



Office of the City Auditor
Ann-Marie Hogan, City Auditor

CONSENT CALENDAR
September 17, 2002

TO: Honorable Mayor and
Members of the City Council

FROM: Ann-Marie Hogan, City Auditor

SUBJECT: BUSINESS LICENSE TAX AUDIT ANNUAL REPORT FY 2001

RECOMMENDATION:

That Council request the City Manager clear the findings and implement the recommendations contained in this report by January 31, 2003 and return to Council in March 2003 with a report on results achieved.

BACKGROUND:

The Business License tax requirement is codified in the Berkeley Municipal Code Chapter 9.04. It was enacted solely for revenue purposes and, as such, is not meant to be a regulatory function. Authority and administration of the Business License tax has been assigned to the Customer Service division of the Finance Department.

The City Auditor initiated a Business License Tax Audit Program in 1982. Its objectives are to:

- 1) Identify and assess unlicensed businesses,
- 2) Evaluate the accuracy of reported gross receipts of licensed businesses, and
- 3) Ensure the effective and equitable implementation of the Business License ordinance by the Finance Department.

Since its inception in 1982 through June 30, 2001 the program has identified \$3,936,849 in revenues.

CURRENT YEAR:

Attached is a summary report for the fiscal year ended June 30, 2001. We sent audit notices to 267 rental properties and 29 City construction contractors. Identified revenue totaled \$234,505 from the following:

- 115 unlicensed real property rentals
- 2 underreporting City construction contractors

We found the non-compliance rate for contractors (under-reporting) to be between 10 and 17 percent. The non-compliance rate for landlords (lack of license) was between 26 and 31 percent. For this reason, continued public outreach, as well as effective follow-up efforts by Finance, could result in significant future increases in revenue.

It is our recommendation that resources be directed towards expanding a campaign to raise awareness of licensing requirements. This should increase revenues from voluntary compliance. We also recommend increased, systematic efforts at follow-up for businesses identified as being potentially out of compliance with licensing requirements.

It should be noted that once a business obtains a license, for rental properties in particular, it generally continues to pay in succeeding years. Due to the nature of rental properties, we anticipate a continued revenue stream of over \$45,000 annually as a result of last year's efforts.

The auditors believe that complete and prompt implementation of the balance of all of our recommendations and continuing efforts to identify unlicensed and underreporting businesses should result in a lower rate of non-compliance in future years.

FINANCIAL IMPLICATIONS:

New revenue identified for FY 2001 was \$234,505.

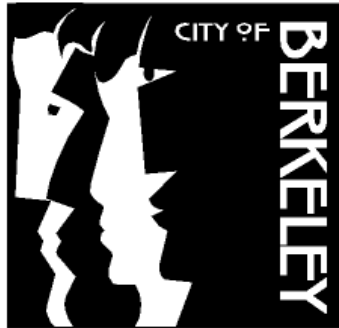
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Ann-Marie Hogan, City Auditor

City of Berkeley



Office of the City Auditor
Ann-Marie Hogan, City Auditor

Business License Tax Audit Program Report

For Year Ending June 30, 2001

Prepared by:

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Presented to Council September 17, 2002

BUSINESS LICENSE TAX AUDIT PROGRAM REPORT
For the Fiscal Year Ended June 30, 2001
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BUSINESS LICENSE TAX AUDIT REPORT For the Fiscal Year Ended June 30, 2001

INTRODUCTION

A. PURPOSE AND OBJECTIVES

The purpose of this report is to present the results of the Business License tax audit program for fiscal year 2001.

The objectives of the Business License tax audit program were to:

- Identify persons/entities engaged in business in Berkeley that have not obtained the required license.
- Ascertain if licensed businesses have accurately reported their gross receipts and paid the appropriate license fees.
- Ensure equitable implementation of the Business License tax ordinance.

B. SCOPE AND METHODOLOGY

The FY 2001 sample reviewed for Business License tax compliance for calendar years 1998, 1999, and 2000 included: 1) real property rental owners selected from a database of Alameda County real properties, and 2) contractors, engaged to do business for the City, who were selected from the City's Contract Management System (CMS) database.

Entities subject to the Business License tax were selected and traced to the City's business license database to determine whether they were registered as a licensed business. Properties that were not in the database were presumed unlicensed. We also examined the contractors' business license gross receipts declared on their business license applications and compared the amounts to the City contract payments.

Property owners and contractors selected for audit were requested to provide information about their gross receipts. We requested and accepted as documentation income tax returns, lease agreements, and/or financial statements. Based on the information provided, we billed the unlicensed businesses for delinquent taxes, penalties and interest as provided for in Berkeley Municipal Code (BMC) Section 9.04.110 and 9.04.120.

Property owners' gross receipts appearing on the submitted documentation were taken at face value. No additional testing was performed unless reported amounts did

not appear to be reasonable. Contractors were billed for underreported gross receipts, which were determined by comparing the amounts reported to the auditors by the contractors to the amounts actually paid by the City.

