



Office of the City Auditor

INFORMATION CALENDAR
March 29, 2011

To: Honorable Mayor and Members of the City Council
From: Ann-Marie Hogan, City Auditor
Subject: Business License Tax Audit Program Report Fiscal Year 2010

SUMMARY

The Business License Tax (BLT) Audit Program Report conveys the results of the Auditor's Office BLT audit program during fiscal year 2010 (FY10). In FY10, the Auditor's Office worked on a joint venture (special) project with the Department of Finance. Its focus was to identify suspected unlicensed Berkeley businesses and bill those found to be unlicensed for unpaid Business License tax, penalties, and interest. The special project covered businesses ranging from professional to personal and repair services; from a grocer to retail, manufacturing, and wholesale trade, recreation and entertainment, and real property rental. In addition to the special project, performance audit work continued on cases carried over from the prior fiscal year, primarily real property rental and auto repair.

CURRENT SITUATION AND ITS EFFECTS

Our Business License Tax audits identified \$143,631 in revenue during FY10; collections totaled \$122,899. The Business License Tax Audit Program had 145 open cases, which included 60 cases carried forward from the prior year. Forty one businesses were billed a net total of \$143,631 for unpaid taxes, penalties, and interest. There were 32 dropped/closed cases and no provisionally billed cases at fiscal year-end. As of June 30, 2010, 19 Business License Tax auditees owed the City \$140,987. Seven of these audit cases, with billed amounts totaling \$42,333, have been charged to the owner's property tax bills by the Finance Department.

Since inception of the audit program in 1982, auditors have billed tax, penalties, and interest totaling over five million dollars. Revenue identified is not a one-time windfall but becomes part of the future revenue stream, assuming auditees pay the correct tax in subsequent years. For each \$100,000 identified by audit, about \$19,000 in recurring tax can be expected for each future year, as long as the audited businesses continue to generate consistent gross receipts. In about five years, revenue identified this year would double.

BLT audit work also acts as a deterrent to those who might consider underreporting or neglect to obtain a license.

POSSIBLE FUTURE ACTION AND FISCAL IMPACTS

The one-time revenue that BLT audits provide could likely result in increased future BLT revenue. Assuming audited businesses continue to pay the higher tax resulting from an audit for the next five to six years, the City should again collect an amount equal to the taxpayer's original audit tax assessment.

We will continue to allocate staff resources to identify underreporting, delinquent and/or unlicensed businesses. As a result, the City will receive tax revenue it may not otherwise receive.

The City is finalizing selection of new software to replace the City's SunGard Public Sector Occupational License module. This could result in increased efficiencies in identifying underreported gross receipts.

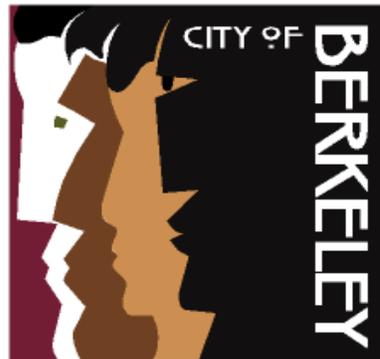
CONTACT PERSON

Ann-Marie Hogan, City Auditor, 981-6750

Attachment

1: Business License Tax Audit Program Report Fiscal Year 2010

City of Berkeley



Business License Tax Audit Program Report

For Fiscal Year Ending June 30, 2010

Prepared by:

Ann-Marie Hogan, City Auditor, CIA, CGAP
Frank Marietti, Sr. Auditor, CIA, CGAP, CFE
Myrna Ortiz, Auditor I

