Tax Alert

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San Francisco Gross Receipts Tax – Frequently Asked Questions from the Real Estate Industry

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The extended due date to file 2015 San Francisco Gross Receipt Tax ("GRT") returns is April 29, 2016. In anticipation of preparing these returns, below are frequently asked questions ("FAQ") posed by commercial real estate investors and operators regarding how the tax may apply to typical commercial real estate investments and transactions.

Below is a table with hyperlinks to each FAQ to be addressed in this alert:

Described below are some of the transactions involved in a typical commercial real estate investment, including the acquisition, ownership structure, operation, and management of commercial real properties, and profit distributions and dispositions relating thereto. This description forms the basis for the FAQ and the discussion of the GRT impact on the owners, investors, management companies, agents and brokers involved.

Base Case Scenario (see Appendix for schematic)

Acquisition and Ownership Structure

West Corp and East Corp (collectively, "Parents") are unaffiliated corporations that invest in real property throughout the world. They have agreed to acquire together from an unrelated party two operating commercial real estate properties, one located in San Francisco and the other located outside San Francisco.

To that end, Parents, through their respective wholly owned limited liability companies, West LLC and East LLC (collectively, "Members"), will form a limited liability company called Venture LLC, and will each hold (through the Members) a 45-percent managing membership interest in Venture LLC. The remaining 10-percent membership interest will be held by outside investors as non-managing members. For federal income tax purposes, Members will each be disregarded from their respective Parents, and Venture LLC will be a partnership.

Venture LLC will be the sole member of two limited liability companies known as SF Prop LLC and Non-SF Prop LLC (collectively, "Owners"), each of which will be disregarded for federal income tax purposes. SF Prop LLC will directly acquire and own real property located in San Francisco, and Non-SF Prop LLC will directly acquire and own real property located outside of San Francisco.

Operation and Management

Owners will each enter into listing agreements with an exclusive listing broker (the "Listing Broker") to fill property vacancies in exchange for a commission based on a percentage of rent paid by the tenant under the lease. In addition, Owner and/or Listing Broker will enter into contracts or other understandings with brokers representing prospective tenants (each a "Procuring Broker"), wherein the Procuring Brokers will be paid a commission if a lease is signed with the applicable tenant. The Listing Broker has no offices in San Francisco, but has employees regularly in San Francisco to market properties located there. None of the Procuring Brokers have offices in San Francisco, but they are regularly present in San Francisco to show properties to potential tenants.

Owners will each enter into separate property management agreements with Management Corp—a wholly owned subsidiary of West Corp. Under the management agreements, Management Corp will collect rental income, coordinate payment of operating expenses, maintain insurance policies, and engage third-party contractors to provide general property maintenance and repairs. Management Corp will deposit rent checks into separate operating bank accounts established by the Owners, and will draw upon those accounts to remit payment for the above expenses on behalf of the Owners. Owners will pay Management Corp a monthly management fee equal to three percent of the gross rents from the managed properties. Management Corp will perform these property management functions from its office in San Francisco.

Distributions and Disposition

Owners will periodically distribute to Venture LLC income generated from the properties in excess of amounts reasonably required to maintain the properties. In turn, Venture LLC will distribute this income to Members and the outside investors in proportion to their respective membership interests, and Members will each distribute their shares of this income to Parents. After several years of owning interests in the properties, Parents will dispose of those interests at a substantial gain.

FAQ 1 – Persons Subject to Tax

The GRT is generally imposed on a broad array of business entities engaging in business in San Francisco, including entities that are not subject to federal income tax, but instead are treated as "flow-through" entities (e.g., entities taxed as partnerships). A business may not realize it is "engaging in business" in San Francisco, as the threshold for doing so is very low. For example, section 952.3(h) of the San Francisco Business and Tax Regulations Code ("Code") provides that simply using San Francisco streets for business purposes for seven or more days during a year is sufficient to meet this threshold. Nevertheless, Code section 952.3(g) provides several exceptions which taxpayers should be aware of. For example, Code section 952.3(g)(3) provides that a person is not considered to be engaging in business in San Francisco solely as a result of being an owner of a pass-through entity that is engaged in business in San Francisco.

