter II, section 21.43.

<sup>28</sup>See San Jose Municipal Code, sections 4.76.440, 4.76.450.

<sup>29</sup>See Oakland Municipal Code, section 5.04.430.

<sup>30</sup>See Berkeley Municipal Code, sections 9.04.196 and 9.04.240.

<sup>31</sup>See Berkeley Municipal Code, section 9.04.196(F).

<sup>32</sup>See East Palo Alto Municipal Code, section 5.08.125, including 5.08.125(F).