

San Francisco May Impose Payroll Tax on Profits Paid by Pass Through Entities

by Richard E. Nielsen, Craig A. Becker and Jonathan A. Mikhalevsky

On July 22, 2008, the San Francisco Board of Supervisors voted 10-0 to place a proposal to increase the tax on “pass through entities” under the Payroll Expense Tax Ordinance on the November ballot. The proposal seeks to tax profits paid to owners of pass through entities—including trusts, partnerships, limited liability companies and limited liability partnerships and S Corporations—who perform work or render services within the city.

In an effort to increase tax revenue, the proposal would impose the 1.5% payroll expense tax on the profits of entities that are not otherwise subject to state and federal income tax by virtue of “passing through” their profits to the income tax returns of their equity holders. “Pass through entities” (e.g., partnerships, limited liability companies and S corporations) include small and medium size businesses but also large professional services entities and real estate and other investment entities that pass their profits onto their owners each year.

The city’s payroll tax would be imposed on profits of a pass through entity that are reported as taxable income by the entity’s equity owners for state and federal purposes. The amount of profits subjected to the payroll expense tax would be limited to profits derived from services performed by the owners within the city and would not include any return on capital investment. In addition to current amounts reported to owners on a W-2 form, the amount subject to the city’s payroll expense tax for owners providing services within the city could be presumed to be, for each owner, an amount that is two hundred percent (200%) of the average annual compensation paid to, on behalf of, or for the benefit of the employees of the pass-through entity whose compensation is in the top quartile (i.e., 25%) of the entity’s employees who are based on the City; provided the total number of employees of the entity based in the City is not less than four. The initial proposal limiting entities larger than 20 employees to apply the safe harbor provision was amended to the current version’s four employees. This amendment will require a second vote at the next week’s Board of Supervisors’ meeting.

Under the proposed ordinance, “pass through entities” would include trusts, partnerships, S corporations, limited liability companies, limited liability partnerships, professional corporations, and any other entity that

is not subject to federal and state income tax by virtue of having its profits recognized as the taxable income of its owners or beneficiaries.

The proposal will also exempt small business enterprises whose taxable payroll expense does not exceed \$250,000 from the payroll expense tax (effectively \$3,750 in tax) effective January 1, 2009. Currently the exemption applies to businesses whose payroll expense tax does not exceed \$2,500.

For further information, please contact:

Richard E. Nielsen **(bio)**
San Francisco
+1.415.983.1964
richard.nielsen@pillsburylaw.com

Robert C. Herr **(bio)**
San Francisco
+1.415.983.1038
robert.herr@pillsburylaw.com

Craig A. Becker **(bio)**
Silicon Valley
+1.650.233.4725
craig.becker@pillsburylaw.com

Jonathan A. Mikhalevsky is a law student working as a summer associate at Pillsbury.

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2008 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.