Presented to Council March 29, 2011

BUSINESS LICENSE TAX AUDIT PROGRAM REPORT

For Fiscal Year Ending June 30, 2010 Table of Contents

<u>Section No.</u>	<u>Section Title</u>	<u>Page No.</u>
I.	PURPOSE AND OBJECTIVE	1
II.	EXECUTIVE SUMMARY	1
III.	BACKGROUND.....	2
	A. General Information	2
	B. Annual Licensing Procedure	2
IV.	SUMMARY OF FY10 PROGRAM RESULTS	3
	A. Cases Initiated.....	3
	B. Case Activities and Assessments.....	3
	C. Provisional Audit Assessments	5
	D. Audits Dropped/Closed.....	5
	E. Issuance of Administrative Citations	5
	F. Business License Tax Appeals.....	5
	G. Cases Referred to Finance.....	6
	H. Projected Business License Tax Revenue	6
	I. Collections	7
	J. Cumulative Statistical Information.....	7
V.	CONCLUSION	9
VI.	SCOPE AND METHODOLOGY	9

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 2010 (FY10).

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, were delinquent in payment of tax, or under-paid the tax due.

II. EXECUTIVE SUMMARY

The Auditor's Office assessed 41 businesses \$143,631 in unpaid taxes, penalties, and interest during FY10. However, an estimated \$8,166 may be forgiven as part of a Council proposed amnesty program for large in-home family daycare providers. About \$45,000 of the \$143,631 is attributed to four residential rental property owners and four auto repair shops carried over from prior years. The remainder is from cases initiated during FY10.

In addition to the one-time revenue that BLT audits provide, they most likely result in increased future BLT revenue. Assuming audited businesses continue to pay the higher tax resulting from an audit for the next five to six years, the City should again collect an amount equal to the taxpayer's original audit assessment. This is because 19% of a typical billing equates to one year of unpaid tax, excluding interest and penalties. To illustrate, during FY10, \$143,631 was billed. During the next five to six years, the City should receive another \$143,631¹ from these taxpayers if they continue to pay the higher tax. This would bring the return on time invested to about \$300,000 over the course of five or six years. An additional but unquantifiable impact is the deterrence value of the program.

During FY10 three rental property owners requested an appeal for their BLT audit assessment. In all three cases, the Administrative Hearing Examiner found no grounds for waiving taxes and/or penalties and interest.

¹ BLT assessments are comprised of three to four years of unpaid tax, penalties and interest. Approximately 19% of each billing represents one year of unpaid tax. At 19%, additional revenue of \$136,449 over five years, or \$163,739 over six years, would be gained.

III. BACKGROUND

A. General Information

The BLT ordinance was enacted in 1977 and is codified under Berkeley Municipal Code (BMC) Chapter 9.04. It was established solely for revenue purposes and is not meant to be regulatory. The Finance Department is responsible for the administration and collection of BLT revenue. The City received revenue from BLT totaling \$14,147,734 during FY10. This is a 2.2% increase from last year.

B. Annual Licensing Procedure

The BMC requires all individuals and entities engaged in business within Berkeley to obtain a Berkeley business license and to pay an annual license fee. Each December the Finance Department sends a BLT renewal form (Tax Declaration) to all applicable licensed businesses listed in the City's Occupational License (OL) database. Taxpayers are instructed to report 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. BLT rates for the FY10 audit cases included 1) Rental properties, taxed at a flat fee of \$77, or at the rate of \$10.81 for each \$1000 of gross receipts, whichever is higher; 2) Manufacturing, Retail and Wholesale Trade, taxed at a flat fee of \$51, or at the rate of \$1.20 for each \$1000 of gross receipts, whichever is higher; 3) Professional Services, taxed at a flat fee of \$51, or \$3.60 for each \$1000 of gross receipts, and 4) Business, Personnel and Repair Services, taxed at a flat fee of \$51, or at the rate of \$1.80 for each \$1000 of gross receipts, whichever is higher.

All licenses are effective January 1 and expire December 31st. 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 28th. Delinquent businesses are assessed the penalties shown below, and interest at the rate of one percent each month on unpaid taxes and penalties. Interest continues to accrue until all taxes, penalties and interest have been paid.

