



Office of the City Auditor

INFORMATION CALENDAR

April 25, 2006

To: Honorable Mayor and
Members of the City Council

From: Ann-Marie Hogan, City Auditor

Submitted by: Ann-Marie Hogan, City Auditor

Subject: Business License Tax Program Audit Report For Fiscal Year 2005

SUMMARY

The attached Business License Tax Program Audit Report identifies the Business License tax revenue identification efforts and accomplishments of the Auditor's Office during fiscal year 2005. All audits initiated during fiscal year 2005 were audits of Berkeley residential rental properties. During the November 2004 election, Berkeley voters passed Ballot Measure P permitting the City to use Rent Board information to help enforce other City ordinances, such as the Berkeley Business License Tax ordinance. The Auditor's Office saw this as a new opportunity to identify rental properties that were unlicensed or were paying significantly less tax than what was due. Audit work associated with audit cases initiated in prior years also continued.

CURRENT SITUATION AND ITS EFFECTS

Business License Tax Program audits completed during fiscal year 2005 resulted in 13 businesses being billed a total of \$156,862. The \$156,862 that was billed includes a \$47,368 audit assessment that was referred to Finance for collection. Collection of this receivable is anticipated to be difficult because this Berkeley business location had been sold and the former parent company is located in another state. The \$156,862 billed also includes a \$68,134 audit assessment, which the auditee appealed to the Hearing Officer in the City Manager's Office. One reason the appellant gave for asking that tax, penalties and interest (including interest on penalties) be waived was that their method of identifying gross receipts subject to Berkeley Business License (apportionment) had been reviewed more than a decade ago by the City Auditor's Office, and had not been challenged. The appellant stated this event represented a binding agreement between them and the City, and was the basis for reporting taxable gross receipts until the current audit. On February 28, 2006, the City Manager and the appellant entered into a written settlement. The City agreed to waive claims to the entire \$68,134. As a result of the audit and the settlement negotiations, the appellant will be paying approximately 80% more in tax each year in the future.

In addition to the \$156,862 billed, four audit cases (residential rental properties) were provisionally billed for a total of \$33,296 in tax, penalties, and interest. These auditees had declined several requests for gross receipts documentation, and therefore, were tentatively billed using Rent Board information. If audit procedures to obtain rental gross receipts information are

not successful, the provisional billings will become finalized as they are.

Since inception of the program in 1982, auditors have billed tax, penalties, and interest totaling \$4,696,348. Additionally, assuming audited businesses pay the correct tax in years subsequent to the audit, the identified revenue is not a one-time windfall, but becomes part of the future revenue stream. For each \$100,000 identified by audit, about \$18,000 in recurring tax can be expected for each future year, as long as the audited businesses continue to generate consistent gross receipts.

Total payments received during fiscal year 2005 from Business License tax audits totaled \$59,974.

POSSIBLE FUTURE ACTION AND FISCAL IMPACTS

The auditors intend to continue to allocate staff resources to identify underreporting and unlicensed businesses, resulting in the City receiving tax revenue it may not otherwise receive.

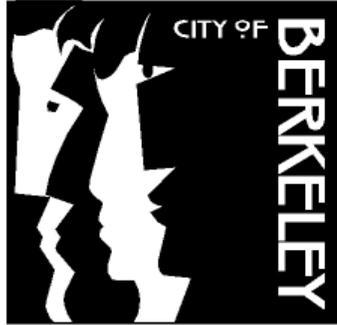
CONTACT PERSON

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Attachments

1: Business License Tax Program Audit Report

City of Berkeley



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

Business License Tax Program Audit Report

For Fiscal Year Ending June 30, 2005

Prepared by:

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Presented to Council April 25, 2006

BUSINESS LICENSE TAX AUDIT PROGRAM REPORT

For the Fiscal Year Ended June 30, 2005

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I. PURPOSE AND OBJECTIVE

The purpose of this report is to present the results of the City Auditor's Business License Tax Audit Program for fiscal year 2005.

The objective of the Business License Tax Audit Program is to recover Business License revenues that the City might not otherwise receive because persons and businesses doing business in Berkeley did not procure a Business License or under-paid the tax due.

II. SCOPE AND METHODOLOGY

During fiscal year 2005, the auditors reviewed individuals / entities engaged in business for Business License tax compliance for licensing years 2002 - 2004, or 2003 - 2005, depending on when the audit was initiated. All audit cases initiated during fiscal year 2005 were residential rental properties suspected of being unlicensed (not paying any tax) or suspected of paying tax based on underreported gross receipts (gross receipts are self-reported by the taxpayer). Rent Board data was used to identify the rental properties selected for audit. Audit Command Language (ACL) audit software was used to compare total rent for each property in the Rent Board's electronic database with self-reported gross receipts for these same properties in the City's Occupational License (OL) database. When Rent Board data indicated a property owner could charge significantly higher total rents than the gross receipts reported to the City, these properties were selected for audit. Residential rental properties with the highest potential unpaid tax were audited first. Also during fiscal year 2005, audit work continued for audit cases initiated in previous fiscal years.