FAQ 1a – Who in the ownership chain is subject to the GRT?

Under Code section 6.2-12(c), SF Prop LLC is engaging in business in San Francisco as a result of its direct ownership and rental of real property located in San Francisco. However, it will not be subject to the GRT. Although the GRT is imposed on a broad array of legal entities, the San Francisco Treasurer and Tax Collector ("Tax Collector") has stated in Regulation 2014-2 that single-owner entities that are disregarded for federal income tax purposes (such as SF Prop LLC) will likewise be disregarded for the GRT. Thus, according to Regulation 2014-2, the San Francisco activities of SF Prop LLC will be attributed to Venture LLC, and subject Venture LLC to the GRT as a result.

As noted above, Code section 952.3(g)(3) expressly provides that an ownership interest in a pass-through entity that engages in business in San Francisco is alone insufficient to create a GRT filing requirement for owners of the pass-through entity. Accordingly, Parents should not be subject to the GRT solely as a result of their indirect ownership interests (through the Members) in Venture LLC. However, if either Parent (or their respective disregarded Members) is otherwise directly engaged in business in San Francisco (e.g., if either have an office or employees, agent, or representative present in San Francisco for more than 7 days of the year), they could be subject to the GRT as a result.

FAQ 1b – Are service providers subject to the GRT?

Management Corp is subject to the GRT since it will conduct management activities from its San Francisco office. Even if Management Corp conducts all of its management activities from outside San Francisco, and has no San Francisco offices, it would still be subject to the GRT because of the regular presence in San Francisco of contractors performing services relating to real property (e.g., maintenance, repairs) located in San Francisco on its behalf. (See, e.g., Code section 6.2-12(g) (performance of services in San Francisco directly, or through agents or representatives for seven days or more during the year subjects a person to tax).)

The Listing Broker and Procuring Brokers would be subject to the GRT despite not having an office in San Francisco because their employees are regularly in San Francisco to market the properties. (See, e.g., Code section 6.2-12(f) and (g) (soliciting business or performing services in San Francisco directly or through agents or representative for seven or more days during the year subjects a person to tax).)

FAQ 2 – Operating Income and Expenses

Code section 952.3(a) defines gross receipts broadly to include the total amounts received or accrued from whatever source derived, and encompass all amounts that constitute gross income for federal income tax purposes. Code section 952.3(c)-(e) provides numerous exceptions which taxpayers should be aware of to assure they are not over-reporting gross receipts subject to the GRT.

FAQ 2a – Who pays the GRT on the rental receipts?

The gross rental receipts of SF Prop LLC are subject to the GRT without deduction for any of the operating expenses relating to the property, since the property is located in San Francisco. Since SF Prop LLC is a single-owner entity that is disregarded for federal income tax purposes, pursuant to Regulation 2014-2, its single-owner Venture LLC would be required to pay the GRT on all of the rental receipts from the property located in San Francisco. However, Venture LLC should not be required to pay the GRT on the gross rental receipts of Non-SF Prop LLC, since all of the gross rental income from Non-SF Prop LLC are from property located outside San Francisco. (See Code section 956.1(b) (gross receipts from the sale, lease, rental or licensing of real property are allocated to where the real property is located).)

FAQ 2b – Are Parents taxed on their distributions of income from Venture LLC?

Since Members are disregarded for both federal income tax and GRT purposes, distributions of Venture LLC income to the Members would be treated for GRT purposes as if made to Parents as the sole owners of those disregarded entities.

Under Code section 952.3(d), a partner's (i.e., Parents') distributive share of partnership income which was already subject to the GRT at the partnership level (Venture LLC) and any actual distributions thereof are not subject to the GRT. Thus, distributive shares or actual distributions of income from Venture LLC attributable to the property located in San Francisco should not be subject to the GRT at the Parent level because it has already been subject to the GRT at the partnership (Venture LLC) level. Furthermore, distributions of income from Venture LLC attributable to Non-SF Prop LLC and its property (located outside of San Francisco) should not be subject to the GRT, as Code section 952.3(d) excludes from gross receipts distributions from an entity treated as a pass-through entity for federal income tax purposes, provided such distributions are "derived exclusively from an investment in such entity, and not from any other property sold to, or services provided to, such entity."

