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Client Alert

SAN FRANCISCO AMENDS BUSINESS TAX ORDINANCE— BOARD OF REVIEW ELIMINATED, STATUTE OF LIMITATIONS FOR REFUNDS INCREASED AND MUCH MORE

Tax

March 26, 2004

On February 19, 2004, San Francisco Mayor Gavin Newsom approved recent changes to San Francisco's Business Tax ordinance adopted by the Board of Supervisors on February 19, 2004. These changes become effective March 20, 2004, 30 days after signing by the Mayor. Most of the changes consolidate various exemptions, definitions and other administrative provisions, as amended, that apply to the Payroll Expense Tax Ordinance (Article 12-A) and other Articles of the Business and Tax Regulation Code, and place them in Article 6 (Common Administrative Provisions). However, the amendments also contain significant changes such as elimination of the Board of Review, increasing the statute of limitations for refund claims to one (1) year from six months, decreasing the statute of limitations period for assessments from four to three years and including stock options in the definition of payroll expense. The amendments also are directed at various legal and procedural issues experienced by the City in recent litigation and amends various provisions concerning enforcement and collection of taxes, including third party taxes. The Tax Collector and the City Attorney have expanded roles due to the various amendments.

Board of Review Eliminated

Former Sections 6.14-2 (Board of Review, Appeals; Exhaustion) and 6.14-3 (Board of Review; Additional Powers and Duties) have been repealed effective March 20, 2004. From and after the effective date of the repeal of said sections, the Board of Review lacks jurisdiction to accept any new petition for redetermination or petition for refund, or any modification or amendment to such petitions pending before the Board of Review upon such effective date. Section 6.14-1(a). With respect to pending petitions, the Board is to promptly review and rule upon all petitions for redetermination and petitions for refund. Section 6.14-1(b).

The Board shall cease to exist when a certification is filed with the Mayor that it has ruled on or otherwise disposed of all petitions. Section 6.14-1(d). The repeal of Section 6.14-3 also results in the Board lacking jurisdiction to approve or disapprove any rule or regulation adopted by the Tax Collector. Section 6.14-1(c).

Refunds

The most significant change relating to refunds is the repeal of the six month statute of limitations. Now the person that paid the tax can file a claim "within the later of one year of payment of such

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amount or when the return accompanying such payment was due.”¹ Section 6.15-1(a). The refund claim must now be filed with the Controller rather than the Tax Collector and the claim shall be on a form furnished by the Controller. A claim may be returned to the person if it was not presented using the form. Section 6.15-1(b).

The amendment to Section 6.15-1 also establishes various deadlines for the City Attorney, rather than the Tax Collector, in reviewing refund claims. Within 20 days after the claim is presented, the City Attorney shall give written notice of its insufficiency. Upon receipt of the claim, the City Attorney shall forthwith request an investigation by the Tax Collector who shall submit a report with respect to the claim and recommendation thereon to the City Attorney within 30 days. The City Attorney may reject any and all claims the Controller forwards to the City Attorney, and shall notify the claimant of such rejection. Section 6.15-1(a).

The City Attorney shall allow, reject or otherwise act upon the claim for refund in a manner specified in Government Code section 912.6 within 45 days after it is presented to the Controller. The claimant may deem the claim for refund denied and seek judicial relief if the City Attorney does not act upon the claim within the 45-day period, or such extended period to which the claimant has agreed. Section 6.15-1(d).²

Section 6.15-1(a) as amended also contains new provisions regarding the settlement authority of the City Attorney. It is provided that the City Attorney may allow or compromise and settle refund claims if the amount is \$25,000 or less. Allowance or compromise and settlement of claims under this section in excess of \$25,000 shall require the written approval of the City Attorney and approval of the Board of Supervisors by resolution.

Exhaustion of Administrative Remedies

There are two sections entitled “Exhaustion of Administrative Remedies.” On their face, they seem to be consistent. However, upon closer examination they may provide a trap for the unwary.