Penalty for Non-payment or Underpayment

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

IV. SUMMARY OF FY10 PROGRAM RESULTS

A. Cases Initiated

The City Auditor's Office initiated 85 new cases in FY10. These cases covered a broad range of industry classification categories. The categories ranged from professional to personal and repair services; from a grocer to retail, manufacturing, and wholesale trade; recreation and entertainment, as well as real rental properties. All of the cases selected were unlicensed businesses, except one business that was later determined delinquent (tax was not paid on the license for one or more years) and one licensed business that appears to have paid taxes based on underreported gross receipts. In addition to the 85 cases, 60 cases were carried over from the previous year: 44 residential rental properties², 2 professional services and 14 automotive repair businesses³.

Summary of FY10 Case Activity

Audit Activity (Residential Rental Properties, Auto Repair Shops and Other Businesses)	Audit Cases Carried Over From FY09 (I)	FY10 Initiated Audit Cases (II)	FY10 Total Audit Cases (I)+(II)
Total Audit Activity	60*	85	145
Less: Billed Audits	(8)	(33)	(41)
Closed/Dropped Audits	(3)	(29)	(32)
Audit Cases Carried Over to FY11	49**	23	72

* Two cases were added when information revealed two additional properties owned by an audited property owner appeared to inaccurately report business license tax due.

** Seven of the 49 Audit Cases carried over to FY11 consist of Auto Shops.

B. Case Activities and Assessments

The Auditor's Office assessed a total net amount of \$143,631 in unpaid taxes, penalties, and interest, of which, a net amount of \$44,911⁴ in unpaid taxes, penalties, and interest was attributed to four residential rental property owners and four auto repair shops

² The Auditor's Office compared Rent Board data to the City's Occupational License (OL) data using Audit Command Language (ACL) data extraction and analysis software to identify the residential rental property audit cases. Properties were selected for audit if Rent Board data indicated a property owner could charge significantly higher total rents than the gross receipts taxpayers self-reported and used to calculate BLT due.

³ Automotive repair shops carried over from FY08 had been selected for audit by comparing OL data to Franchise Tax Board, telephone directory, and City search website information. The automotive repair shops selected appeared to be unlicensed or reporting much lower gross receipts than similar businesses in the same industry.

⁴ The Auditor's Office reduced one billing by \$325 based on supporting documentation provided during an Appeal Hearing.

Business License Tax Audit Program for FY 2010

carried over from prior year(s). From the cases initiated in FY10, thirty three cases resulted in total billings of \$98,720. However, an estimated \$8,166 may be forgiven as part of a Council proposed amnesty program for large in-home family daycare providers.

FY10 Assessment Composition

Assessment Composition	Audit Assessments for Cases Carried Over from FY08 Auto Body Repair Shops (I)	Audit Assessments for Cases Carried Over from FY09 Real Rental Properties (II)	Assessments for Cases Initiated in FY10 Mixed Categories (III)	FY10 Total Assessment (I)+(II)+(III)
Unpaid BLT	\$ 16,695	\$ 5,458	\$ 60,337	\$ 82,490
Penalty Assessments	\$ 8,348	\$ 2,729	\$ 24,853	\$ 35,930
Interest Charges	\$ 9,982	\$ 2,024	\$ 13,530	\$ 25,536
Adjustment		(\$ 325)*		(\$ 325)
TOTAL	\$ 35,025	\$ 9,886	\$ 98,720	\$ 143,631

* Adjustment based on supporting documentation provided at Appeal Hearing.

Large In-home Family Daycare Providers

Four large in-home family daycare providers were part of a joint venture special project with Finance. Like the other special project cases, these suspected unlicensed daycare providers were notified of their obligation to register for a Berkeley business license and report gross receipts. Two provided the Auditor's Office with the requested gross receipt information and were billed.

