

# **BUSINESS LICENSE TAX AUDIT PROGRAM REPORT**

## **For the Fiscal Year Ended June 30, 2000**

### **INTRODUCTION**

#### **A. PURPOSE AND OBJECTIVES**

The purpose of this report is to present the results of the Business License Tax Audit program for FY 1999-2000.

The objectives of the business license audit program were to:

- Determine if all persons/entities doing business in Berkeley have obtained licenses required under the Berkeley Municipal Code, Chapter 9.04.
- Ascertain if licensed businesses have accurately reported their gross receipts and paid the appropriate license fees.
- Ensure effective and equitable implementation of the Business License ordinance.

#### **B. SCOPE AND METHODOLOGY**

The FY 1999-2000 review for business license compliance covered real property rental owners for calendar years 1997, 1998 and 1999. Our audit subjects were selected from a database of Alameda County real properties. In addition, 11 health professionals and one retailer were selected from Pacific Bell's Street Address telephone directory.

To identify unlicensed businesses, we selected properties subject to the business license tax and traced them to the city's business license database. Properties that were not in the database were presumed unlicensed and were notified of the audit.

Property owners selected for audit were requested to provide information about their gross receipts. We evaluated documentation in the form of income tax returns, lease agreements or financial statements. Except for some reported amounts that were questioned for reasonableness, the gross receipts appearing on the submitted documentation were taken at face value, and no detail testing was conducted. We billed for delinquent taxes, penalties and interest as provided for in Section 9.04.110 and 9.04.120 of the Berkeley Municipal Code.

Our work was performed in accordance with the Government Auditing Standards prescribed by the Comptroller General of the United States.

## **C. BACKGROUND**

The Business License tax is codified in Berkeley Municipal Code (BMC) 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 Services division of the Finance Department.

BMC section 9.04.075 requires all persons/entities engaged in business within Berkeley to obtain a license and pay an annual license fee. Business license tax is assessed on gross receipts generated within Berkeley. All licenses are considered issued on January 1 and expire on December 31 that year. Every annual license renewal for which full payment is not received on or before February 28 of each year, or, for newly established businesses within thirty days after commencing business, is declared delinquent. If full payment is not received by April 1, a penalty of 50 percent of the license tax is added and collected. In addition to the penalties imposed, interest at the rate of 1 percent per month, on the amount of the fee and penalties from the date on which the license fee first became delinquent, will 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 for the fees due.

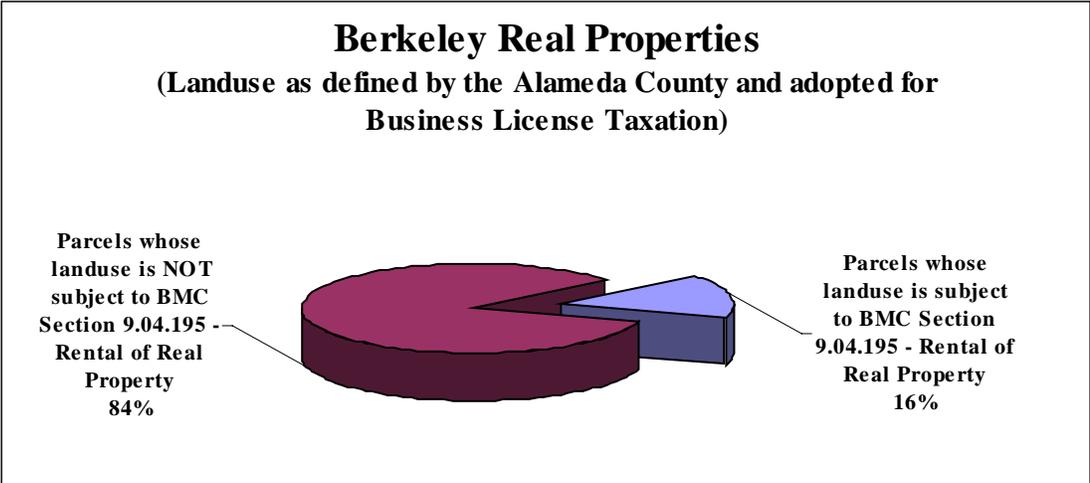
As the above procedure of license renewal indicates, the City depends largely on the accurate disclosure of information by the reporting entity. Because of this, business license revenues collected may or may not reflect the true facts of the taxpayer's business. Although tax declarations received are reviewed, this is limited to checking for arithmetical errors. Because of concern about reporting accuracy and the limited checking done, the City Auditor's office, in collaboration with the Finance Department, began a systematic audit of business licenses in 1982.