Business owners selected for audit were requested to provide documentation identifying their gross receipts, such as income tax returns, and/or financial statements. Based on the information provided, business owners were billed for unpaid Business License taxes plus penalties and interest, as provided for in Berkeley Municipal Code (BMC) Section 9.04.110 and 9.04.120.

Prior to fiscal year 2002, the City Auditor's annual Business License Tax Program Audit report included our accomplishments in Business License revenue identification as well as audit findings and recommendations resulting from control weaknesses or system deficiencies observed during the course of our audit work. For the time being, we have limited the scope of our audit to focus on our Business License tax compliance efforts. However, we will continue to monitor and report on the implementation status of our earlier recommendations through our own follow-up reporting to the City Manager and to Council, as we do with other audits.

Audit work was performed in accordance with Generally Accepted Government Auditing Standards for a performance audit. Audit work was limited to those areas specified in the scope and methodology section of this audit.

III. BACKGROUND

General Information

The City's accounting system, FUNDS, reports that the City received Business License tax, penalties, and interest revenue totaling \$11,087,438 during fiscal year 2005. The Business License tax requirement is codified in BMC Chapter 9.04. It was enacted solely for revenue purposes and, as such, is not meant to be a regulatory function. The Finance Department has responsibility for the administration and collection of Business License revenue. For fiscal year 2005, the Auditor's Office assigned one auditor to the Business License Tax Audit Program.

Annual Licensing Procedure

In December of each year, the Finance Department sends a Business License tax renewal form (Tax Declaration) to all business license holders listed in the City's OL database. Taxpayers are instructed to fill-in their gross receipts information, calculate the tax, and return the form to the Finance Department with payment. Newly established businesses are required to obtain a Business License within 15 days of commencing business.

BMC section 9.04.035 requires all individuals/entities engaged in business within Berkeley to obtain a license and to pay an annual license fee. Business License tax is generally assessed on a business's prior year gross receipts generated within Berkeley. In some instances, the tax is a fixed fee, or is assessed based on gross payroll. Rental property is taxed at a flat rate of \$77, or at the rate of \$1.081 for each \$100 of gross receipts, whichever yields the higher tax. 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.

If full payment is not received by February 28 each year for license renewals, or, for newly established businesses, within thirty days after commencing business, the tax is delinquent and a penalty of 10 percent of the license tax is added. If full payment is not received by April 1 for license renewals, or within 60 days following the commencement of business for newly established businesses, a penalty of 50 percent of the license tax is added. Interest accrues at the rate of 1 percent each month on the unpaid taxes and penalties, and will continue to accrue until paid.

Passage of Ballot Measure P

During November 2004, Berkeley voters passed Ballot Measure P, authorizing the amendment of the "Rent Stabilization and Eviction for Good Cause Ordinance". The Measure P amendment contained verbiage that, for the first time, permitted the City to use Rent Board information to help enforce other City ordinances, such as the Berkeley Business License Tax ordinance. The Auditor's Office saw this as a new opportunity to identify property owners who had not licensed residential rental property or were underreporting the gross receipts used to calculate the Business License Tax due.

The Auditor's Office used ACL audit software to analyze and compare Rent Board file data and City OL file data. The auditors developed lists of rental properties for which it appeared property owners had not licensed the property, were underreporting gross receipts used to calculate the tax due, or were delinquent in renewing the license (had a license, but had not paid tax for one or more years). At the request of Finance staff, half the properties identified as appearing unlicensed (95 properties) were referred to the Finance Department – Customer Service Division for follow-up and collection on April

15, 2005. In addition, 100 percent of the properties that appeared delinquent were referred to the Finance – Revenue Collection Division for follow-up and collection. Regarding this schedule of delinquent properties, this information was intended to supplement similar information Finance obtained from the OL database.

IV. SUMMARY OF PROGRAM RESULTS

A. Audits Initiated

During fiscal year 2005, the City Auditor’s Office initiated 62 audits. All were audits of Berkeley residential rental properties. In some cases, the same individual owned more than one of the audited properties. Twenty-two of the 62 audits were initiated because the property appeared to be unlicensed. Thirty audits were initiated for licensed properties whose owners appeared to have paid tax based on underreported gross receipts (basis for tax). Ten audits were initiated on properties whose license appeared delinquent (no tax paid on the license for one or more years). These ten properties were referred to Finance to review, at their request. For each audit case, Business License Tax years 2002 – 2004 or 2003 - 2005 were reviewed to determine if the correct tax had been paid.