The City depends largely on the accurate disclosure of information by the reporting entity. Because of this, business license revenues collected may or may not reflect the true facts of the taxpayer's business.

Our work was performed in accordance with Government Auditing Standards as prescribed by the Comptroller General of the United States and was limited to those areas specified in the Scope and Methodology section of this report.

C. BACKGROUND

The Business License tax requirement is codified in the Berkeley Municipal Code Chapter 9.04. It was enacted solely for revenue purposes and, as such, is not meant to be a regulatory function. Authority and administration of the Business License tax has been assigned to the Customer Service division of the Finance Department. According to the City's accounting system, FUNDS\$, the actual 2001 Business License tax, penalties and interest revenue was \$9,785,360.

BMC section 9.04.075 requires all persons/entities engaged in business within Berkeley to obtain a license and to pay an annual license fee. Business License tax is assessed on gross receipts generated within Berkeley. All licenses are effective on January 1 and expire on December 31. A license renewal is delinquent if payment is not received on or before February 28 of each year.

Newly established businesses are required to obtain a business license, within fifteen days of commencing business. If full payment is not received by April 1, a penalty of 50 percent of the license tax is added. Interest at the rate of 1 percent per month on the amount of the fees and penalties continue to accrue, until paid.

In December of each year, the Finance Department sends a Business License tax renewal form (Tax Declaration) to all business license holders in the City's database. Taxpayers are instructed to fill-in their gross receipts information, calculate the tax, and return the form to the Finance Department with payment.

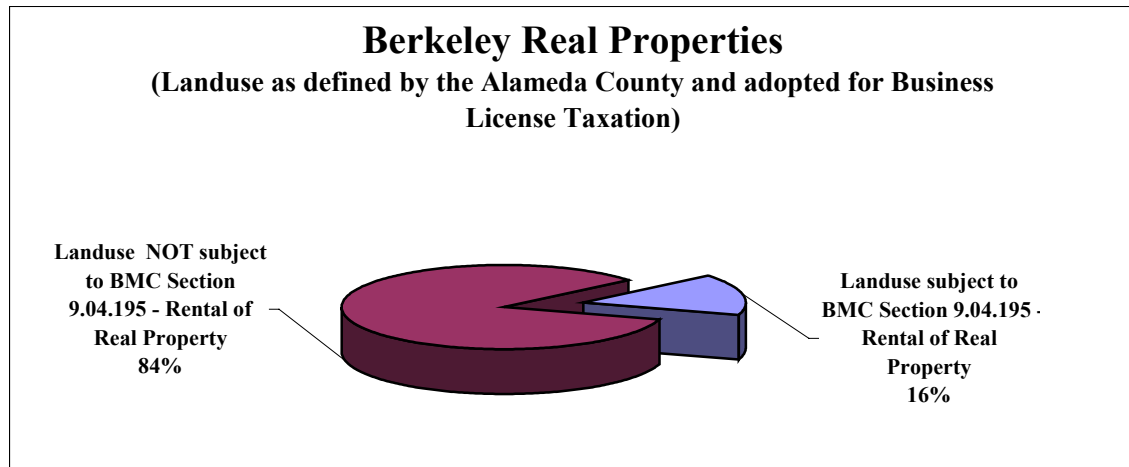
In 1982, the Auditor's Office collaborated with the Finance Department and began a citywide systematic audit of business licenses. Based on the adopted budget for fiscal years 2000 and 2001, Finance formed a temporary Business License Project Team (Special Project) consisting of two Field Representatives and one Office Assistant to increase efforts to identify and collect Business License taxes. Business License tax revenue was anticipated to offset the cost of funding Special Project.

Since its inception in 1982, the City Auditor's Office Business License tax audit program has identified \$3,936,849.

SUMMARY OF PROGRAM RESULTS **For Fiscal Year Ending June 30, 2001**

A.1 PARCELS OF REAL PROPERTY REVIEWED AND AUDITS INITIATED

According to County records identified on the Win2 Database, there are 29,288 parcels of real property in the City of Berkeley. Of these, 4,720 parcels appear to be subject to the licensing requirement of the Berkeley Municipal Code (BMC) Chapter 9.04.195, “ Every person engaged in the business of renting or letting a building structure or other property...except property designated for and used exclusively for residential use which contains fewer than three dwelling unit, shall pay an annual license fee as provided in Section 9.04.240 for each thousand dollars gross receipts.”



