



Office of the City Auditor

INFORMATION CALENDAR

February 13, 2007

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 FY06

SUMMARY

The attached Business License Tax Program Audit Report identifies the Business License Tax revenue identification efforts, challenges, and accomplishments of the Auditor's Office during fiscal year (FY) 2006. The audit work performed during FY06 consisted of Business License Tax audits of Berkeley residential rental properties carried over from FY05. The Auditor's Office was able to use the passage of Ballot Measure P (which permits the City to use Rent Board information to help enforce City ordinances) as a new opportunity to identify rental properties that were unlicensed or were paying significantly less tax than what was due. New Business License Tax audit cases were not initiated during FY06, in part, because of auditor position reductions and vacancies within the Auditor's Office Performance Audit Division. Also, auditors invested staff time to improve the current systems in order to manage future revenue audit work more efficiently.

CURRENT SITUATION AND ITS EFFECTS

Business License Tax Program audits resulted in 11 businesses being billed a total of \$44,002 for unpaid taxes, penalties, and interest. As of June 30, 2006, five cases totaling \$71,657 were referred to Finance for collection. Collection of one of these receivables in the amount of \$47,368 is anticipated to be difficult. The Berkeley business location has been sold and the former parent company is located in another state.

In addition to the \$44,002 billed, three audit cases (residential rental properties) provisionally billed in FY05 for \$28,886 are continuing. These auditees had declined several requests for gross receipts documentation and were tentatively billed using Rent Board information. If efforts to obtain rental gross receipts information are not successful, the provisional billings will become finalized as they are.

During FY06 four appeals were heard by the City's Hearing Officer. As a result, the City waived a total of \$80,153 in tax, penalties, and interest.

Since inception of the program in 1982, auditors have billed tax, penalties, and interest of over \$4,000,000. 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.

POSSIBLE FUTURE ACTION AND FISCAL IMPACTS

In FY06 the auditors invested staff time in making improvements to current systems in order to manage the revenue audit work more efficiently. We also encountered barriers to the efficient and effective identification and collection of revenue.

In FY07 the objectives of our audit program have been expanded to include the identification of barriers that prevent the efficient identification and collection of Business License Tax. This will include examining the adequacy and accuracy of data available in the City's computerized systems.

We expect to develop recommendations that will result in more efficient identification and collection of revenue by the City Auditor's Office and Finance Department staff. This could result in increased revenue and/or reduced cost in the long run.

CONTACT PERSON

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Attachment

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, 2006*

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Presented to Council February 13, 2007

# **BUSINESS LICENSE TAX AUDIT PROGRAM REPORT**

**For Fiscal Year Ending June 30, 2006**

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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 (BLT) Audit Program for fiscal year (FY) 2006.

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

## **II. SCOPE AND METHODOLOGY**

The City Auditor's Office assesses the City's compliance with the BLT ordinance by auditing entities and/or individuals engaged in business within Berkeley. During FY06 no new BLT audit cases were initiated because the auditor position assigned to most BLT audit functions was vacant for over nine months. Therefore, the audit work performed was on "in-process" BLT audits carried over from FY05. Most of these audit cases were residential rental properties selected to determine whether they were unlicensed (not paying any tax) or underreporting gross receipts (gross receipts are self-reported by the taxpayer).

The auditors identified these audit cases by comparing the Rent Board data to the City's Occupational License (OL) data using Audit Command Language (ACL). Properties selected were those lacking a business license, and those for which Rent Board data indicated a property owner could charge significantly higher total rents than the gross receipts used by taxpayers to calculate BLT revenue due the City.

Audited rental property owners were requested to provide documentation identifying their gross receipts for audited BLT years, generally 2003 – 2005. Based on the information provided, the auditors billed business owners for any unpaid BLT, plus penalties and interest, in accordance with the Berkeley Municipal Code (BMC) Section 9.04. In addition to auditing these businesses, the auditors were heavily involved with an appeal initiated in FY05 involving a wholesale business.