Berkeley has 36 large in-home family daycares registered with the State. Our review of 16 found all 16 had not obtained a Berkeley business license. Assuming all 36 are unlicensed, it is estimated that a total of \$140,000 in one-time business license tax revenue, penalties, and interest may have been generated from these large in-home daycare providers.

City Council members stated that in-home family daycare is a large and critical component of the daycare network and that a loss of providers would result in a serious negative impact on the families and workers within the Berkeley community. Therefore, at the May 18, 2010, City Council meeting, Council proposed that City staff review the zoning code requirement for large family day care 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 that exempts qualifying large family in-home daycares from all business license taxes, fees, and fines accrued before January 1, 2010. Final action and determination by Council is pending the analysis of the required fees and zoning requirements by the City Manager.

C. Provisional Audit Assessments

Provisional audit assessments are tentative billings based on Rent Stabilization Board data. If a residential rental property owner declines several requests to provide gross receipt documentation that support the BLT due, they are provisionally billed. When a provisional bill is issued, the auditee is asked to pay the assessment and/or file an appeal, or provide the requested documentation. If the auditee continues to be non-responsive, the provisional bill becomes final. Because provisional assessments are subject to change prior to finalization, they are not included in the “FY10 Assessment Composition” table above.

One provisional audit assessment totaling \$2,829 was carried over to FY10. The property owner was requested to provide supporting documentation to substantiate their reported gross receipts. After review of the supporting documentation, the Auditor’s Office finalized the billing. No provisional assessments were issued in FY10.

D. Audits Dropped/Closed

A review of City records and documentation provided by the business owners resulted in thirty two cases being dropped or closed. Cases are “closed” if an auditee provides documentation which substantiates they are in compliance with the BLT Ordinance. Cases are “dropped” when it is determined that an audit should not be performed. For example, a case is dropped when a business thought to be located in Berkeley is found to be located in another City and is not subject to Berkeley BLT.

E. Issuance of Administrative Citations

Two administrative citations were issued during FY10. In December 2006, Council granted the auditor job classifications the authority to issue administrative citations to auditees who are not in compliance with BMC 9.04.285 or 9.04.035⁵. An administrative citation provides a means to address BMC violations and to promote quick resolution. In most cases, an administrative citation issued by the Auditor’s Office is \$200; however, the citation is a fine that can be as much as \$1000.

F. Business License Tax Appeals

Three rental property owners requested an appeal for their BLT audit assessment. In all three cases, the Administrative Hearing Examiner found no grounds for waiving taxes and/or penalties and interest. Auditees have the opportunity to appeal BLT audit

⁵ BMC Section 9.04.285 Examination of books, records, witnesses—Information confidential—Penalty. “The Director of Finance or any authorized employee, is authorized to examine the books, papers and records of any person subject to this chapter for the purpose of verifying the accuracy of any return made or, if no return was made, to ascertain the license fees due under this chapter”.

BMC Section 9.04.035 License required. “It shall be unlawful for any person, either for himself/herself or for any other person, to commence or carry on any business specified in this chapter, in the City, without first having procured a license from the City to do so, or without complying with any and all regulations of such business contained in this chapter.”

assessments to the Administrative Hearing Examiner⁶. This is done by submitting a written appeal request, generally applicable within 30 calendar days from the date of a final or provisional invoice.

G. Audit Cases Referred to Finance

Adequate Documentation Not Provided

Cases are referred to the Finance–Revenue Collection Division for follow-up when the auditee fails to:

- Respond to audit letters and telephone calls, or
- Provide the auditor with adequate documentation to perform an audit. (D-3-c#7B)

No cases were referred to Finance during FY2010.

Unpaid Audit Assessments

As of June 30, 2010, the BLT accounts receivable consisted of 19 cases totaling \$140,987. The Finance Department charged 7 of the 19 cases, with receivables totaling \$42,333, to the owners' property tax bills.