Since its inception, the Business License Tax Audit program has identified \$3,702,344 of additional revenues.

**SUMMARY OF PROGRAM RESULTS**  
**For Fiscal Year Ending June 30, 2000**

**A. PARCELS REVIEWED AND AUDITS INITIATED**

According to County records, there are 28,869 parcels in the City of Berkeley. Out of this, 4,720 appear to be subject to the licensing requirement of the Berkeley Municipal Code (BMC) Chapter 9.04 based on land use.



We analyzed and reviewed 1,148 taxable parcels (24% of 4,720) for business license tax compliance. Of these, we sent audit notices to 281 property owners that were not found in the city’s database.

Based on our sample, 12 to 15 percent of rental property owners liable for the business license tax were unlicensed.

**B. AUDIT ASSESSMENTS ISSUED**

We completed a total of 114 audits during the fiscal year. This resulted in total assessments of \$216,236, comprised of the following:

Particulars	Amount
Unpaid Business License Taxes	\$131,809.44
Penalty Assessments	59,166.59
Interest Charges	25,260.30

TOTAL	\$216,235.91
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Except for 11 unlicensed health care professionals and one unlicensed retail operator, 102 of these assessments were for unlicensed real property rentals.

**C. AUDITS DROPPED**

Based on our verification of auditees' documentation and information available in City records, we dropped 103 cases for the following reasons:

- 31 businesses ceased operation or moved out of Berkeley
- 22 businesses were in compliance; licenses were held under a different name or different address.
- 16 businesses were exempt: full-time employees; activity was an isolated transaction; non-profit organization; vacant; less than three dwelling units.
- 2 businesses were exempt because they are engaged in warehousing operations solely to service the licensee's retail business.
- 25 rental properties were determined exempt because they are owner-occupied and no units are rented.
- 7 auditees were referred to Finance for follow-up action. Review of FUND\$-OL showed that these auditees subsequently applied for a license through the Finance Department.

**D. COLLECTIONS**

Total collections for the fiscal year amounted to \$271,456. Of this, \$158,801 (or 73% of \$216,236) was collected from the current fiscal year billings.

As of June 30, 2000, the total Accounts Receivable outstanding for the Business License Tax Audit Program was \$172,613.

**E. BUSINESS LICENSE APPEALS GRANTED**

Of the 114 audit assessments issued during the fiscal year, 10 auditees filed appeals in accordance with BMC Section 9.04.280. Hearings resulted in the waiver of \$2,910 in penalties and interest.

While the appellants did not contest the assessment of the business license tax for up to three years, they stated that they felt the 50% penalty assessment and interest charges were excessive. Of 10 appellants, 8 stated that they were unaware of the city's business license requirement. Most argued that despite contacts they had with other city departments, they were never informed of the need to apply for a license.

The appellants also stated that they believed that compliance with the City's Rent Board registration requirements fulfilled their obligation with respect to rental property.

# OPERATIONAL ISSUES

## I. ISSUES IDENTIFIED DURING THE FISCAL YEAR

**Finding 1 Contractor claimed exclusion of sub-contractor payments deducted from gross receipts is not supported as required by the ordinance.**

**Conditions Observed:** Current procedure in the Finance Department allows contractors to deduct from gross receipts sub-contractor 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 sub-contractor 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*”.

Without the list, Finance staff cannot determine whether under-reporting occurred due to: 1) contractors claiming deductions in excess of actual sub-contractor payments, and 2) under-reporting of gross receipts by sub-contractors. As a result, the city may be losing revenues from under-reporting of gross receipts from both contractors and sub-contractors.