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

#### A. General Information

The BLT ordinance was first enacted in 1977 and is codified under Berkeley Municipal Code (BMC) Chapter 9.04. It was established solely for revenue purposes and, as such, is not meant to be a regulatory function. The City received revenue from BLT totaling \$11,431,671 during FY06. This represents approximately nine percent of the City's General Fund Revenues. The Finance Department has responsibility for the administration and collection of BLT revenue.

#### B. Annual Licensing Procedure

BMC requires all individuals/entities engaged in business within Berkeley to obtain a Berkeley business license and to pay an annual license fee. In December of each year the Finance Department sends a BLT renewal form (Tax Declaration) to all business license holders listed in the City's OL database. Taxpayers are instructed to identify their gross receipts, calculate the tax due, 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.

BLT is generally assessed on a business' prior year gross receipts generated within Berkeley. However, in some instances the tax is assessed based on gross payroll, value added (gross receipts less value of raw materials), or a flat fee. Rental property is taxed at a flat fee of \$77, or at the rate of \$1.081 for each \$100 of gross receipts, whichever is higher.

All licenses are effective January 1 and expire December 31<sup>st</sup>. A business license is delinquent if not paid within thirty days after commencing business. A business license renewal is delinquent if payment is not received annually on or before February 28<sup>th</sup>. Delinquent businesses are assessed penalties. These businesses are also assessed interest at the rate of 1 percent each month on unpaid taxes and penalties, which continue to accrue until paid.

Type of Business	Number of Days Delinquent or Delinquent Date	Penalty
New	After 30 days	10%
New	After 60 days	50%
Renewal	After February 28	10%
Renewal	After April 1	50%

**C. Passage of Ballot Measure P**

In 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 permits the City to use Rent Board information to help enforce other City ordinances, such as the Berkeley BLT ordinance. The Auditor’s Office used this information to identify rental property owners who appeared not to have licensed their property or who appeared to have underreported the gross receipts used to calculate the BLT due.

<b>IV. SUMMARY OF PROGRAM RESULTS</b>
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**A. Audits Initiated**

The City Auditor’s Office did not initiate any new BLT audits during FY06, largely due to auditor position reductions and vacancies. The BLT audit work performed focused on completing and billing some of the 45 audit cases carried over from FY05. The majority of these audit cases were residential rental properties.

**B. Audit Assessments**

During FY06 the Auditor’s Office assessed (billed) 11 residential rental property owners a total of \$44,002 in unpaid taxes, penalties, and interest. The remaining 34 BLT audits were carried over to FY07.

Composition of FY06 Audit Assessment	Amount Assessed
Unpaid BLT	\$25,192
Penalty Assessments	\$12,372
Interest Charges	\$ 6,438
<b>TOTAL</b>	<b>\$44,002</b>

Summary of FY06 Audit Activities	FY06
<b>TOTAL Audits Carried Over from FY05</b>	<b>45</b>
Add: Audits Initiated	0
Less: Audits Billed	(11)
Less: Audits Dropped	0
<b>Audit Cases Carried Over to FY07</b>	<b>34</b>

### **C. Provisional Audit Assessments**

Provisional audit assessments are invoices billed as an interim measure based on Rent Board data when a residential rental property owner declines several requests to provide gross receipts documentation to identify unpaid tax. No provisional audit assessments were issued during FY06. Four provisional rental cases were carried over from FY05. One of the four cases was finalized during FY06. The other three cases that had been provisionally billed during FY05, for a total of \$28,886 (tax, penalties, and interest), are still under audit.

### **D. Audits Dropped**

Cases are “dropped” if an auditee provides documentation that supports they are in compliance with the BLT Ordinance. No audit cases were “dropped” during FY06.