Status of Audits Initiated in Fiscal Year 2005 (As of June 30, 2005)				
Audit Status	Unlicensed	Underreporting	Delinquent	Total
Invoiced (Tax Due)	6	2	0	8
Provisionally Assessed*	3	1	0	4
Closed (No Unpaid Tax Identified)	1	1	0	2
Given to Finance to Review	0	0	10	10
In Process	12	26	0	38
Total Count of Audits Initiated in FY 2005	22	30	10	62

*Provisionally Assessed = Invoiced using Rent Board data. Amount invoiced is subject to change if gross receipts documentation that the auditee previously declined to provide is provided. See section C of this report for more information.

B. Audit Assessments

Most of the 62 audit cases initiated during fiscal year 2005 were not completed, awaiting the receipt of requested information from the auditees. During fiscal year 2005, 13 businesses were assessed (billed) a total of \$156,862 for unpaid taxes, penalties and interest. Four of these businesses were residential rental properties owned by the same person. Eight of the 13 audits assessed were both initiated and billed during fiscal year 2005, accounting for \$28,117 of the \$156,862 in unpaid taxes, penalties and interest billed. The other five audit cases were initiated in fiscal year 2004 and resulted in the assessment of \$128,745.

Composition of FY 2005 Audit Assessment Totals	Amount Assessed
Unpaid Business License taxes	\$85,038
Penalty Assessments	\$41,781
Interest Charges	\$30,043
TOTAL	\$156,862

Composition of Audit Cases That Were Billed During Fiscal Year 2005				
Industry Classification Category	Underreporting	Delinquent	Unlicensed	Total # of Assessments
Real Property Rental	2	1	5	8
Manufacturing	2*	0	0	2
Business, Personal and Repair Services	1*	0	0	1
Wholesale	2*	0	0	2
TOTAL	7	1	5	13

* = Audits initiated in fiscal year 2004

Summary of FY 2005 Audit Activity	Prior Years	FY 2005	Total
Audits Carried Over	11	N/A	11
Add: Audits Initiated	N/A	62	62
Less: Audits Dropped	-1	-2	-3
Less: Audits Billed	-5	-8	-13
SUBTOTAL	5	52	57
Less: Audits Referred to Finance	-2	-10*	-12
TOTAL # Audits Carried Over to FY 2006	3	42	45

* = These audits, initiated by the Auditor's Office, were referred to Finance for action at the request of Finance staff.

C. Provisional Audit Assessments

In addition to the 13 audit cases billed for a total of \$156,862, 4 audit cases (residential rental properties) were provisionally billed for a total of \$33,296 in tax, penalties, and interest. These auditees had declined several requests for gross receipts documentation, and therefore, were tentatively billed using Rent Board information. One of the auditees appears to be underreporting gross receipts used to calculate the tax due. The other three appear to be unlicensed. If audit procedures to obtain rental gross receipts information are not successful, the provisional billings will become finalized as they are. As a last resort, Finance will be asked to place a lien on these properties to collect all unpaid tax, penalties and interest.

D. Audits Dropped

Based on our review of auditee documentation and City records, three audit cases were determined to be in compliance with the Business License Tax ordinances and dropped (closed without a billing). Two of these dropped audit cases were cases initiated in fiscal year 2005.

E. Audits Referred to Finance

During fiscal year 2005, two audit cases were referred to Finance-Revenue Collection for follow-up because there was no response from audit letters or the auditor was unable to obtain adequate documentation to perform an audit. Finance representatives reported that during fiscal year 2005 they had closed six referred cases (all referred during prior fiscal years), and received a \$1,086 payment from a seventh referral. Finance representatives reported eleven referrals were in process at the end of fiscal year 2005.

In addition, the Auditor's Office provided Finance-Revenue Collection with periodic accounts receivable reports identifying the audit cases that had been assessed by the auditors, but for which payment had not been received. For assessments greater than 60 days old, Finance was asked to perform collection efforts. As of June 30, 2005, only one case required collection efforts. This audit case was a \$47,368 billing that was billed in early fiscal year 2005. Collection is anticipated to be difficult because the Berkeley business location had been sold and the former parent company is located in another state.