**Recommendation:** We recommend that Finance Department -

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

Finance Response

1. *Finance concurs and is in the process of reviewing current renewals for compliance and follow-up. This requirement will be reiterated in materials prepared for next year's renewals. Deadline: September 2001.*
2. *Finance concurs and has already started to compile this material. In addition, we are using the comment line in the OL module to note the submission of a list. Complete.*
3. *Finance concurs, and will establish a threshold based on taxes to be paid (not gross receipts or net receipts). Deadline: September 2001.*
4. *Finance concurs with the objective, but believes it can be implemented through administrative regulation, rather than having to amend the ordinance. This regulation will reinforce the requirement for subcontractor information, and that it include their business license numbers. Deadline: September 2001.*

**Finding 2 Majority of Construction Contractors are not Excluding Sub-Contractor Payments from Reported Gross Receipts.**

**Conditions Observed:** The Business License Brochure, which was last updated in February 1996, showed examples of tax computation and application of allowable exclusions for Retailers, Wholesalers, Manufacturing firms, Business Services and Real Property rentals but did not include Construction Contractors. Either the majority of general contractors are not aware of the exclusion available to them under the ordinance or they are deducting sub-contractor payments from gross receipts without so indicating on the form (see finding 1).

Of 13 contractors tested, only one deducted sub-contractor payments from gross receipts. Because of this, contractors may have overpaid their license fees due to over-reporting of gross receipts. On the other hand, because no list is available for review to ensure that each sub-contractor is licensed, the city may be losing revenue from contractors who automatically deducted sub-contractor payments from gross receipts.

**Recommendation:** We recommend that the Finance Department -

1. Include an example of tax computation for Construction Contractors in the Business License Tax Brochure.

Finance Response

*Finance agrees with the intent but not the implementation. As seen by the 1996 BLT brochure, it's impractical to include numerous examples in the brochure, itself. Attempting to include too much specific detail results in an overload of information and user confusion. We will have examples of*

*various business calculations available on separate forms, which may be picked up at Customer Service, enclosed, upon request, with business license applications, or be accessible on our website. Deadline: the BLT brochure and related materials will be revised and available September 2001.*

**Finding 3      Confidentiality of Taxpayer’s Information Accorded only on Declaration Statements Filed with the Finance Department.**

**Conditions Observed:** Over the last two years, a citizen and a local newspaper have requested the information of businesses operating without licenses through the Public Records Act. The City Auditor’s office audit assessment invoices contain confidential taxpayer-supplied information. Because of this, we requested the 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 from that information.
2.      Specifies what taxpayer information is open for public inspection.

*Finance Response*

*Finance concurs with the objective to protect confidential taxpayer information and propose an amendment. In sponsoring such an amendment, Finance will confer with other departments, including the Auditor, since this is where the cited infringements have taken place. Deadline: December 2001.*

## II. PRIOR YEAR'S AUDIT RECOMMENDATIONS REPORTED CLEARED

### 1. Conflict between BMC and SIC Tax Code Groupings (Finding A)

**Conditions Observed:** A conflict between the BMC and the SIC Tax Code groupings existed because of flaws in a 1990 amendment to the Business License Ordinance. The unintended consequences resulted in: a) reduction rather than increase of tax revenues; and b) inadvertent reclassification of certain businesses from the professional/semi-professional to business services classification with 50% lower tax rates.

We recommended that a measure to rationalize the Business License Ordinance be placed on the November 2000 ballot and that Finance make a revision to the tax rate schedule to bring it into conformance with the BMC.

**Resolution:** Measure U was placed on the November 2000 ballot and approved by Berkeley voters with the required majority specified under Proposition 218 to affect necessary revisions in the Business License Ordinance. The increase in the tax rate is effective July 1, 2001. Also, as of April 2000, the tax rate schedule was revised to conform to the BMC.

According to the City Manager's report to Council on June 27, 2000, estimated annual increased revenue to the city would be \$508,336.