Section 6.13-5 appears to be based in part on former Section 6.14-2 which simply required exhaustion of administrative remedies by completing an appeal to the Board of Review prior to

¹ Previously, a claim could be filed within six months from the time the return was due or the tax was paid, whichever period expired later. The change to one year from payment or when the return accompanying such payment was due seems to create some ambiguity. What about prepayments? Does the period begin to run when such payments are made or from when the return and final payment is made?

² The amendments to the refund procedure seem to parallel much of the Government Code which the City previously either explicitly or implicitly attempted to place much reliance upon in various court cases. However, it should be noted that the deemed denial provisions of Government Code section 911.6 are not fully adopted as Section 6.15-1(d) provides the claimant may deem a claim not acted upon as denied whereas under the Government Code a claim not acted upon shall be deemed denied. This distinction more closely parallels provisions in the Revenue and Taxation Code where failure to act by the government provides an open-ended statute of limitations to bring an action. See Geneva Towers LP v. City and County of San Francisco, 29 Cal. 4th 769 (2003). However, see discussion regarding Section 6.15-4(c) which requires an action be filed within 2 years of the accrual of a cause of action.

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seeking judicial relief. Under the prior provisions that could be accomplished following a petition for redetermination or petition for refund but did not necessarily require both. Now, Section 6.13-5 provides that prior to seeking judicial relief, persons against whom a determination is made must exhaust their administrative remedies by (1) petitioning to the Tax Collector for redetermination, and (2) paying the full amount owed as set forth in the final determination and presenting a claim for refund to the Controller.

Section 6.15-4 has been added to provide that persons claiming they are aggrieved must first pay the amount of disputed tax, penalty and interest, and present a claim for refund to the Controller, prior to seeking judicial relief. Section 6.15-4(a). Presentation of a claim for refund that substantially complies with Sections 6.15 et seq. is a prerequisite to suit. Section 6.15-4(b). Any judicial proceeding shall be commenced no later than six (6) months from the date the notice of denial of the claim for refund was personally delivered or deposited in the mail, or within two (2) years of accrual of the cause of action if notice of denial of the claim for refund is not served on the person as set forth in Section 6.15-3. Section 6.15-4(c).

A person only reading the new Section 6.15-4 would not realize that if a determination had been issued one cannot apparently bypass petitioning for redetermination as required under Section 6.13-5 by paying the tax and filing a refund claim as is permitted in other statutory contexts such as the sales and use tax. A claimant could probably file a joint or combined petition and claim if payment is made within the 30 day period. However, the way the ordinances are written if a determination is allowed to go final and then payment is made, a claimant may be precluded from going to court because a petition had not been filed. This would seem to raise due process issues as generally there must be post-payment judicial remedies available.

The two-year provision in Section 6.15-4(c) is similar to that provided in the Government Code where a claim is deemed denied if not acted upon by the agency within 45-days. However, either a conflict or minimally a trap for the unwary has been created under Section 6.15-1(d). The purported elective “deemed denial” provision in Section 6.15-1(d) seems to create an open-ended statute of limitations for a claimant where the City fails to deny and/or properly give notice of such denial within the 45-day period. However, under Section 6.15-4(c), where a claimant does not receive a notice of denial, a claimant must commence an action within 2 years of the accrual of its cause of action which is the later of the date the return was due or the tax was paid (see Section 6.15-1(a)). Thus, subdivision (c) and (d) are at odds with each other. Under Section 6.15-4(c) the elective deemed denial under Section 6.15-1(d) could be interpreted to become mandatory at the end of the two-year period if the City has not otherwise acted, notwithstanding the fact that subdivision (d) has no such limitations.

New Stealth Increases

The amendments characterized as consolidations of exemptions, definitions and administrative provisions also contain some increases in the cost of doing business in the City as discussed more fully below. These increases involve expanding the definition of compensation to include bonuses

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and stock options, the imposition of interest not only on unpaid taxes but now also on unpaid penalties, an increase in the amount of required prepayments (50% to 52%) and penalties thereon if delinquent (from 10% to a maximum now of 20%) and inclusion of administrative collection costs in the liability of a taxpayer for unpaid amounts.

