



Office of the City Auditor

INFORMATION CALENDAR
June 26, 2012

To: Honorable Mayor and Members of the City Council
From: Ann-Marie Hogan, City Auditor
Subject: Business License Tax Program Audit Report for Fiscal Year 2011

SUMMARY

The Business License Tax (BLT) Audit Program Report presents the results of the Auditor’s Office BLT audit program during Fiscal Year 2011 (FY11). The BLT audit program increases businesses’ compliance with the Berkeley Municipal Code and generates additional revenue for the City. During FY11, the Auditor’s Office assessed 40 businesses a total of \$200,437, after appeal adjustments, in unpaid taxes, penalties, and interest. In the last ten years, businesses have paid \$1.2 million in revenue that the City otherwise would not have received and can be expected to pay an additional \$1.4 million over the next five years.

CURRENT SITUATION AND ITS EFFECTS

As of June 30, 2011, 38 businesses owed the City \$269,260 for FY11 and prior years. The Department of Finance forwarded six of these cases, totaling \$6,451, to Alameda County to be applied to the business owners’ property tax bills. We recently published a separate performance audit on business license tax revenue and collections, titled [“Business License Taxes: Providing Better Guidance and Customer Service Will Increase Revenues.”](#) The report makes several recommendations to Finance that should substantially improve their timeliness in collecting delinquent business license taxes.

We select for review or audit businesses that appear to be unlicensed, delinquent in renewing their license, or underreporting their gross receipts to the City. The BLT audit program increases the public’s awareness about the business license requirements and may deter businesses from not obtaining a license or from underreporting their gross receipts.

POSSIBLE FUTURE ACTION AND FISCAL IMPACTS

The BLT audit program is an effective means to generate tax revenue that the City may not otherwise receive. The Auditor’s Office has billed taxes, penalties, and interest totaling more than \$1.5 million during the past ten fiscal years. Revenue we identify is not a one-time windfall, but is an ongoing source of income for the City. We estimate that our assessments during the past ten fiscal years will generate recurring business license tax revenue of about \$280,000 annually, as long as the businesses continue to generate consistent gross receipts. Over the next five years, these assessments can be expected to generate an additional \$1.4 million in business license tax revenue for the City.

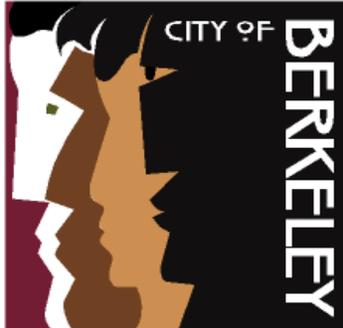
CONTACT PERSON

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Attachment

1: Business License Tax Program Audit Report Fiscal Year 2011

City of Berkeley Office of the City Auditor



Business License Tax Audit Program *For Fiscal Year Ending June 30, 2011*

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Presented to Council June 26, 2012

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EXECUTIVE SUMMARY

Business License Tax Audit Program increases City revenue

\$1.2 million in taxes, penalties, and interest collected in last ten years

We assessed \$200,437 in FY 2011

The Business License Tax Audit Program is an effective way to increase revenue for the City and raise the public's awareness about Berkeley's business license requirements. The Auditor's Office collected \$72,165 in taxes, penalties, and interest as a result of our business license audits in Fiscal Year (FY) 2011 and \$1.2 million over the last ten years. Assuming these businesses continue to operate, the business license tax revenue generated from our audits becomes part of the City's ongoing revenue stream. As a result, these audits can be expected to generate an additional \$1.4 million over the next five years.

We worked on 150 business license cases during FY 2011. We:

- Assessed 40 businesses a total of \$200,437 in unpaid taxes, penalties, and interest.
- Dropped or closed 76 cases, generally after reviewing City records and documentation provided by the business owners and concluding that the businesses were in compliance with the business license tax ordinance.
- Carried over 36 in-progress cases to FY 2012, including two partial assessments.

The Auditor's Office oversight and impartial reviews of businesses operating in Berkeley provide equitable treatment by ensuring that all businesses pay their appropriate amount of business license taxes, as required by the Berkeley Municipal Code.