### 2. Data Entry Conventions: Inconsistent Set-Up of Accounts in the FUNDS Occupational Licenses Module by the Finance Department Staff (Finding F)

**Conditions Observed:** During the course of our audit work, we found that a number of accounts set up in FUNDS - OL were not consistent with data entry conventions. For example, a taxpayer's name may be set up – first name, last name while others are set up last name, first name. Although the business license database has improved due to corrections made, the auditors noted an increase in entry errors again in the latter part of the year. These inconsistencies make queries and research of the database technically difficult.

**Resolution:** Customer Services staff received training to reinforce consistent and accurate data entry within FUNDS Occupational License Module. In addition, the auditors agreed that all accounts set-up inconsistent with data entry protocols will be brought to the attention of the Finance Department on an on-going basis, rather than in the annual report. Accordingly, Finance will make the appropriate correction entry.

## III. PRIOR YEAR'S AUDIT RECOMMENDATIONS – STILL OUTSTANDING

**1. Uncollectible Accounts not Written-off (Finding B)**

**Conditions Observed:** As of June 30, 2000, outstanding accounts totaling \$55,098 were known to be uncollectible and should be written off. California Code of Civil Procedure Section 338 prescribes that all actions to collect a liability created by statute should be commenced within three years. Since the city is barred from instituting further collection action, the continued inclusion of these uncollectible accounts in the Accounts Receivable balance overstates the city's financial position by \$55,098. We have consistently recommended that the Finance Department develop a citywide policy to write-off uncollectible accounts.

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 report completion of implementation of this recommendation at the February 26, 2002 Council Meeting.

*Finance Response*

*The Auditor had previously "recommended that the Finance Department submit an amendment to the Business License Tax ordinance to include a provision for write-off." As we have reported in response to this recommendation, we determined that this issue should be addressed Citywide, rather than as an amendment to only the Business License Ordinance. Consistent with this, Finance is now the lead department for the Citywide Project to Update City Write-Offs. Deadline: December 2001*

**2. Payments for Property Liens Placed through the County Tax Collector's Office are not Monitored (Finding C)**

**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 are collected. 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 placed, subsequent payments are not reported to the auditors. As a result, the Accounts Receivable balance

is not adjusted for paid liens. It is our concern that the city's 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 the Finance Department report the status of the outstanding property liens. We also recommended that Finance develop a written procedure for handling property liens.

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

*Completed: The Auditor's Office received reports in January 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.*

*Completion date: September 2001.*

**Auditor Comment:** Customer Service has provided a report of all outstanding property liens placed during the last three years. From this list, we found \$18,288 in property liens satisfied within the next two assessment periods. It appears, therefore, that the \$17,792 in outstanding liens placed from 1990 to 1997 may have been satisfied and payments received by the city. Accordingly, the accounts receivable balance as of June 30, 2001 will be adjusted to reflect the receipt of these payments.

**Auditor Recommendation:** We again recommend that the Finance Department develop a written procedure for handling property liens placed through the County. We also recommend that Finance report completion of this recommendation at the February 26, 2002 Council Meeting.

*Finance Response*

*We concur. A procedure for tracking and reporting on these liens will be drafted and submitted for review. Completion date: September 2001*

**3. Business License Tax Brochure Needs to be Updated (Finding D)**

**Conditions Observed:** The Business License Tax Brochure, which is designed to assist taxpayers in calculating their annual Business License tax, needs to be updated and made available to the business 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 has 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. This is the third year that this condition been reported.

The Finance Department 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.*

**Auditor Recommendation:** Although implementation of this recommendation appears to be in progress, we recommend that Finance Department make the updated the Business License Tax Brochure available to the business public by September 2001, as reported. We also recommend that Finance report completion of this recommendation at the February 26, 2002 Council Meeting.

*Finance Response*

*We concur. As reported to Council on February 27, 2001, completion date is September 2001.*

**4. Promote Awareness of the Business License Tax Ordinance (Finding E)**

**Conditions Observed:** Our audits continue to find that a large number of businesses within the city are operating without business licenses, and are not paying the annual license fees. Based on our audit activity this fiscal year, it appears that many real property owners are not aware of the City's business license requirements. Based on our samples over the years, unlicensed businesses appear to continue to be over 12% of total business. We reported this condition in our 1997, 1998 and 1999 annual reports.