Payroll Expense

Section 902.1 (formerly section 902.6) adds bonuses and stock options (“property issued or transferred in exchange for the performance of services) to be included in compensation which is the base for the payroll expense. The section also adds subdivision (b) which requires a service provider receiving an ownership interest in a person to include in its payroll expense an amount equal to the excess of the fair market value of such ownership interest on the date such right is exercised over the price paid for such interest. Subdivision (c) incorporates former section 902.4 concerning real estate salespersons or mortgage processors which makes them employees of the real estate broker or mortgage broker.

Prepayments

Section 6.9-3 was amended to provide that small firm prepayments (annual payroll expense tax greater than \$2,500 but less than \$50,000) for its first installment for the payroll expense tax shall be computed using 52% (previously 50%) of the person’s taxable payroll expense for the preceding tax year. Section 6.9-3(a)(2)(A). Large firm (annual payroll expense tax greater than \$50,000) quarterly prepayments shall be ¼ of the person’s estimated tax liability, computed using 104% (previously 102%) of the person’s taxable payroll expense for the preceding tax year. Section 6.9-3(a)(2)(B). Every person who fails to pay any tax prepayment (payroll expense and third party taxes) before the relevant delinquency date shall pay a penalty in the amount of 5% of the amount of the delinquent prepayment per month, or fraction thereof, up to 20% in the aggregate (previously in lieu of the 5% and 20% thresholds, there was a flat 10% penalty on any underpayment)

The Tax Collector is given discretion under Section 6.9-3(d) to adjust the amount of a tax prepayment if the taxpayer can establish by clear and convincing evidence that an installment will amount to more than the one half or one quarter, whichever is relevant, of the taxpayer’s liability for the tax year.

Interest Accrues on Tax and Penalties

Section 6.11-1 was amended to provide that the amount of the determination, inclusive (previously was exclusive) of penalties, shall bear interest at the rate of one percent per month.

Collection Costs and Attorney Fees

Various sections were amended to include as recoverable by the City its administrative collection costs. See Section 6.6-1(h); Section 6.9-7. Section 6.17-5 provides that in addition to the penalties imposed by Sections 6.17-1, 6.17-2 and 6.17-3, the Tax Collector may recover the actual costs of

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collection incurred by the City up to the time any amount owed is finally paid, including reasonable attorney fees and costs.

Determinations, Collections and Petitions

The statute of limitations for the Tax Collector to issue determinations for unpaid tax where a return has been filed was changed from four years to three (3) years. Section 6.11-2. Similarly, the period within which the Tax Collector can commence a legal action for collection where a return has been filed is within three (3) years from the date any amount became due and payable, or from the date the return is required to be filed or actually filed, whichever period expires later. Section 6.10-3(a).

Subdivision (b) of Section 6.10-3 was amended to provide that the Tax Collector may record or file a tax lien in any other office or any other jurisdiction as permitted by law.

Section 6.11-3 was amended to provide that where the Tax Collector makes a determination based on an estimate because the taxpayer has failed to file a return that any such determination shall be prima facie evidence of the person's liability in any subsequent administrative or judicial proceedings. A similar provision was not added to determinations where returns have been filed.

Subdivision (b) of Section 6.13-1 was added to require that every petition for redetermination be verified by the person against whom the Tax Collector made the determination, stating under penalty of perjury the specific grounds upon which the petition is founded. Further, if the Tax Collector determines that the petition is incomplete, the Tax Collector can either deny the petition or may require the petitioner in writing to supplement the petition with additional information or records the Tax Collector deems necessary to decide the petition. Failure of the petitioner to provide all of the information and records within 30 days shall be sufficient ground for the Tax Collector to deny the petition, and the petitioner shall be subject to the penalties and sanctions provided in Section 6.17-3.

The Tax Collector must now give the petitioner 15 days rather than 10 days notice of a requested oral hearing. Section 6.13-2. The Tax Collector could previously increase the amount of a determination before it becomes final provided it was asserted five days before the hearing. This provision was amended to provide that any increase or decrease can be of tax, penalties or interest and that the Tax Collector must provide written notice of any increase. Section 6.13-3. As mentioned above, there is no longer a Board of Review, so all references to appeal rights have been deleted including those in Section 6.13-4 which now provides that a determination becomes final 15 days after service.