FAQ 2c – On what fees is Management Corp subject to the GRT?

Management Corp will be subject to the GRT on the fees paid to it by Owners with respect to the management services it renders for the property located in San Francisco. Management fees earned by Management Corp for managing the property located outside of San Francisco should not be subject to the GRT even if Management Corp is based in, or conducts all of its management activities in San Francisco. (See Code section 956.1(e) (gross receipts from services are allocated to where the purchaser of the services received the benefit of the services.).)

The exception to this general rule is that all of Management Corp's fees may be excluded from the GRT if they were paid by a "related entity" required to be included with Management Corp in a single combined GRT return. Code section 952.3(d) excludes from the GRT amounts received from or charged to any person that is a related entity to the taxpayer. Under Code section 952.5, a person is a "related entity" to a taxpayer if that person and the taxpayer are permitted or required by the California Franchise Tax Board under Section 25102 *et seq.* of the California Revenue and Taxation Code, or any successor, to have their income reflected on the same combined report.

There is a great deal of uncertainty surrounding GRT combined returns, including the treatment of pass-through entities such as Venture LLC that are owned proportionately by two or more unrelated entities and taxed as a partnership for federal and California income tax purposes. For example, it is unclear whether all amounts received from a related party are excluded from the GRT where the related party owns only a minor (e.g., 1 percent) interest in a pass-through entity. While the Tax Collector has provided very little guidance on the topic, for businesses with partnership interests, the reference to California Revenue and Taxation Code section 25102 may be subject to varying interpretations.

Although SF Prop LLC actually pays Management Corp the fees associated with managing property located in San Francisco, since SF Prop LLC is disregarded, those payments are treated as being made by Venture LLC (as the single owner of SF Prop LLC) to Management Corp. If the income of Management Corp and 45 percent of the income of Venture LLC are included in a California combined return filed by West Corp. (the sole owner of Management Corp), Venture LLC and Management Corp may arguably be considered related entities for GRT purposes, and thus the management fees would be excluded from Management Corp's GRT.

FAQ 2d – Is Management Corp subject to the GRT on amounts it collects as agent of Owners?

Under Tax Collector Regulation 2014-3, the GRT is not imposed on gross receipts received as an agent of another. The rents Management Corp collects on behalf of Owners and deposits into their respective bank accounts, and any amounts withdrawn by Management Corp from the operating bank accounts to pay for expenses relating to the properties (e.g., insurance, taxes, repairs) should not be considered gross receipts of Management Corp for GRT purposes. In both cases, Management Corp is acting as agent on behalf of the Owners, and will either transfer the funds to their bank accounts in the case of rent, or pay their legal obligations to third parties, in the case of the various expenses associated with the properties.

If instead Management Corp paid these expenses directly from its own account, and was reimbursed for these expenses pursuant to the management agreement, the reimbursement may be considered a taxable gross receipt of Management Corp. Regulation 2014-3 provides two examples to illustrate what is and is not a nontaxable agency receipt. In one example, a court filing fee received by an attorney from a client is not a taxable gross receipt of the attorney because the attorney received the filing fee from the client solely as an agent to pay the client's legal obligation to the court. In the other example, a contractor enters into a "cost-plus" arrangement with a customer. The example concludes that the costs incurred by the contractor to perform the contract are the contractor's own obligation, and are not agency receipts excluded from the contractor's taxable gross receipts.

It is unclear under this guidance whether expense reimbursements paid to Management Corp would be subject to the GRT. To minimize this uncertainty, it is advisable that payment of all expenses be made directly by the property owners to avoid the possibility that reimbursed expenses are treated as taxable gross receipts.

FAQ 2e – If the property lease agreements require the tenants to pay for operating expenses, would Owners be subject to the GRT on these payments?

While Owners would likely be subject to the GRT on receipt of payments from San Francisco tenants to reimburse Owners for operating expenses, if the tenants were responsible for operating expenses under the lease agreements, and paid those expenses directly without reimbursement from the Owners, payment of such expenses should not be included in the Owners' gross receipts under Regulation 2014-3, as they would not be legal obligations of the Owners.