In those reports, we recommended that the Finance Department conduct various activities to promote citizens awareness of the Business License tax ordinance. Last year, we recommended that, "*The Finance Department's request for additional positions to promote citizen awareness and compliance with the Business License Tax was approved by Council in the current year budget. We recommend that a report on these activities be made to Council by the mid-year budget review in February 2001.*"

The Finance Department report to Council on February 27, 2001 listed the following accomplishments in promoting citizens awareness about the Business License ordinance:

- *Business License Information postcards mailed to realtors and title companies and hand delivered to local realtors.*
- *City of Berkeley December 2000 news brief, featuring information on Finance Customer Service and Business License renewal, mailed with Rent Board January newsletter, reaching 3,000 landlords and over 19,000 tenants.*
- *News brief mailed with current year Business License renewal notices, more than 13,000.*
- *Business License awareness letter mailed to over 4,000 Berkeley property owners with parcels identified to have three or more units.*
- *Customer Service staff met with the Berkeley Board of Realtors.*
- *Customer Service Co-Manager and Finance Director made a presentation to the Berkeley Property Owners Association.*

**Auditor Comment:** These efforts by the Finance Department in promoting citizens awareness of the Business License Tax Ordinance were generally directed to real property owners. We commend these efforts and continue to urge the expansion of the awareness program to other types of businesses. In particular, as we noted in our FY97/98 report, many business owners in the professional/semi-professional category believed that they did not need any license other than their California State License to practice their professions. We have recommended action to increase awareness of the Business License ordinance for several years.

**Auditor Recommendation:** We recommend that the Finance Department expand their activities to increase awareness of business license tax for other types of businesses, and to report such accomplishments to the City Council by February 26, 2002.

*Finance Response*

*We concur. The Business License Tax Project, as well as routine Business License Tax activities, will be expanding public awareness efforts to additional business classifications during this year. A key focus of these efforts will be to work with other City departments that have contact with various new and continuing businesses, and include business license tax information &/or materials for distribution to them. We will report to Council in February 2002 on the status of new public awareness activities.*

**5. Insufficient Follow-up Actions by the Finance Department on Non-**

## **Respondents to Audit Notices (Finding G)**

**Conditions Observed:** As of June 30, 2000, we reported to the Finance Department that 16 businesses were either delinquent or operating without licenses, and that these businesses have not responded to our audit notices. Section 9.04.250 of the BMC provides enforcement remedies to the Director of Finance, acting through deputies or duly authorized assistants;

- shall have the 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;
- any person who fails to exhibit the same on demand shall be deemed guilty of an infraction and shall be subject to penalty by fine under section 1.20.020 of the BMC ;
- shall cause a complaint to be filed against any and all persons found to be violating any of said provisions.

In addition, an interdepartmental MOU between the Finance Department and the Auditor's Office provides that, "*Finance will send follow-up letters to demand compliance or issue citations as necessary*". During the audit period, the Auditor has not been copied on demand letters sent to businesses that failed to respond to our audit notices. We also received no evidence that a citation had been issued by the Finance Department on businesses reported. This is the third year that this condition has been reported.

The Finance Department report to Council on February 27, 2001 listed the following actions:

- *Business license staff are performing on-site inspections to determine compliance for exhibition of an active license; this is a continuing responsibility of Field Inspectors.*
- *It has been the experience of Field Investigators that their first-hand notification of an impending infraction and fine usually results in compliance. In addition, as a result of receipt of new judicial books and training in citation procedures for Field Investigators, we anticipate a more aggressive practice of issuing citations for non-compliance.*
- *Finance is considering possible thresholds for return on staff time used to take recourse in small claims court. Completion Date for determination: July 2001.*

**Auditor Recommendation:** We again recommend that the Finance Department copy the auditors on demand letters sent to non-compliant auditees and report implementation to the City Council by February 2002. A report on resolution of the recommendations related to infractions, fines, and small claims court actions should also be in this report.