Filing and Paying By Mail

Filing and paying by mail is permitted and the date of postmark shall be deemed the date of filing of any return or other document with, or make any payment to, including a prepayment to, the Tax Collector. Section 6.9-6(a). But be aware of the new provision that the Tax Collector must receive the return or other document, or the payment, as a result of the timely mailing, in order for the mailing to be deemed the date of filing or payment. Section 6.9-6(b). This is another trap for the

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unwary and seems to counter the presumption ordinarily associated with using the U.S. mails. It is provided that the Tax Collector may apply this rule by regulation to postmarks not made by the U.S. Postal Service. Since actual receipt is required, certified mail return receipt requested is better than regular mail but still does not afford any protection if indeed the mailing is never received notwithstanding timely delivery to the U.S. Postal Service.

Presumably this section is applicable to petitions for determination within the “any other document” provisions. Petitions are to be filed with the Tax Collector within 30 days after service of a notice of determination (see Section 6.13-1(a). However, there appears to be no similar date of postmark and actual receipt provisions concerning refund claims which are to be (payroll expense and third party taxes) filed with the Controller, thus making Section 6.9 inapplicable and apparently no postmark provision for refunds. This may be an oversight as refunds were previously filed with the Tax Collector.

Interestingly, if mailed, service of notices by the Tax Collector are deemed complete at the time of deposit in the U.S. Post Office. See Section 6.13-1(b) Nothing is provided regarding actual receipt by the taxpayer.

New Sanction Regarding Failure to Produce Requested Records

As mentioned above, Section 6.13-1(b) was amended to provide that the Tax Collector can deem a petition for redetermination incomplete and request the petitioner to produce additional documentation. Failure to produce such documentation can result in denial of the petition and imposition of penalties and sanctions as set forth in Section 6.17-3. Section 6.17-3(d) imposes a sanction in the absence of a showing of reasonable cause of precluding a petitioner in any administrative or judicial proceeding from introducing any record previously requested by the Tax Collector on or before the earliest of the hearing on the petition, finality of the jeopardy determination or finality of the deficiency determination.

Estoppel

Section 6.13-6 was added apparently to preclude any assertion of estoppel against the Tax Collector. Said section provides that the Tax Collector’s issuance of a notice of deficiency or failure to issue such a notice for any period may not be treated as precedent for any particular method or manner of reporting or treating any item included or excluded on any return for purposes of any other or future item appearing or reported on a return.

Nexus

Section 905 regarding nexus was deleted and moved to Section 6.2-12 and modified. Previously the focus of nexus was whether an employee of a person engaged in certain activities in the City. Now, the actions of representatives or agents of the person also are included. In addition, subdivisions (9) and (10) have been added to include in engaging in business the exercising of corporate or franchise

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powers within the City for the benefit or partial benefit of the person or liquidating a business when the liquidators thereof hold themselves out to the public as conducting such business.

Third Party Taxes

Section 6.7-1(a) was amended to provide that all amounts of third party tax so collected shall be held to be a special fund in trust for the City. Subdivision (g) of Section 6.7-1 was amended to further clarify the liability of a person with a controlling interest in an operator responsible for collecting and remitting tax. A person shall be considered responsible for performing the acts of collecting, accounting for, and remitting third party taxes to the City if and to the extent such person has the power to control the financial decision-making process by which the operator allocates funds to creditors in preference to the operator's obligation to remit third party taxes to the City. When such person responsible for such acts cannot otherwise be determined, there shall be a rebuttable presumption that the President and Chief Financial Officer of a corporation or any managing partner or member of an association is the person responsible for performing such acts. The liability of such persons shall be joint and several with each other and the operator.

Conclusion

The amendments to San Francisco's Business Tax Ordinance contain many significant changes which need to be carefully reviewed. For the most part, the amendments are intended to strengthen the authority of the Tax Collector and force greater cooperation by taxpayers and as such create numerous potential traps for the unwary.

Further Information

If you wish to obtain further information, please contact Richard E. Nielsen, (415.983.1964, rnielsen@pillsburywinthrop.com).

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