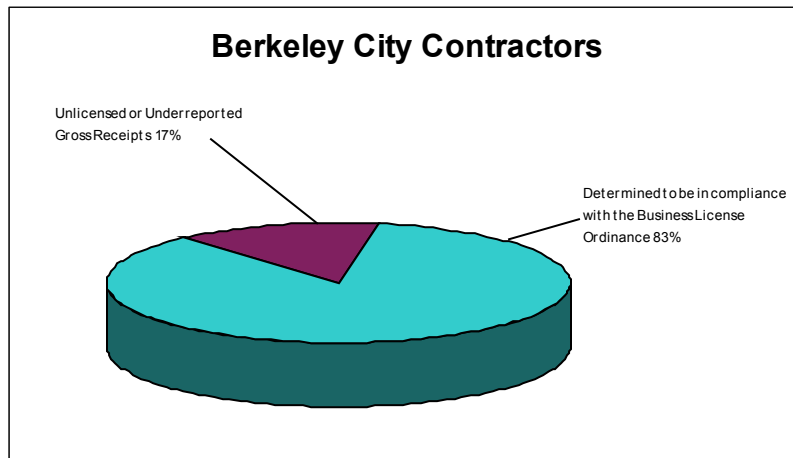
We analyzed and reviewed 267 parcels containing rental properties (6% of 4,720) for Business License tax compliance. There were a total of 298 open audit cases, of which 172 were audit notices sent during the fiscal year and 126 were carryovers from previous years. Of these, 115 assessments were issued and 183 cases were dropped. (See section C. Audits Discontinued (terminated) of this report.)

A.2 CITY CONSTRUCTION CONTRACTORS REVIEWED AND AUDITS INITIATED

We used the City’s Contract Management System (CMS) database to identify all Capital Projects and Public Works construction contracts. CMS is designed to track and provide information about City contracts. The auditors identified a total of 494 construction contracts tied to Capital Projects and Public Works. The auditors identified 271 construction contractors, 101 of them had contracts in excess of \$200,000. We reviewed the 101 construction contractors with contracts in excess of \$200,000 to determine their compliance with Business License Tax requirements. Twenty-nine contractors were identified for audit and sent audit

notifications because they appeared to be either unlicensed or underreporting their Business License gross receipts. Of the 29 contractors sent audit notifications two (2) were assessed in FY 2001. The remaining 27 contractor cases were processed in FY 2002.

Outcome of the 29 contractor cases: 10 of them were billed for underreported gross receipts, 12 were dropped, and 7 were referred to Finance for follow-up.



B. AUDIT ASSESSMENTS OF CONTRACTORS AND LANDLORDS

We completed a total of 117 audit assessments (billings) during the fiscal year. This resulted in identified revenue of \$234,505, as follows:

Particulars	Amount
Unpaid Business License taxes	\$ 137,642.91
Penalty Assessments	68,051.34
Interest Charges	28,810.34
TOTAL	\$ 234,504.59

This revenue reflects 115 assessments for unlicensed real property rentals and 2 assessments for underreporting City construction contractors.

C. AUDITS DISCONTINUED AND/OR TERMINATED

Based on our review of auditees' documentation and information available in City records, 183 cases were dropped for the following reasons:

- 2 business licenses were assessed by Finance
- 3 businesses ceased operation or moved out of Berkeley
- 18 businesses were in compliance; licenses were held under a different name or different address.

- 23 businesses were exempt: less than three dwelling units or vacant
- 26 rental properties were determined exempt because they were owner-occupied and/or no units were rented.
- 107 auditees who did not respond to the second notices sent by the Auditor's Office were referred to Finance for follow-up action (see Finding P-4.)
- 4 auditees' information improperly recorded in database

D. COLLECTIONS

Total collections for the fiscal year were \$288,421. Of this, \$197,167 was collected based on fiscal year 2001 billings and \$ 91,254 was collected based on prior years' billings.

As of June 30, 2001, the total accounts receivable outstanding for the Business License tax audit program was \$98,411. Accounts receivable of \$55,308 (25 taxpayers) were recommended for write off by Finance. The write-offs were based on one of the following reasons:

- City's three year statute of limitations
- taxpayer relocated, or
- taxpayer filed for bankruptcy

E. BUSINESS LICENSE APPEALS GRANTED FOR LANDLORDS

Of the 117 audit assessments issued during fiscal year 2001, thirty auditees, landlords, filed appeals in accordance with BMC Section 9.04.270. Hearings resulted in the City waiving \$2,223 in penalties and interest. There were no appeals filed by construction contractors.

Taxpayers disputed the 50% penalty assessment and interest charges, stating that the rates were excessive. In prior years, taxpayers also documented excessive penalty assessments and interest as the basis for their appeals. Most appellants did not contest the three-year assessment.

Of the 30 appellants (landlords) noted above, 26 stated that they were unaware of the City's business license tax requirement. Most argued that, despite interaction they had with other City departments, they were never informed of the need to apply for a business license. Furthermore, appellants stated that they believed that compliance with the City's Rent Board registration requirements fulfilled their obligation with respect to rental property.

F. \$39, 902 REVENUE DECLINE BASED ON OCTOBER 10, 2000 COUNCIL ACTION IN FAVOR OF LANDLORDS

On October 10, 2000, the Council directed the City Manager to waive the penalties and interest for the periods 1997, 1998 and 1999. This waiver was limited to rental properties of three and fewer units on one parcel when the owner owns no other properties in the City of Berkeley and has not had a business license in the past.