FAQ 2f – How much of the commission must Listing Broker report as gross receipts?

If Listing Broker receives a full commission and in turn pays half of it to the Procuring Brokers, Listing Broker may be required to pay the GRT on the full commission, or only on the half of the commission retained. According to Regulation 2014-3, the GRT is not imposed on gross receipts received as an agent of another. The examples provided in Regulation 2014-3 offer little guidance to Listing Broker in this situation. In any event, Listing Broker should only be subject to the GRT on commissions relating to the property located in San Francisco.

However, when Listing Broker's contract with Owners specify that Owners pay the commission to Procuring Brokers directly, the risk that part of the commission would be taxed twice, first upon receipt by Listing Broker, and again upon payment by Listing Broker to the Procuring Brokers should be reduced.

FAQ 3 – Dispositions

Under Code section 954(e), transfers of real property located in San Francisco are exempt from the GRT if they are subject to the San Francisco Real Property Transfer Tax ("Transfer Tax"). Where such transfers of interests in real property located in San Francisco are not subject to the Transfer Tax, certain GRT issues may arise.

FAQ 3a – What if SF Prop LLC transferred its San Francisco property in a transaction not subject to the Transfer Tax?

Where a transfer of real property is not subject to the Transfer Tax, there are GRT provisions that would reduce the amount of gross receipts that may be subject to tax. Generally, all receipts from the sale of property are subject to GRT without deduction for the cost to acquire the property. However, under Code section 952.3(e), gross receipts from the sale or exchange of *real property* does not include the cost to acquire the property sold or exchanged. Thus, while the cost to acquire San Francisco real property is excluded from the gross receipts subject to the GRT on the sale of such property, there are no provisions permitting or requiring basis adjustments that are made for federal income tax purposes to be taken into account for the GRT.

FAQ 3b – What if SF Prop LLC transferred its San Francisco real property in a transaction where gain is deferred for federal income tax purposes?

Under Code section 952.3(a), gross receipts must be reported by taxpayers at the time such receipts are recognized as gross income for federal income tax purposes. Thus, if SF Prop LLC transferred its San Francisco real property in a transaction where gain is deferred for federal income tax purposes (e.g., Internal Revenue Code ("IRC") section 1031), that would not result in gross receipts subject to the GRT because the gross receipts realized from the transfer would not be recognized for federal income tax purposes. It should be noted that most IRC section 1031 deferred exchanges of San Francisco real