Finance Response

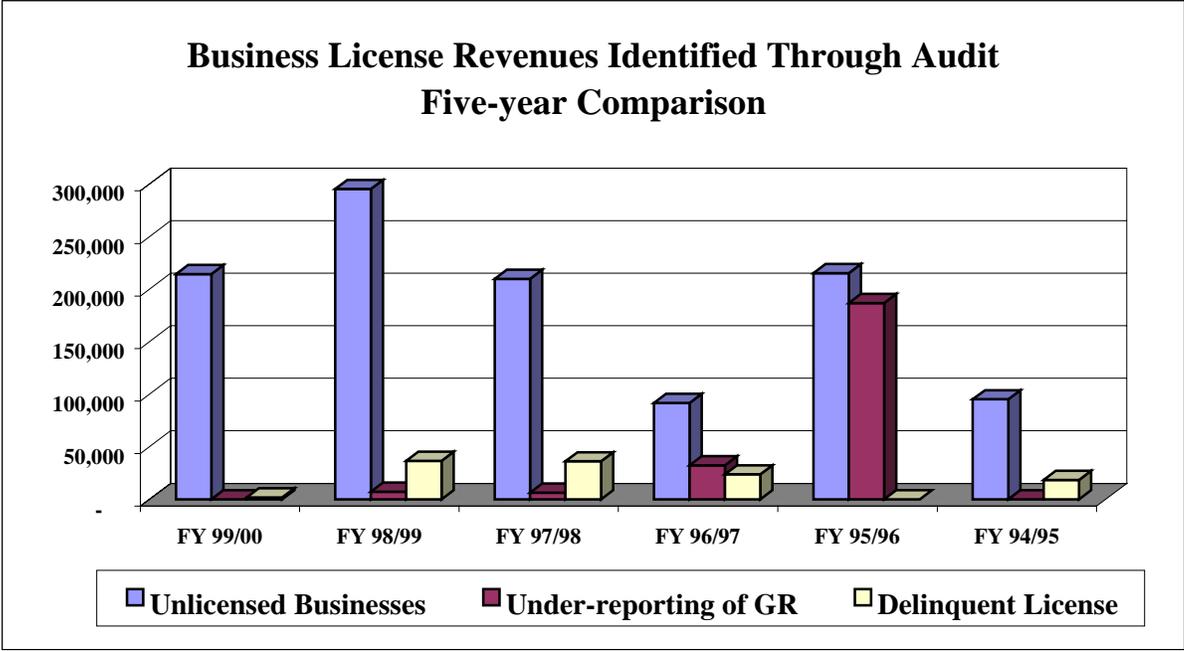
*Finance continues to concur with the recommendation and will copy the Auditor on letters of non-compliance referred by the Auditor from their identification efforts. We further offer that where communication for non-compliance occurs by phone, a summary will be sent to the Auditor of these calls, with contact name and outcome. Finance will report on resolution of the recommendation in our report to Council.*

## CONCLUSION

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

### BUSINESS LICENSE TAX REVENUES Identified through Audit

<b>Fiscal Year</b>	<b>Unlicensed Businesses</b>	<b>Under-reported Gross Receipts</b>	<b>Delinquent Licenses</b>	<b>TOTAL</b>	<b># Of Hours Spent on Business License</b>	<b>Total FTE (@ 80% Productive Time)</b>
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
<b>TOTAL</b>	<b>\$1,121,643</b>	<b>\$ 233,118</b>	<b>\$ 98,410</b>	<b>\$1,471,645</b>	<b>6,918</b>	<b>4.14</b>



As the preceding table shows, the business license tax audit program has identified 580 unlicensed businesses for a total revenue \$1,121,643 in the last six years alone. 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 the future revenue stream.

The auditors believe that complete implementation of the balance of our recommendations, as well as continuing efforts to identify unlicensed and under reporting businesses, should result in a lower rate of non-compliance in future years.

We reported on March 15, 1999 that the non-compliance rate among businesses appeared to be between 12 and 19 percent. This year, we found a non-compliance rate for landlords to be between 12 and 15 percent. For this reason, continued and expanded awareness efforts by the Finance Department 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, in part because of the penalties and interests charged, we believe that it would be a much more efficient use of citywide resources, as well as a service to the business community, for Finance to promptly implement and sustain an awareness campaign as recommended.