This Council action appeared to be based on citizen complaints related to Business License tax bills. According to the October 10, 2000 Council item, one of the Council members noted that:

- 1) the City of Berkeley never informed the taxpayer that they owed business taxes in the previous years that were being billed and
- 2) it was unfair to charge penalties and interest when notices were not sent out previously to the property owners.

Council's rationale for waiving penalties and interest for smaller property owners and for properties that were partially owner-occupied, appeared to be that such owners were less likely to know that they must pay business license fees.

Pursuant to Council Action of October 10, 2000, the City refunded penalties and interest in the amount of **\$39,902.39**

- | | |
|-----------------------|--------------------|
| 1) Finance - | \$21,779.48 |
| 2) Auditor's Office - | \$18,122.91 |

An October 24, 2000 report to Council estimated a \$24,000 reversal of penalties and interest to customers previously billed (actual \$39,902) with estimated lost revenue opportunities of \$141,000 over a two-year period.

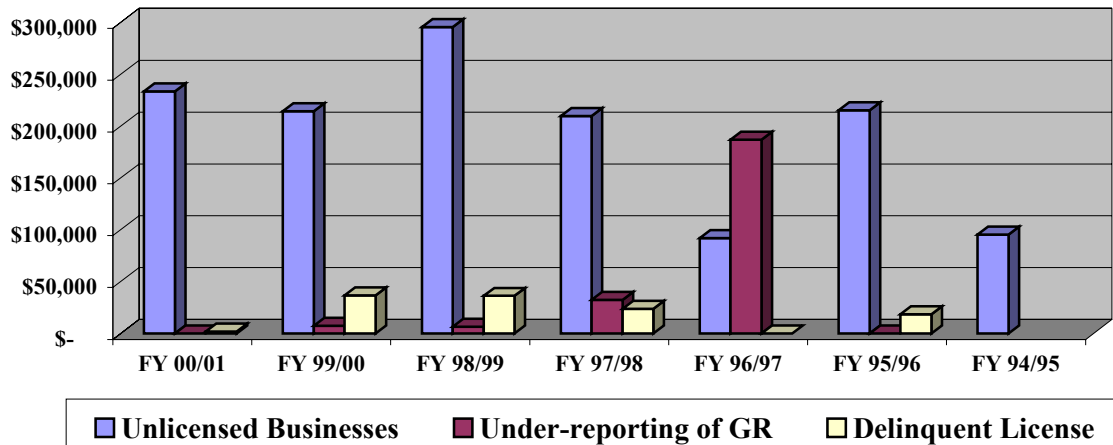
G. CUMULATIVE STATISTICAL INFORMATION

The Business License Audit function in the Auditor’s Office continues to show a high rate of return for the staff time invested.

**Auditor’s Office
Business License Tax Revenues
Identified through Audit**

Fiscal Year	Unlicensed Businesses	Under-reported Gross Receipts	Delinquent Licenses	TOTAL	# Of Hours Spent on Business License	Total FTE (@ 80% Productive Time)
FY00/01	\$ 233,571	933.76	0	\$ 234,505	1915	1.15
FY99/00	214,361	0	1,875	216,236	1,553	.93
FY98/99	295,323	7,283	36,591	339,197	2,536	1.52
FY97/98	209,723	6,466	36,175	252,364	835	.50
FY96/97	91,798	32,468	23,769	148,035	783	.47
FY95/96	215,249	186,901	0	402,150	689	.41
FY94/95	95,189	0	18,474	113,663	522	.31
TOTAL						

**City Auditor’s Office
Business License Revenues Identified Through Audit
Seven-year Comparison**



OPERATIONAL ISSUES

I. ISSUES IDENTIFIED DURING FISCAL YEAR 2001

Finding 1 Outdated Standard Industrial Classification (SIC) System used by Finance

Conditions Observed: The City's business license module uses the 1987 version of the Standard Industrial Classification (SIC) System. In 1997, the United States Government updated the SIC and released, "The North American Industry Classification System." A taxpayer securing a business license with industry code classification under the 1997 version will find that it does not match the City's business license rate schedule since the classifications used by the City are based on the 1987 version of the SIC.

BMC Section 9.04.160 provides that: "*A. Every person primarily engaged in the business of providing business, personal or repair services, or social services, or transportation services, as defined in the current U.S. Government printing office publication Standard Industrial Classification Manual, not specifically taxed by other provisions of this chapter, shall be classified within the business, personal and repair services category and pay a license fee for each thousand dollars of gross receipts for services performed within the City as provided in Section 9.04.240*"

By using codes with business classifications that are inconsistent with the current federal industry identification standards, the City is in non-compliance with the BMC. In addition, if businesses are incorrectly classified they could, consequently, be charged incorrect Business License tax rates.

Recommendation: We recommend that Finance either adopt the current (1997) version of the North American Industry Classification System or submit an amendment to BMC Section 9.04.160 (A) to Council. The amendment should both bring the City into compliance with its own regulations, and allow for use of current and future updates to the SIC. In addition, the Business License tax rate schedule should be updated to reflect the new codes.

