New San Francisco Gross Receipts Tax May Hit Investment Managers/Fund Sponsors

In General

On November 6, San Francisco voters approved "Proposition E," a measure that introduces a new gross receipts tax on all taxable business activities attributable to the city of San Francisco. The measure is intended to replace, over time, the city's 1.5% payroll expense tax. The gross receipts tax will be phased in, and the payroll expense tax will be phased out, over a five year period, beginning in tax year 2014. The phase-in factor will be 10% in 2014 and will reach 100% in 2018. The new tax will be imposed at graduated rates, which will vary based on the taxpayer's industry. For businesses in the financial services industry, the tax, once fully phased in, is expected to be imposed at rates between 0.40% (for gross receipts up to $1 million) and 0.56% (for gross receipts in excess of $25 million). Taxpayers deriving gross receipts from business activities both from within the city of San Francisco and outside the city are required to allocate or apportion their taxable gross receipts in accordance with the new rules.

The new tax will likely be welcomed by many start-ups and other businesses that have a material payroll but that generate little in revenues. However, investment managers and certain private equity and venture sponsors that have a relatively higher ratio of "revenues" to payroll expense are generally more likely to be hurt by the new tax.

Although the definition of gross receipts excludes "investment receipts"-- which are generally defined as interest, dividends, capital gains, and other amounts received on account of financial instruments as well as distributions from business entities -- this exclusion applies only to items that are directly and *exclusively derived from the investment of capital and* ***not from the provision of services to any person***. Similarly, gross receipts do not include any allocations of income or gain, or distributions from an entity treated as a pass-through entity for U.S. federal income tax purposes, but only if such allocations or distributions are derived *exclusively from an investment in the entity and* ***not from services provided to the entity***. Any gross receipts of such a pass-through entity subject to the tax at the entity level are not again taxed at the owner level.

Impact on Funds/Investment Managers/Fund Sponsors

Because of the investment receipts exception, the gross receipts tax generally should not apply at the fund level or to income earned by a limited partner with respect to its investment in the fund (if the limited partner is not otherwise providing services).

However, absent an applicable exemption, management fees and incentive fees paid for the services of San Francisco based managers/sponsors appear to be within the purview of the new gross receipts tax. It is worth noting that San Francisco has already attempted to tax these types of fees pursuant to the existing payroll expense tax. The extension of the payroll tax to partner business profits, first effective for the 2009 year, is currently being litigated.

Given the breadth of the language of Proposition E:

- The gross receipts tax may also reach partnership capital interests as well as profits interests -- including carried interests -- *if such interests are received for services*. In contrast, the existing payroll tax appears not to cover pure carried interests. Note that profits interests potentially subject to the tax would include not only the usual carried interests but also any profits interests received in connection with a waiver of a management fee.

- Were carried interest subject to the gross receipts tax, it is unclear whether the service component of the transaction could ever be viewed as entirely closed or whether any future income from the interest would be "tainted."
- To the extent some portion of the manager's income may be claimed to be from investment, it is unclear how income allocations and distributions would be apportioned between the income from investment and any income received in connection with services provided by the manager.

It is not clear whether allocations in respect of profits interests held by a purely passive general partner would be protected from the reach of the new tax, where a separate entity serves as the management company and renders investment advice to the fund. Managers otherwise subject to these rules who have not already split their management company and general partner may wish to discuss this option with their tax and legal advisors.

We also note that certain aspects of the tax may come to be clarified by San Francisco tax authorities and some may even be litigated.

For more information, please contact a member of Ropes & Gray's tax practice group or your regular Ropes & Gray attorney.