The Auditor's Office provides the Finance-Revenue Collections Division with accounts receivable reports identifying the audit cases that have been assessed by the auditors and for which payments have not been received. Finance staffs use various means to collect BLT due, including adding the unpaid audit assessments to the property owners' tax bill.

H. Projected Business License Tax Revenue

Business License Tax revenue from the BLT Audit Program is typically projected at \$125,000 to \$150,000 annually per full-time equivalent (FTE) employee assigned. For FY10 plans were to significantly exceed this projection because of the Special Project with Finance⁷.

There was an average of 1.11 FTE assigned to the program during FY10. For every dollar spent on salaries, fringe benefits, and BLT Program administration, the auditors identified and billed approximately \$1.01 in BLT penalties and interest. As noted on page one, that one time revenue amount should double over the next five to six years if the audited businesses continue in business at the same level of gross receipts.

Some factors affecting this ratio include staff salary increases, time dedicated to establishing new and unified procedures for the special joint venture project, appeal hearing cases, and the daycare issue.

⁶ The Administrative Hearing Examiner is located in the City Manager's Office.

⁷ Finance estimated the entire Special Joint Project could generate \$400,000 in one-time BLT revenue. The Auditor's largely completed their portion of the Special Joint Project during FY10 and billed only \$98,720.

FY10 Total Billed	FY10 Auditor Salaries*	Ratio
\$143,631**	\$142,751	1.01 : 1

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

** As discussed on page one of this report (Executive Summary), future annual revenue of \$27,290 per year, or about \$136,000 to \$164,000 over the next five or six years, can be anticipated from these billings assuming these businesses continue to pay the higher tax.

I. Collections

BLT audit collections totaled \$122,899 during FY10. Of this, \$65,079 was collected from prior year billings, including a total of \$11,250, collected by the County Assessor's Office through the owner's property tax bills.

J. Cumulative Statistical Information

During the last ten years, the City Auditor's BLT Audit Program has identified 392 businesses and residential rental property owners that owed the City \$1,546,264 in tax, penalties, and interest. During this same ten-year period, payments totaling \$1,397,531 were received. Since the inception of the program in 1982 unpaid tax, penalties, and interest identified by the City Auditor's Office BLT Audit Program has totaled \$5,248,933.

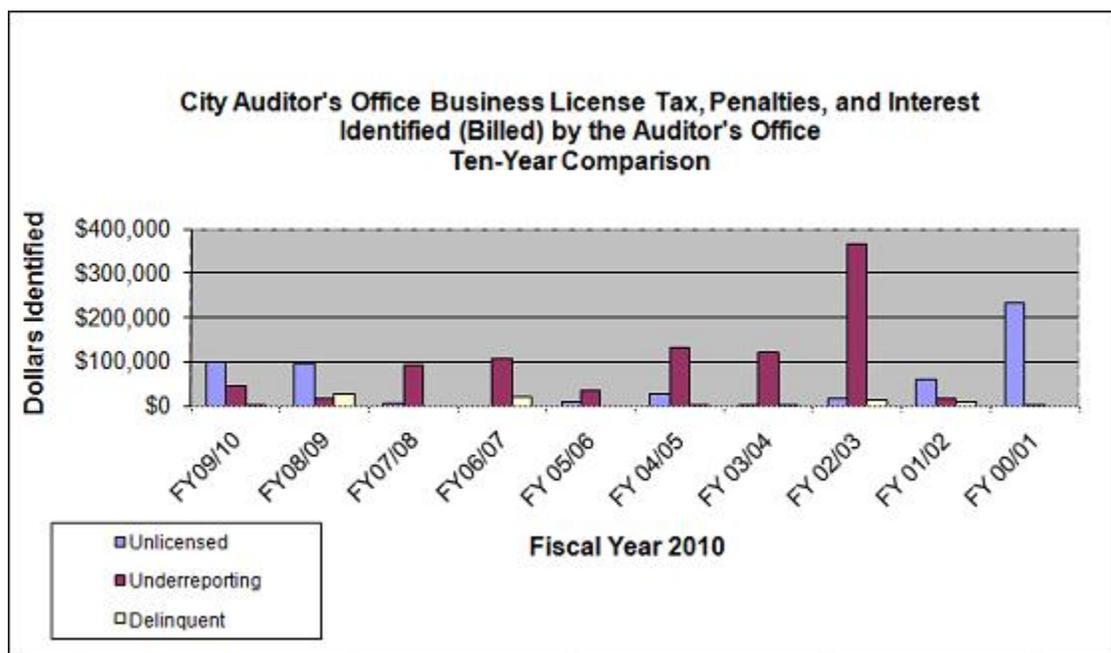
In addition to the one-time revenue that these BLT audits provided, they most likely result in increased future BLT revenue. Assuming audited businesses continue to pay the higher tax resulting from an audit for the next five to six years, the City should again collect an amount equal to the taxpayer's original audit assessment. This is because 19% of a typical billing equates to one year of unpaid tax, excluding interest and penalties. With over five million dollars assessed since the BLT Audit program started, this additional revenue could easily be substantial.