City Manager's Response

The City Manager concurs and will propose an amendment to the ordinance specifying use of the "most practicable version" of the SIC Manual, instead of "current" Manual. The revised ordinance will be brought to Council by September 24, 2002.

Finance will amend the ordinance in this manner because the timely implementation of a more current SIC Code is beyond the City's existing applications program (HTE), and available human and technology resources. Finance will identify and reclassify those businesses misclassified within the current SIC code, and revise any incorrect fees, by December 31, 2003.

Finding 2 Duplicate and Invalid Accounts in HTE/FUNDS Occupational License (OL) Module

Conditions Observed: The Occupational License (OL) Module, the City's formal database used to document businesses in the City, is being used by Finance to track records of actions taken on accounts. Because of this use, it contains duplicative and erroneous information tied to invalid accounts. The OL Module is incapable of deleting invalid accounts due to a flaw in HTE/FUNDS, the City's financial software.

Special Project is not using the OL Module as intended. Special Project staff enters each potential non-compliant business into OL after sending the first letter of inquiry to the taxpayer. This creates an account for each taxpayer notified.

New accounts may need to be deleted, if:

- the street number information is incorrect,
- the taxpayer's business license is under a different name,
- the business terminated its operations, or
- there was a change of ownership

Since the system does not allow duplicate or invalid accounts to be deleted, the numbers of these invalid accounts grow significantly. We could not determine whether this problem could be corrected by the vendor (HTE) or by Information Systems.

Recommendation: We recommend:

- 2.1 That the City Manager work with IT and Finance to determine a resolution to enable Finance to delete duplicative and invalid accounts and report back to Council by December 17, 2002.
- 2.2 That Finance discontinue using OL to track unlicensed notices and start using a separate database for this purpose.

City Manager's Response

The City Manager concurs. Finance has communicated with Information Technology about this and other technology or systems-related problems. We will wait for the anticipated September 2002 update of the HTE software to see if it includes a remedy for this situation. Finance will report back to

Council by December 17, 2002. The Business License Project has initiated and continues to revise its own database for tracking records of action taken on accounts.

Finding 3 No Effective Monitoring System in Place to Track Unlicensed Businesses Contacted and Non-respondents

Conditions Observed: The auditors requested, from Finance staff, a copy of the database or the spreadsheet used to identify all businesses that were previously notified or billed by Finance. The information was not provided to the auditors because Finance did not have an effective standardized tracking system in place.

Lack of a standardized monitoring system of Finance's activities makes it difficult to monitor Business License activity and prepare useful performance and management reports. Lack of an effective monitoring system may also increase the possibility that a taxpayer may be erroneously contacted more than once.

Recommendation: We recommend that the Finance Department:

- 3.1 Create and maintain an effective standardized monitoring system of all billings/notifications sent out for Business License tax review.
- 3.2 Design the database to include pertinent information, including the status of the account.
- 3.3 Report monthly to the City Manager on useful management information such as resources used and revenue identified by the Business License Special Project.

City Manager's Response

The City Manager concurs and will implement the recommendations. Finance's Business License staff had also identified the need for its database to function more effectively. Unfortunately, this database has been inconsistently monitored largely due to significant turnover in personnel. An improved version of the database is expected to be ready by January 31, 2003.

Finance currently provides general standard reports on Business License activity to the City Manager's Office. However, more detailed monthly reports on Business License activity will be developed and delivered to the City Manager.

Finding 4 Insufficient Follow-up on Delinquent Business License Renewals

Conditions Observed: Finance does not have formal procedures and guidelines in place that identify the maximum and minimum number of notifications sent to taxpayers prior to imposing tax, penalties, and interest. According to the OL Module, there are numerous business accounts that show a status of seven or more renewal notifications sent to the same taxpayers without any follow-up action or alternative collection effort. The auditors found no evidence of follow up efforts for delinquent business license accounts.

Section 9.04.250 of the BMC authorizes Finance to exercise the following enforcement remedies:

- power and authority to enter, free of charge and at any reasonable time, any place of business required to be licensed and demand an exhibition of its license certificate;
- deem any person who fails to exhibit the same on demand guilty of an infraction subject to penalty by fine under section 1.20.020 of the BMC ;
- cause a complaint to be filed against any and all persons found to be violating any of said provisions.

Penalties for infractions are:

- a fine not exceeding one hundred dollars for a first violation
- a fine not exceeding two hundred dollars for the second violation
- a fine not exceeding five hundred dollars for each additional violation of the same section of the same ordinance within one year

The City is losing tax revenue from taxpayers who are not renewing their business licenses. These taxpayers appear to be in violation of the business license ordinance and should be assessed with the imposed tax, penalties and interest, or fines.

According to Finance’s audit response dated February 27, 2001, “It has been the experience of Field Investigators that their first-hand notification of an impending infraction and fine usually results in compliance.” Based on that statement, Finance’s use of infraction and fines can be successful in the enforcement of the Business License ordinance.

Please note that the City is subject to the statute of limitation, which only allows three years of collection of back taxes. Any levies beyond three years are uncollectible.