AUDIT OBJECTIVES

Audit increases compliance with City's business license requirements

The objectives of the Business License Tax Audit Program are to increase businesses' compliance with Berkeley's licensing requirements and to recover unpaid business license revenues. Recoveries are revenues the City collects from the following categories of businesses:

1. Unlicensed: Businesses operating in Berkeley that have never purchased a business license and have not paid the applicable business license taxes.
2. Delinquent: Businesses that have not renewed their business license or paid the business license taxes owed.
3. Underreporting: Licensed businesses that have underreported their gross receipts and consequently underpaid their business license taxes.

BACKGROUND

Business license taxes raise revenue for municipal purposes

General fund received \$14.5 million in FY 2011

The City Council enacted the business license tax ordinance in 1977, codified as Chapter 9.04 in the Berkeley Municipal Code, to raise revenue for municipal purposes. The Department of Finance (Finance) is responsible for administering and collecting business license tax revenue. The City collected \$14.5 million in revenue for business license taxes, penalties, and interest in fiscal year 2011.

License must be renewed annually

The Berkeley Municipal Code requires all individuals and entities engaged in business within Berkeley to obtain a Berkeley business license and to pay an annual license fee. The business license year is January 1 through December 31. New businesses are required to obtain their license within 15 days of commencing business. Each December, Finance sends a business license renewal form (Tax Declaration) to all licensed businesses listed in the City's Occupational License (OL) database. Businesses are instructed to report, depending on their tax rate code, their gross receipts, gross payroll, or flat fee amount due; calculate the tax due; and return the form to Finance with payment on or before the last day in February.

Penalties and interest are added when license tax is not paid timely

Businesses that do not renew by the February deadline and new businesses that do not submit their initial application within 30 days after opening their business must pay a late filing penalty of 10 percent. The penalty increases to 50 percent for renewing businesses that file more than one month late and for new

businesses that file more than 60 days after commencing business. Late-filing businesses must also pay interest at the rate of one percent each month, or fraction thereof, on the unpaid taxes and penalties. The BMC requires interest to continue accruing until the business pays all taxes, penalties, and interest due.

Business license taxes generally assessed as percentage of gross receipts

Business license taxes are generally calculated on a business' prior year's gross receipts generated within Berkeley. In some instances, the tax is calculated using another tax basis, such as gross payroll, gross receipts less the value of raw materials, or a flat fee. Tax rates vary depending on the business type and its business license tax code, which is based on business categories in BMC 9.04 and the North American Industry Classification System (NAICS).¹

Closing businesses required to file final tax declaration within 30 days

Any business that closes during the calendar year is required to file an amended tax declaration within 30 days of closing and pay business license taxes based on its actual gross receipts for the period of the year that the business was in operation.

SUMMARY OF FY 2011 PROGRAM RESULTS

40 businesses assessed \$200,437 in delinquent taxes, penalties, and interest

During FY 2011, we assessed 40 businesses a total of \$200,437, after appeal adjustments, in unpaid taxes, penalties, and interest. Businesses paid \$72,165 during FY 2011 as a result of our assessments. This revenue includes \$40,086 received from Alameda County for prior years' assessments that businesses owners paid through their business property tax bill.

Audit generates ongoing revenue stream for the City

Our goal is for the Business License Tax Audit Program to pay for itself through increased revenue collections. We accomplish this through collections of taxes, penalties, and interest on our

¹ NAICS classifies businesses into industry groups based on a business' operations and is also used for business statistic purposes. The United States, Canada, and Mexico jointly developed NAICS in 1997 to replace the Standard Industrial Classification (SIC) system, to recognize the new businesses in our economy, and to allow comparison of economic data across borders in North America.

current year assessments and through ongoing collection of taxes from the businesses we have brought into compliance, assuming the businesses continue to operate and pay their business license taxes. The table below shows the amount of revenue the City can expect to receive over a five-year period, based on our assessments during the past ten years.