Regarding the list of 94 potentially unlicensed residential rental properties that the Auditor's Office provided to Finance on April 15, 2005, Finance representatives reported that only fourteen of these properties were determined to be unlicensed. Finance representatives further reported that mailings were sent to these 14 property owners, resulting in 10 properties being registered and \$750 in tax received. Finance representatives also reported that a separate schedule provided by the Auditor's Office identifying potentially delinquent rental properties licenses resulted in the identification of only two previously unknown delinquent properties. Receipt of the unpaid tax associated with these two properties is anticipated to be received in a subsequent fiscal year.

F. Business License Tax Appeals

Businesses can appeal a tax bill resulting from audits to the Hearing Officer in the City Manager’s Office, in accordance with BMC Section 9.04.270. During fiscal year 2005, there were appeal hearings scheduled for two audit cases. For one of these cases, the billing was issued in fiscal year 2004 and totaled \$19,820. The Hearing Officer waived \$6,982 in penalties, and the interest associated with these penalties, because she was of the opinion the appellant had not deliberately underpaid tax. A revised billing reflecting the decision of the Hearing Officer was issued in early fiscal year 2006.

The second audit case scheduled for an appeal hearing in fiscal year 2005 pertained to a fiscal year 2005 billing totaling \$68,134. The appeal hearing was rescheduled to take place in fiscal year 2006. Both the City Attorney’s Office and the appellant’s attorney were involved with this appeal. The case was complicated. One reason the appellant gave for asking that tax, penalties and interest (including interest on penalties) be waived was that their method of identifying gross receipts subject to Berkeley Business License (apportionment) had been reviewed more than a decade ago by the City Auditor’s Office, and had not been challenged. The appellant stated this event represented a binding agreement between them and the City, and was the basis for reporting taxable gross receipts until the current audit. On February 28, 2006, the City Manager and the appellant entered into a written settlement. The City agreed to waive claims to the entire \$68,134 in tax, penalties, and interest. As a result of the audit and the settlement negotiations, the appellant will be paying approximately 80% more in tax each year in the future.

G. Projected Business License Tax Revenue

In fiscal year 2005, the City Auditor’s Office budgeted one full-time equivalent (FTE) auditor to perform Business License tax audits. Revenue of \$125,000 was projected from these audits. The actual FTE for the fiscal year, including supervisory time, was 1.15 FTE. During fiscal year 2005, for every dollar spent on salaries and fringe benefits and for administration of the Business License tax Program, the auditors identified and billed approximately \$1.36 in Business License tax, penalties, and interest. The Performance Audit division spent \$58,628 less than what was budgeted for fiscal year 2005.

<u>Total Revenue</u>	<u>Auditor Salaries*</u>	<u>Ratio</u>
\$156,862	\$115,320	1.36 : 1
<p>*Auditor Salaries = auditor salaries + supervisory salaries + fringe benefits divided by .80 to account for vacation, sick leave, training, and other administrative use of time.</p>		

H. Collections

Total payments received during fiscal year 2005 from Business License tax audits were \$59,974. Of this, \$57,363 was collected from prior fiscal year billings. As of June 30, 2005, the accounts receivable balance for the Business License Tax Audit Program was \$162,238.

During the ten year period ending fiscal year 2005, payments totaling \$2,100,054 were received; \$2,305,054 if a \$205,000 settlement payment resulting from a billing issued outside this period is included.