### **E. Audit Cases Referred to Finance**

#### Auditees That Declined To Provide Auditors With Adequate Documentation

When an auditee does not respond to audit letters and telephone calls, or does not provide the auditor with adequate documentation to perform an audit, the case is referred to the Finance-Revenue Collection Division for follow-up, with the exception of those that are provisionally billed. Finance staff use various means to license these auditees and collect BLT due. During FY06 no such audit cases were referred to Finance. However, Finance had a total of 11 referral cases given to them during FY04 and FY05. Finance representatives have reported that during FY06 no BLT revenues were collected from these cases and they remain open.

#### Unpaid Audit Assessments

The Auditor’s Office provided the Finance-Revenue Collections Division with accounts receivable reports identifying the audit cases that had been assessed, but for which payment had not been received. Finance was asked to perform collection efforts for unpaid audit assessments that were outstanding for over 60 days. As of June 30, 2006, five cases totaling \$71,657 required collection efforts. Four of the five cases were residential rental properties owned by the same person. In August 2006 Finance representatives reported that these four properties had been liened for the amounts due. The fifth case, billed in August 2004 for \$47,368 is anticipated to be difficult to collect. The Berkeley business location has been sold, and the former parent company is located in another state.

#### Residential Rental Properties With Potential Delinquent License

As stated in the FY05 annual “BLT Program Audit Report,” 122 residential rental properties that appeared delinquent were referred to the Finance – Revenue Collections Division (at their request) for follow-up and collections. These delinquent properties were identified by the auditors by comparing OL data (Business License database) and Rent Board data using ACL software. This information was intended to supplement similar information Finance stated they had from the OL database. Audit work for 10 of the 122 cases had begun before these cases were given to Finance. Finance reports that during FY06 property tax liens had been placed on three of these ten rental properties, for an aggregate amount of \$12,834. Additionally, a property tax lien was placed on a fourth property in the amount of \$2,083 for one year of unpaid BLT. Finance representatives stated an additional tax year would be liened

when the taxpayer provided additional information. Last fiscal year Finance representatives reported they neither billed nor collected any additional BLT from efforts involving these 122 referred accounts.

Potential Unlicensed Residential Rental Properties

On April 15, 2005, a list of 94 potentially unlicensed residential rental properties was provided to Finance – Customer Service for follow-up and collection. During FY06 Finance representatives reported that this list was used to license some new rental properties. However, due to staff vacancies in the division, more specific information regarding this activity would not be available until February 2007. Finance representatives also reported that approximately 14 of the 94 properties identified were actually found to be unlicensed. They further reported that mailings were sent to the 14 property owners, resulting in 10 properties being registered and \$750 in revenues collected.

**F. Business License Tax Appeals**

Auditees have the opportunity to appeal a tax bill resulting from an audit to the Hearing Officer in the City Manager’s Office. Four audit cases completed the appeal process. The following documents the determinations made by the Hearing Officer. In one case, a settlement was negotiated with the City.

<b>Appeals</b>	<b>Business Type</b>	<b>Decision / Settlement Date</b>	<b>Invoice Amount</b>	<b>Amount Waived By City</b>
1a	Wholesaler	3/1/06	\$68,133	\$(68,133)
1b		3/1/06	14,909	(4,909)
2	Rental Property	6/6/06	6,697	(0)
3	Rental Property	12/12/05	1,421	(129)
4	Retailer	6/9/05	19,820	(6,982)
	<b>TOTAL</b>		<b>\$110,980</b>	<b>\$(80,153)</b>