Projected Business Tax License Revenue Based on 10 Years of Audits

Fiscal Year	Amount Assessed	Percent Attributable to One Year of Taxes	Estimated Amount of Ongoing Annual Revenue	Estimated Five Year Revenue
2011	\$200,437	14%	\$28,061	\$140,306
2010	\$143,631	19%	\$27,290	\$136,449
2009	\$138,223	22%	\$30,869	\$154,347
2008	\$95,660	19%	\$17,857	\$89,284
2007	\$128,460	17%	\$21,410	\$107,052
2006	\$44,002	18%	\$7,920	\$39,602
2005	\$156,862	18%	\$28,235	\$141,176
2004	\$125,070	18%	\$22,513	\$112,563
2003	\$393,295	20%	\$78,659	\$393,295
2002	\$82,374	20%	\$16,475	\$82,374
TOTAL	\$1,508,014		\$279,290	\$1,396,448

Unpaid assessments given to Finance to collect

During the past ten years, businesses have paid the City \$1.2 million as a result of our assessments. At the end of each fiscal year, we give the Department of Finance, Revenue Collections Division, an accounts receivable report that identifies uncollected assessments for our business license cases. Finance staff can use various means to collect delinquent business license taxes owed, including adding the unpaid assessments to the owner's business property tax statement, pursuing collections through Small Claims Court, bank levies, and till taps.² Alameda County collects some business licenses, taxes, penalties, and interest on behalf of the city through the

² Finance must obtain a court order to conduct a till tap. When conducting a till tap, a Finance Department field agent, accompanied by a deputy sheriff, seizes the cash from a business' cash register. Finance may need to conduct multiple till taps to collect the full amount a business owes to the City.

business' property tax bill. When this happens, the County retains 1.7 percent of the amount collected as an administrative fee, which reduces the amount the City receives.

Almost \$270,000 on accounts receivable report

Our June 30, 2011, accounts receivable report included \$269,260 owed by 38 businesses. In addition to amounts we billed in FY 2011 that businesses have not yet paid, this amount includes:

- \$6,451 for six businesses that Finance forwarded to Alameda County to be collected with the owners' business property tax bills.
- \$8,166 assessed in FY 2010 for two large in-home family daycare providers. Finance may forgive this amount based on a Council-proposed amnesty program for daycares.³
- \$47,368 assessed to a business in FY 2005. Finance is unlikely to collect this assessment because the business has been sold and the parent company is located out of state. Additionally, the account is beyond the statute of limitations for pursuing collection. On April 3, 2012, the City Council adopted a resolution to write off this uncollectable account.
- \$15,817 assessed on four businesses in fiscal years 2008 and 2009.

Recommendations in recent performance audit will improve timeliness of collections

We recently published a separate performance audit on business license tax revenue and collections, titled "[Business License Taxes: Providing Better Guidance and Customer Service Will Increase Revenues.](#)" The report makes several recommendations to Finance that should substantially improve their timeliness in collecting delinquent business license taxes.

150 business license cases in FY 2011

We worked on 150 business license cases during FY 2011:

- 62 potentially unlicensed businesses, including 24 carried over from prior years.

³ On May 18, 2010, the City Council asked City staff to review the zoning code requirement for large family daycare businesses; consider changing their business license tax rate from \$3.60 to \$1.80 per \$1,000 in gross receipts; and possibly create an amnesty period to exempt qualifying large family in-home daycares from all business license taxes, fees, and fines accrued before January 1, 2010. The Council's final determination and action is pending the City Manager's analysis of the zoning requirements and fees.

- 88 audits of delinquent and underreporting businesses, including 48 carried over from prior years.

76 cases closed or dropped in FY 2011

We closed or dropped 76 cases:

- We closed cases when the taxpayers provided documentation to substantiate they were in compliance with the business license tax ordinance.
- We dropped cases when we determined, for example, that the:
 - business did not exist.
 - business is located in another jurisdiction.
 - Department of Finance was already reviewing the business.

We carried over 36 cases that are still in progress to FY 2012.

Administrative citations issued to achieve compliance

We issued two \$200 administrative citations during FY 2011. We issue administrative citations when a business has not complied with our requests for documentation that will allow us to determine if the business is in compliance with the business license tax ordinance. An administrative citation encourages businesses to provide the documentation we have requested. In most cases, the citations we issue are for \$200, but they can be as high as \$1000.