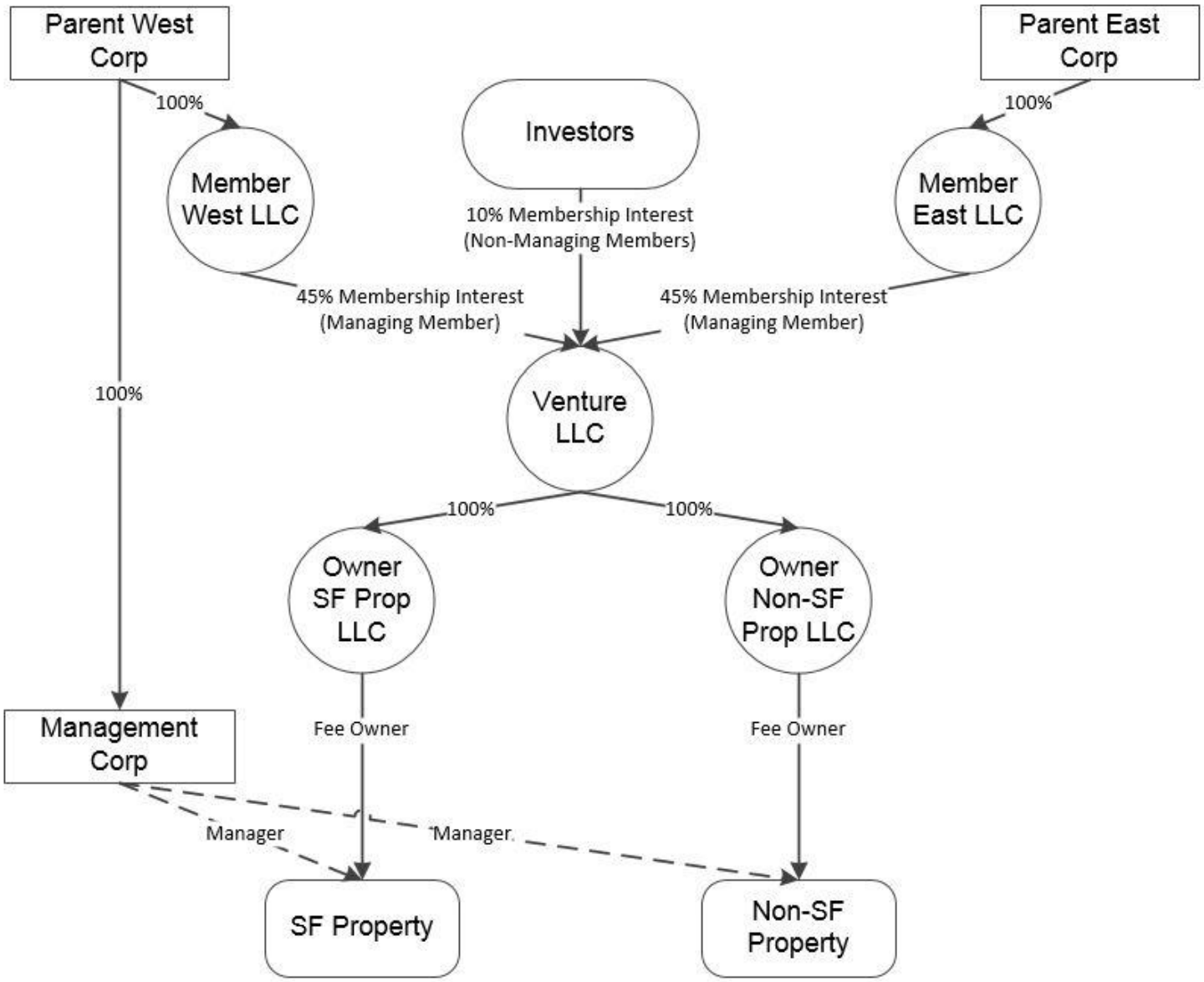
property are subject to the Transfer Tax, and are thus not subject to the GRT pursuant to Code section 954(e).

FAQ 3c – What if West Corp. (through wholly owned West LLC) sold its 45-percent interest in Venture LLC to an unrelated party?

Code section 952.3(d) excludes "investment receipts" from the GRT. Investment receipts include capital gains and amounts received on account of financial instruments, so long as such gains/amounts are directly derived exclusively from the investment of capital and not from the sale of property other than financial instruments, or from the provision of services. A "financial instrument" includes interests in stocks or other similar written instruments evidencing a right to participate in the assets of any business, bonds or other evidence of indebtedness, or any other marketable security. If the sale of the 45-percent interest in Venture LLC results in capital gains, or if the LLC interest is a "financial instrument," receipts from the sale may be excluded from tax if the sales proceeds are "directly derived exclusively from the investment of capital and not from the sale of property or from the provision of services."

Application of the GRT in the commercial real estate context is surrounded by a myriad of uncertainty. While additional guidance from the Tax Collector is certainly needed, absent such guidance, taxpayers will need to address these issues on their own before the April 29, 2016 extended due date for filing 2015 GRT returns. For additional information on the GRT, please see our client alerts of April 29, 2014, March 2, 2015, and February 23, 2016.

APPENDIX


Parent West Corp
Parent East Corp
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Investors
Member West LLC
Member East LLC
10% Membership Interest (Non-Managing Members)
45% Membership Interest (Managing Member)
45% Membership Interest (Managing Member)
100%
Venture LLC
100%
100%
Owner SF Prop LLC
Owner Non-SF Prop LLC
Management Corp
Fee Owner
Fee Owner
Manager
Manager
SF Property
Non-SF Property

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If you have any questions about the content of this alert, please contact one of the authors, the Pillsbury attorney with whom you regularly work, or one of the attorneys below.

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