Recommendation: We recommend that the Finance Department:

- 4.1 Generate and implement standardized written notification and collection policies and procedures.
- 4.2 Initiate more aggressive collection action against businesses failing to renew their business license

City Manager's Response

The City Manager concurs. Finance will generate and implement standardized written notification and collection policies and procedures by December 31, 2002.

Finding 5 Public Outreach Not Adequately Performed

Conditions Observed: This finding clarifies the previous recommendation related to performing business license public outreach to all business categories. The auditors previously recommended that Finance promote citizen's awareness of the business license requirement. When Finance performed public outreach specific to real property owners they deemed this recommendation implemented. However, our recommendation was that public outreach be made to all business license categories, not just real property owners.

The auditors continue to encounter taxpayers claiming that they do not have any knowledge of the business license requirement. It is important to promote citizens' awareness of the requirement to secure a license when doing business in the City of Berkeley.

The City Council action on October 10, 2000, waiving citizens' penalties and interest for triplex property owners, was a result of citizens' complaints of not being informed of the business license requirement. In addition, the appeals records for the Auditor's Office show that 87% of the appeals were due to owners claiming that they were not aware of the licensing requirement.

Recommendation: We recommend:

- 5.1 That the City Manager ensure that efforts of Finance - Business License tax compliance are coordinated with the Planning Department's Service Center, Public Works, and all other relevant City departments so that information on business license requirements is provided to all permit applicants and new business owners.
- 5.2 That the Finance Department performs public outreach activities such as notices, brochures, or flyers to business owners, affiliates and community

organizations. When performing public outreach activities, Finance should take advantage of the City's website.

City Manager's Response

The City Manager concurs. A revised schedule of outreach accomplishments and activities, along with a specific plan of continued action and target dates will be prepared and submitted to Council by October 15, 2002.

II. PRIOR YEARS' AUDIT FINDINGS – STILL OUTSTANDING AS OF JUNE 30, 2001

P-1 Lack of Citywide Procedures for Writing-off Uncollectible Accounts (Outstanding: 5 years)

Conditions Observed: The auditors have consistently recommended that the Finance Department develop a citywide policy to write-off uncollectible accounts.

We reported this issue to Council in FY 96, FY 97, FY 98, FY 99 and FY 2002. In June 1999, Finance agreed to work with the City Attorney's Office to develop an addition to the BMC that allows a generally accepted government accounting process for completing write-off across all applicable accounts citywide. Finance has not given the auditors an estimated date for completion.

The Finance Department, in an audit response submitted to Council on February 27, 2001 stated that the project is in process. They stated that, "since the report was issued, this recommendation has been included in the City Manager's Project Management System to update City Write-Offs. Completion date per the CM Project Management System: December 2001".

Auditor Recommendation: The auditors recommend that Finance finalize and distribute to City staff a citywide policy to write-off uncollectible accounts.

City Manager's Response

*The City Manager has approved the new **Administrative** Regulation (A.R.) 3.15 for Citywide Write-Off. The A.R. will be published on the City's website by September 10, 2002*

P-2 Need to Finalize, Publish, and Make Available to the Public the Business License Tax Brochure (Outstanding: 4 years)

Conditions Observed: The Business License tax brochure, which is designed to assist taxpayers in calculating their annual Business License tax, needs to be finalized and made available to the public. The brochure was last updated in February 1996.

In January 1998, the Auditor's Office and the City Attorney's Office submitted brochure revisions at the request of the Finance Department. However, the updated brochure was not released. In last year's response to our audit recommendation, Finance stated that a draft brochure had been prepared and submitted to the Finance Director. However, this new brochure has not been published. At the entrance conference held on November 13, 2000, a Finance employee was designated to update the brochure and incorporate the effects of Measure U. (Measure U was a City ballot aimed at correcting an error in the City's Business License tax rate identified by the Auditor's Office in a previous audit.)

The Finance Department's report to Council on February 27, 2001 stated the following implementation status on our recommendation.

In Process: Substantial additional work is needed on this document; the materials are currently under review by Finance Administration; and when the brochure reaches a more developed stage it will be submitted to the City Attorney and City Manager's Office for review and approval prior to completion. Completion Date: September 2001 Past Due.

This is the fourth year that this finding has been outstanding

Auditor Recommendation: Although implementation of this recommendation appears to be in progress, we recommend that Finance Department finalize, publish and make the updated Business License tax brochure available to the public.

City Manager's Response

The status and completion date for the brochure will be provided to Council on October 15, 2002.

P-3 Payments for Property Liens Placed through the County Tax Collector's Office are Not Monitored (Outstanding: 4 years)

Conditions Observed: As of June 30, 2000, the Finance Department attached property liens due to unpaid Business License taxes in the amount of \$36,080. This is recorded as accounts receivable in the City's financial records. The County collects these liens at the same time and in the same manner as special assessments. This money is remitted to the City in July and December each year. However, because Finance does not have a procedure in place to track liens, subsequent lien payments are not reported. As a result, the accounts receivable balance is not adjusted for paid liens. It is our concern that the City's financial statements are chronically incorrect as to the City's accounts receivable balance, if the county has in fact, remitted payments to the City.