Seven appeal hearings in FY 2011; our recent performance audit recommends clarifying the BMC to reduce number of appeals

Seven business owners we audited requested an appeal hearing during FY 2011. By the end of the fiscal year, the hearing examiners had delivered decisions on two of these cases, plus a decision for an appeal hearing that occurred at the end of FY 2010. The appeal hearings for the remaining five cases will be held in FY 2012.⁴ We had some concerns about whether two of these decisions met the intent of the Berkeley Municipal Code. We discussed these decisions with one of the hearing examiners and learned that factors considered in some decisions include:

⁴ The hearing examiners also hear appeals on business license cases managed by the Department of Finance, and on other City issues that are subject to appeal, such as parking citations.

- the business license tax forms do not clearly reflect BMC requirements.
- lack of clarity and ease of finding business license tax information on the City's website.
- some unclear and outdated BMC provisions.
- City staff provide inconsistent verbal information to businesses regarding business license requirements.

Our performance audit, titled "[Business License Taxes: Providing Better Guidance and Customer Service Will Increase Revenues](#)," issued in May 2012, makes recommendations that address these issues.

FISCAL IMPACT

Audits generated \$1.2 million in revenue during last ten years

During the last ten years, the City has collected \$1.2 million as a result of our Business License Tax Audit Program. This revenue is not a one-time windfall, but becomes part of the City's revenue stream in future years. Based on the dollars assessed, we estimate the City may receive up to \$1.4 million over the next five years, for a total of \$2.6 million.

CONCLUSION

Audits help achieve compliance and equitable treatment for businesses

The Business License Tax Audit Program is an effective way to generate revenue and increase the public's awareness about Berkeley's business license requirement. We attempt to achieve equitable treatment for all businesses operating in Berkeley by ensuring that all businesses pay their appropriate amount of business license taxes, as required by the business license tax ordinance. We expect that retroactive payments, penalties, and interest resulting from our audits and reviews will result in greater compliance, including deterring businesses from underreporting their gross receipts or failing to purchase a business license.

APPENDIX A:

Scope and Methodology

We review or audit entities and individuals engaged in business within Berkeley to determine their compliance with the Business License Ordinance. For each business selected, we review the three or four most recent business license tax years to determine if the business has paid the appropriate amount of taxes. For those that have not, we assess taxes retroactively and add penalties and interest in accordance with the Berkeley Municipal Code.

Unlicensed Business Reviews

We brought unlicensed businesses into compliance by notifying them of the licensing requirements and assessing the appropriate taxes, penalties, and interest. We requested each unlicensed business to submit:

- a New Business License Application Form.
- a Business Information Sheet on which they report their gross receipts and provide their North American Industry Classification System (NAICS) code.
- an initial payment of \$76 (\$25 registration fee plus \$51 minimum license fee) or, if a rental property, \$102 (\$25 registration fee plus \$77.00 minimum license fee).

If the business did not provide a NAICS code, we assigned it based on the type of work the business does. We used Finance's NAICS code conversion chart to determine the appropriate tax category and rate. We calculated the amount of business license taxes, penalties, and interest due based on the gross receipts the business reported and sent the business an invoice requesting payment. Because the objective of these reviews is to encourage unlicensed businesses to purchase the required business license, we did not verify the accuracy of their reported gross receipts. However, if we select these businesses for a future audit, we would verify their gross receipts at that time.

Audits of Delinquent or Underreporting Businesses

We audited businesses that did not renew their business licenses or that may have underreported their gross receipts. For delinquent businesses and other businesses we selected to audit for compliance with the business license requirements, we requested that the business provide us documentation showing their gross receipts for the three or four most recent business license tax years. Examples of such documentation included income tax returns, sales tax returns, rental agreements, rent rolls and financial statements. For delinquent businesses and other businesses we identified as having underreported their gross receipts, we calculated the amount of business license taxes, penalties, and interest due and sent the business an invoice requesting payment.

During an audit, we also address other issues encountered, such as:

- an incorrect NAICS code or change in a business' operations that the business owner did not report but that could affect the business' tax rate.
- a business' location change that will affect future business license renewals.
- a different business in the location being audited.