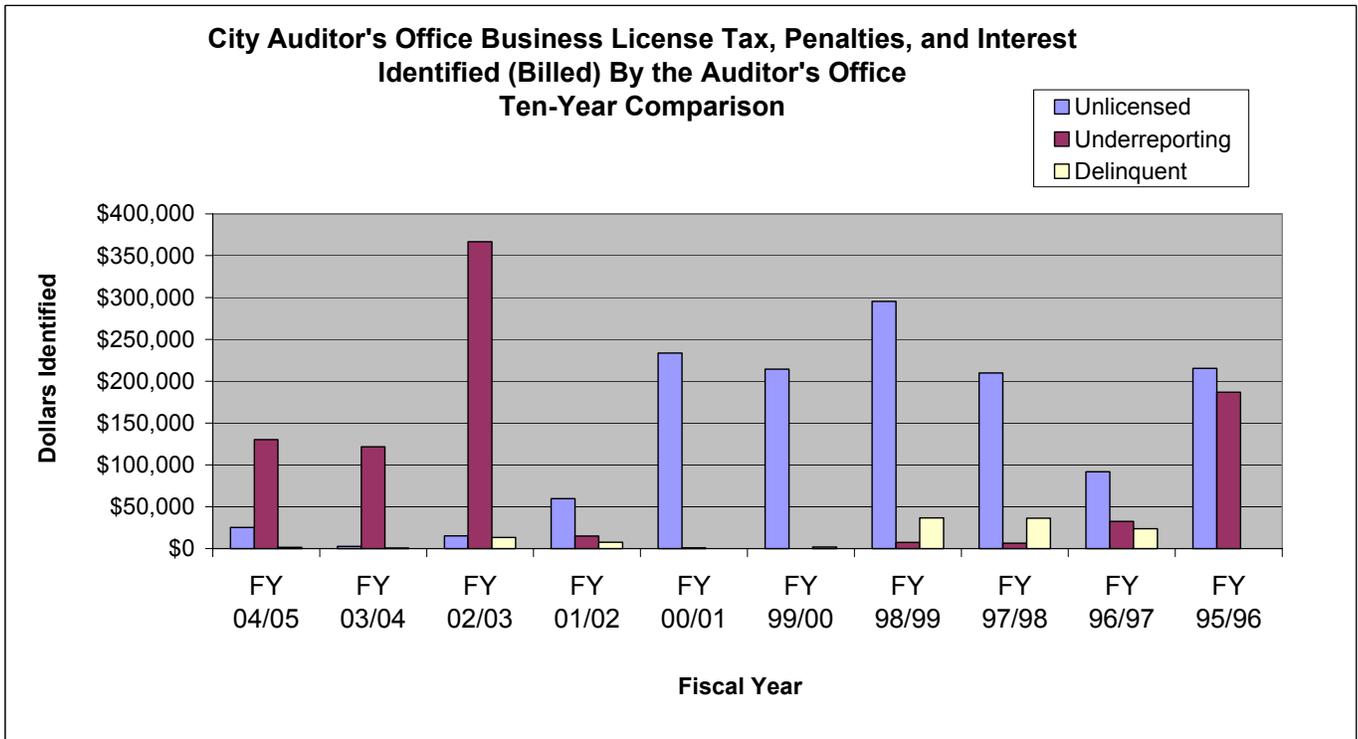
I. Cumulative Statistical Information

The Business License Tax Program audit function in the City Auditor’s Office continues to show a good rate of return for the staff time invested. In the case of rental properties, it is anticipated that most new taxpayers will continue to pay tax for the foreseeable future, given the relative stability of the property rental business.

**Business License Tax, Penalties and Interest
Identified (Billed) By The Auditor’s Office
Ten-Year Comparison**

Fiscal Year	Unlicensed Businesses		Under-reporting of Gross Receipts		Delinquent Licenses		Total	No of Hours Spent	% of FTE @ 80% Productive Time*
04/05	5	\$25,281	7	\$130,160	1	\$1,421	\$156,862	1,918	1.15
03/04	1	2,770	15	121,766	1	534	125,070	1,806	1.09
02/03	8	15,162	31	366,680	8	13,351	395,193	3,457	2.08
01/02	54	59,701	8	15,020	1	7,653	82,374	2,236	1.34
00/01	115	233,571	2	934	0	0	234,505	1,915	1.15
99/00	112	214,361	0	0	2	1,875	216,236	1,553	0.93
98/99	186	295,323	5	7,283	3	36,591	339,197	2,536	1.52
97/98	152	209,723	9	6,466	14	36,175	252,364	835	0.50
96/97	25	91,798	16	32,468	15	23,769	148,035	783	0.47
95/96	60	215,249	59	186,901		0	402,150	689	0.41
TOTALS	718	\$1,362,939	152	\$867,678	45	\$121,369	\$2,351,986	17,728	

* Productive Time is calculated based on 2,080 work hours per year @ 80%. The 80% figure is used so that the cost of the hours spent includes an allowance for sick leave, vacation days, holidays, and training and other administrative uses of time.



V. CONCLUSION

During the last ten years, the City Auditor’s Business License Tax Audit Program has identified 915 businesses that owed the City \$2,351,986 in Business License taxes, penalties, and interest. During this same ten year period, payments totaling \$2,305,054 were received if a \$205,000 settlement payment resulting from a billing issued outside this period is included. Since inception of the program in 1982, unpaid tax, penalties, and interest identified by the City Auditor’s Office Business License tax audits have totaled \$4,696,348. 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. Our reporting of revenue identified, and our performance target per auditor, addresses the first year’s revenue only; about 54% is unpaid tax, while 46% is penalties and interest. Unpaid tax generally includes unpaid tax for the last three years audited. Accordingly, for each \$100,000 in tax identified by audit, about \$18,000 ($\$54,000 / 3$ years) in tax for each succeeding year can be expected, as long as the audited businesses are generating consistent gross sales. If rents increase, the tax revenue will increase as well.