We recommended that Finance develop a written procedure for handling property liens.

A Finance report submitted to Council on February 27, 2001 regarding audit implementation stated:

Completed: The Auditor's Office received reports on all current property assessment liens.

In Process: A procedure for tracking and reporting on these liens will be drafted and submitted for review, noting that resolution is still required to address the impact of delays on prior year's records from the county.

Auditor Recommendation: We again recommend that Finance develop written procedures for handling property liens placed through the County.

City Manager's Response

Finance completed the Business License Property Lien Procedures on June 19, 2002. The City and the County had incompatible database formats. Completion and implementation of these procedures were resolved with the successful conversion of the database formats.

P-4 Insufficient Follow-up: Taxpayers Who Fail to Respond to Letters from Auditors (Outstanding: 3 years)

Conditions Observed: Since the BMC specifically assigns enforcement to Finance; Finance agreed to perform follow-up action on auditees who did not respond to second audit notices.

An agreement between the Auditor's Office and Finance provides that, "*Finance will send follow-up letters to demand compliance or issue citations as necessary*". During the period under audit, the auditors did not receive copies of any demand letters sent to businesses that failed to respond to our audit notices. In addition, we received no evidence that any citations had been issued by Finance on businesses referred to them for collection action.

It appears that no collection actions were taken by Finance on these cases. This is the 4th year that this condition has been reported. The following documents the number of non-respondents reported to Finance for follow-up: 1998- 31 cases, 1999-34 cases, 2000-16 cases, and 2001-107 cases.

Section 9.04.250 of the BMC provides enforcement remedies to the Director of Finance, acting through deputies or duly authorized assistants to:

- enter, free of charge and at any reasonable time, any place of business required to be licensed and demand an exhibition of its license certificate;
- deem any person who fails to exhibit the same on demand guilty of an infraction and shall be subject to penalty by fine under section 1.20.020 of the BMC ;
- cause a complaint to be filed against any and all persons found to be violating any of said provisions.

The Finance Department's response to this recommendation in 1999 was, "Aggressive enforcement of the Business License Ordinance will be a priority of the Business License Project, if the project is approved in the budget process."

Auditor Recommendation: Finance should perform follow-up and enforcement action related to businesses that fail to respond to audit letters. Finance should furnish the Auditor's Office copies of the demand letters sent to non-compliant auditees and report implementation. A report on resolution of actions related to infractions or citations, fines, and small claims court actions should also be provided to the Auditor. Follow-up on all 107 cases from Fiscal Year 2001 should be performed up to and including site visits and penalty by fine under BMC Section 1.20.020, by August 31, 2002.

City Manager's Response

The Procedures for Processing Auditor Generated Accounts have been in place since Fall 2001. Disposition of the 107 cases from FY 2001 is still underway. The current status is:

- 26 Business License on file (2 due for FY99, 24 either current or due for the current year)
- 11 Identified by Business License review team
- 44 Addresses are not on file
- 24 Addresses on file, but no active Business License
 - 1 Owner-occupied rental property
 - 1 Auditor working on

These are scheduled to be completed by August 31, 2002 and reported to the Auditor's Office.

**P-5 Confidentiality of Taxpayer's Information
(Outstanding: 2 years)**

Conditions Observed: During FY 99 and FY 00, a citizen and a local newspaper have used the Public Records Act to request information about businesses operating without licenses. The City Auditor's assessment invoices contain confidential taxpayer-supplied information. Because of this, we requested a formal City Attorney's opinion as to whether we are required to provide this information to requesters. The City Attorney stated that the reference in BMC Section 9.04.090 regarding confidentiality appears to refer only to the Declaration Statement by taxpayers filed with the Finance Department. Therefore, auditor prepared documentation is a matter of public record even if it includes confidential taxpayer information.

Recommendation: We recommend that the Finance Department propose an appropriate amendment to the Business License ordinance that:

1. Provides confidentiality of all tax information provided to the City as a whole, to the extent that this is consistent with the Public Records Act. Moreover, this should include reports prepared by City staff that includes this information.
2. Specifies what taxpayer information is open for public inspection.

Finance's Response

The confidentiality ordinance is already in effect, having received its 2nd reading by Council on April 23, 2002.

P-6. Lack of Enforcement of Requirement that Subcontractors' Information be Provided by Contractors. (2 years)

Conditions Observed: Current procedure in Finance allows contractors to deduct from gross receipts subcontractor payments without the required documentation. For instance, over a period of three years, one contractor deducted \$12,593,814 in gross receipts with no supporting subcontractor list, reducing its Business License tax liability by \$22,668.

BMC Section 9.04.180 (B)– Construction Contractors provides that: “*Any person subject to a license under provisions of this section may exclude from gross receipts the portion of those receipts paid to subcontractors, providing that a list of such subcontractors and the amounts of payment is reported to the Finance Department*”.