Appeal 1a and 1b

During FY05 a wholesale business was identified as having underreported BLT, and on January 4, 2005, it was assessed \$68,133 in tax, penalties, and interest. This billing covered BLT years 2001 – 2004. The auditee appealed the billing. During the appeal process, the Auditor’s Office also calculated tax, penalty, and interest due from this business for BLT year 2005, which had become delinquent. This was done under the advisement of the City Attorney’s Office. The total amount due for the 2005 tax year in tax, penalties, and interest was \$14,909 as of February 1, 2006. The City’s Hearing Officer, the Auditor’s Office, the City Attorney’s Office, the appellant, and the appellant’s attorney, were all involved with this appeal case. The City’s Hearing Officer determined that the business was more properly characterized as a “wholesale business” rather than an “administrative headquarters”. One reason the appellant gave for asking that tax, penalties, and interest be waived was that he had undergone a BLT audit more than a decade ago by the City Auditor’s Office, and at that time their method of identifying gross receipts subject to Berkeley business license had not been challenged. On February 28, 2006, the City Manager and the appellant entered into a written settlement whereby the City agreed to waive the entire \$68,133 in tax, penalties, and interest for BLT years 2001 - 2004. It was also agreed that \$4,909 of the \$14,909 billing for BLT year 2005 would be waived. However, as a

result of the audit and the settlement negotiations, the appellant will be paying approximately 80% more in tax each subsequent year.

Appeal 2

In March 2006 a residential rental property owner was identified as underreporting BLT due for BLT years 2003 – 2005 and billed \$6,697 in tax, penalties, and interest. The auditee appealed, requesting penalties and interest be waived based on the grounds that the miscalculation of tax had occurred because of an inadvertent use of net incomes rather than gross receipts. On June 6, 2006, the Hearing Officer issued her decision, finding no grounds to waive the penalties and interest. At the request of the property owner, Finance representatives established a 24-month payment plan with the property owner.

Appeal 3

The Administrative Hearing Officer concluded that confusion within the City records concerning the correct address of the appellant’s rental property prevented acceptance of the appellant’s timely offer of his 2005 BLT payment. Therefore, penalties in the amount of \$129 were waived on December 12, 2005.

Appeal 4

A retailer was identified as underreporting BLT and billed \$19,820 during FY04. The Hearing Officer upheld three years of back taxes but waived \$6,982 in penalties and interest associated with the penalties, in late FY05, based on the complexity of the retroactive reclassification. Her decision was that the appellant had not deliberately underpaid tax. An updated billing reflecting the Hearing Officer’s decision in the amount of \$12,838 was issued on July 25, 2005.

**G. Projected Business License Tax Revenue**

The “Audit Plan for Fiscal Year 2006”, which was provided to Council on June 28, 2005, stated the 2006 BLT Audit Program was projected to identify \$150,000 in revenues for each full-time-equivalent (FTE) employee working on the program. Due to two position vacancies, the Performance Audit division spent \$205,706 (31%) less than what was budgeted for FY06. The actual FTE for the program, including supervisory time, was 0.58 FTE. For every dollar spent on salaries, fringe benefits, and BLT Program administration, the auditors identified and billed approximately 60 cents in BLT penalties and interest.

FY06 Total Revenue	FY06 Auditor Salaries*	Ratio
\$44,002	\$72,890	0.60: 1

\*Auditor Salaries = auditor salaries + supervisory salaries + fringe benefits divided by .80 to account for vacation, sick leave, training, and other administrative use of time.

**H. Collections**

Total payments received during FY06 from BLT audits were \$38,329. Of this, \$14,130 was collected from prior fiscal year billings. As of June 30, 2006, the accounts receivable balance for the BLT Audit Program was \$86,551.

**I. Business License Tax Program Database Improved**

The Auditor's Office has maintained its BLT program audits in Microsoft Access database since FY02. During FY06 a menu-driven screen and several reports, including an account receivable aging report, were developed by the audit staff to facilitate data entry and information retrieval. These improvements are expected to reduce the amount of time the auditors spend verifying and reconciling BLT information.

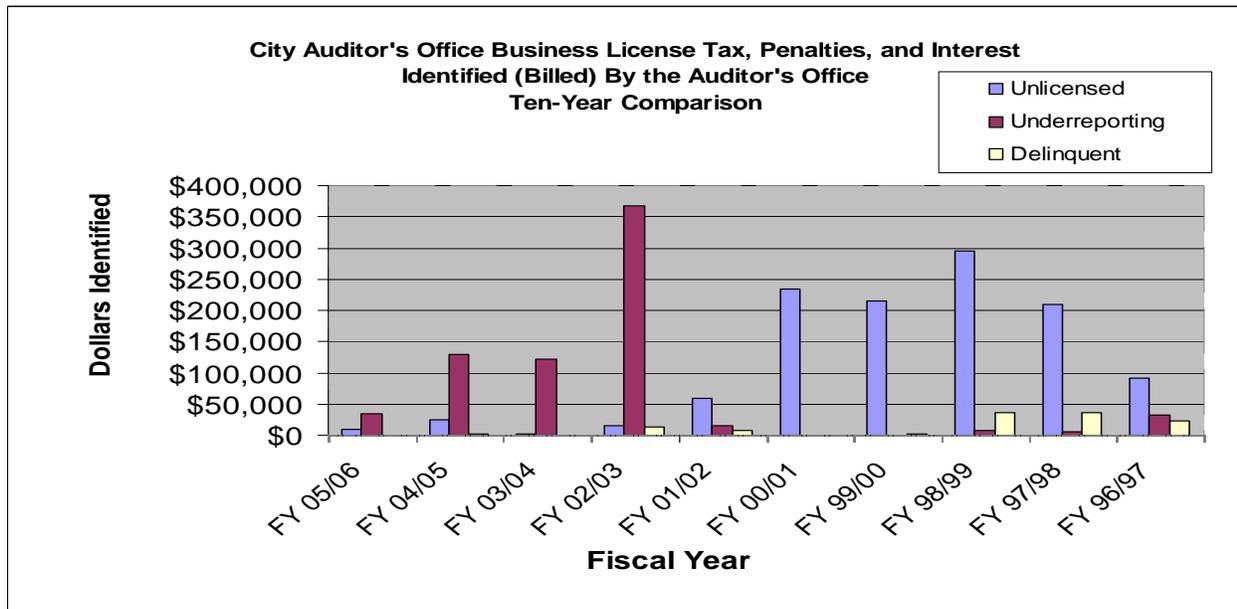
**J. Cumulative Statistical Information**

During the last ten years the City Auditor's BLT Audit Program has identified 807 businesses and residential rental property owners that owed the City \$1,993,838 in tax, penalties, and interest. During this same ten-year period payments totaling \$2,081,064 were received. Payments exceed billings because a settlement payment of \$205,000 from a billing issued outside this period was received. Since inception of the program in 1982 unpaid tax, penalties, and interest identified by the City Auditor's Office BLT audits totaled \$4,740,350.

**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	Number of Hours Spent	% of FTE @ 80% Productive Time*
								(A)	(A)/0.8/2,080
05/06	5	\$9,584	6	\$34,418	0	\$0	\$44,002	973	0.58
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
<b>TOTALS</b>	<b>663</b>	<b>\$1,157,274</b>	<b>99</b>	<b>\$715,195</b>	<b>45</b>	<b>\$121,369</b>	<b>\$1,993,838</b>	<b>18,012</b>	

\* 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, training, and other administrative uses of time.



**V. CONCLUSION**

BLT audit work has historically been cost-effective in generating revenue by identifying unlicensed and underreporting businesses. Presumably, the audit work also acts as a deterrent to those who might consider underreporting or neglecting to obtain a license.

In FY06 the auditors invested staff time in making improvements to current systems in order to manage the revenue audit work more efficiently. We also encountered barriers to the efficient and effective identification and collection of revenue.

In FY07 we have expanded the objectives of our audit program to include the identification of barriers that prevent the efficient identification and collection of Business License Tax. This will include examining the adequacy and accuracy of the data available in the City's computerized systems.

The BLT revenue identified during our audits is not a one-time windfall, but becomes a part of the future revenue stream. Typically, approximately 54% of our BLT billings are comprised of unpaid tax, and the remaining 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 receipts.