Finance staff cannot determine whether under-reporting of gross receipts occurred. Contractors could be claiming deductions in excess of actual subcontractor payments and under-reporting gross receipts by subcontractors. As a result, the City may be losing revenue from under-reporting of gross receipts from both contractors and subcontractors.

Recommendation: We recommend that Finance -

1. Implement the requirement in the ordinance that contractors who avail themselves of the exclusion must submit to the Finance Department a list of subcontractors and the amounts of payment made.
2. Set-up a filing system for all subcontractor lists submitted by contractors during license renewal process. If a filing system is maintained, as recommended, these subcontractor lists could be periodically tested and audited for accuracy.
3. Set a materiality threshold and review subcontractor lists exceeding the threshold for additional tax, penalties and interest.
4. Propose an amendment to the Business License ordinance to require contractors to report the business license numbers of subcontractors in order to qualify for exclusion of such payments from gross receipts.

Finance's Response

1. *Finance has implemented the ordinance requirement and established written Procedures for Listing of Subcontractors for Contractors Business Licenses.*
2. *The filing system for subcontractor lists was established last year.*
3. *The audit threshold in these procedures is for contractors with gross receipts of \$200,000 and subcontractor payments of \$500. In addition, a letter has been sent to contractors in our business licenses records,*

notifying them of the opportunity to file this exemption from their gross receipts, and reinforcing the requirements to do so.

- 4. Finance is not pursuing an ordinance amendment at this time, and has implemented this recommendation by internal department regulation.*

SUMMARY OF DISPOSITION OF RECOMMENDATIONS

New Findings for Business License Tax Annual Report for Fiscal Year 2001 are:

- 1) Outdated Standard Industrial Classification (SIC) System Used by Finance.
- 2) Duplicate and Invalid Accounts in HTE/FUNDS Occupational License (OL) Module.
- 3) No Effective Monitoring System in Place to Track Unlicensed Businesses Contacted and Non-respondents.
- 4) Insufficient Follow-up on Delinquent Business License Taxpayers -Renewals.
- 5) Public Outreach Not Adequately Performed

Below are the improvements that were reported implemented by Finance:

- The Business License tax uncollectible accounts receivables reported by the Auditor's Office were written off.
- Public outreach was performed specific to real property owners' rental units
- Discontinued use of OL to track unlicensed notices and started using a separate database.
- Finance's Citations Handbook was published, documenting guidelines related to issuing citations.
- Filing system was established for contractors' listing of subcontractors.
- Implemented procedures to enforce subcontractor requirements for construction contractors.
- Council approved the amendment to the ordinance regarding taxpayer confidentiality.
- Implemented procedures for processing property liens.

Status of Prior (Multiple) Years' Findings Outstanding as of June 30, 2001 as confirmed by the Auditor's Office:

- P-1** Lack of Citywide Procedures for Writing-off Uncollectible Accounts. (5 years). Resolved June 15, 2002
- P-2** Need to Finalize, Publish, and Make Available to the Public the Business License Tax Brochure. (4 years outstanding)
- P-3** Payments for Property Liens Placed through the County Tax Collector's Office are Not Monitored. (4 years) Resolved June 19, 2002
- P-4** Insufficient Follow-up on Taxpayers Who Fail to Respond to Letters from the Auditor. (3 years outstanding)
- P-5** Confidentiality of Taxpayer's Information. (2 years) Resolved May 23, 2002
- P-6** Lack of Enforcement of Requirement that Subcontractors' Information be provided by Contractors. (2 years) Resolved May 22, 2002

CONCLUSION

In the last seven years, the City Auditor's Business License tax audit program identified 695 unlicensed businesses for an increase in total Business License tax revenues of \$1,706,150. Once a business obtains a license it usually continues to pay in succeeding years. Therefore, the identified revenue is not a one-time windfall, but becomes a part of future revenue streams. As an example, we identified \$137,642 of unpaid business license taxes (excluding penalties and interests) covering a three-year period or over \$45,000 per year. Although most businesses cease operations after five years causing a revenue stream that diminishes over time the businesses audited during this period were rental property owners (115) and construction contractors (2). Almost all of the tax assessed was from rental properties. Due to the business nature of rental properties we anticipate a continued revenue stream of a substantial portion of this amount annually, for the foreseeable future.

The auditors believe that complete and prompt implementation of the balance of all of our recommendations and continuing efforts to identify unlicensed and underreporting businesses should result in a lower rate of non-compliance in future years.

We found the non-compliance rate for contractors to be between 10 and 17 percent. The non-compliance rate for landlords was between 26 and 31 percent. For this reason, continued and expanded public outreach, as well as effective follow-up efforts by Finance could result in significant future increases in revenue with relatively insignificant increase of staff resources.

Although the Auditor's Office is currently identifying revenue at a ratio of 6:1 employee cost, partly because of the penalties and interests charged, we believe that public outreach would be a much more efficient and equitable long term use of citywide resources. Finance's prompt implementation of an awareness campaign would be a much-needed service to the community as demonstrated by Council action on October 10, 2000.