The audits also likely have a deterrent effect, decreasing the number of businesses that do not obtain a license or underreport tax due.

**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 (A)	% of FTE @ 80% Productive Time* (A)/0.8/2,080
	Count	Dollars	Count	Dollars	Count	Dollars			
09/10	32	\$ 98,214	8	\$ 44,911	1	\$ 506	\$ 143,631	1,851	1.11
08/09	3	\$ 96,903	19	\$ 15,693	2	\$ 27,911	\$ 140,507	1,322	0.79
07/08	1	\$ 4,987	32	\$ 90,673	0	\$ 0	\$ 95,660	1,398	0.84
06/07	0	\$0	22	\$106,919	2	\$ 21,541	\$128,460	1,515	0.91
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
TOTAL	224	\$546,172	143	\$927,174	16	\$ 72,917	\$1,546,264	18,391	

** 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

The BLT Audit Program has been an effective means of generating revenue by identifying unlicensed and underreporting businesses. The audit work may also act as a deterrent to those who might consider underreporting or neglect to obtain a license.

The BLT revenue identified during our audits is generally not a one-time windfall, but becomes a part of the future revenue stream. In FY10, 57% of our BLT billings were comprised of unpaid tax, and the remaining 43% were penalties and interest. The BLT audit historically included unpaid tax for a three-year period. Accordingly, for each \$100,000 in tax identified by audit, about \$19,000 (\$57,000 / 3 years) in tax for each succeeding year can be expected, as long as the audited businesses are generating consistent gross receipts.

VI. SCOPE AND METHODOLOGY

The City Auditor's Office assesses compliance with the BLT ordinance by auditing entities and individuals engaged in business within Berkeley. One hundred and forty five cases were under audit and/or review during FY10. These cases fall into one of two groups:

1. Joint Venture (Special) Project
2. Performance Audits

Joint Venture (Special) Project - Identification of Unlicensed Businesses

In FY10, Finance staff developed a list of suspected unlicensed businesses and Finance and Audit staff used this list as part of a Special Project. Finance split the list so that half was referred to the Auditor's Office and the other half to the Finance Revenue Development Unit for follow-up and billing. The Auditor's Office selected eighty five businesses for the FY10 Special Project. These cases consisted of entities and individuals suspected of being unlicensed. Compliance with the BLT ordinance was determined by requesting business owners to provide information regarding their business operation and to self-report gross receipts. The information provided was used to calculate their unpaid BLT.

Consistent with Finance's procedures, the Auditor's Office mass mailed letters to these businesses. Businesses were requested to complete and remit a New Business License Application Form; self-report gross receipts, provide their North American Industry Classification System (NAICS) code⁸; and submit an initial payment of \$76 (\$25 registration fee plus \$51.00 minimum license fee), or \$102 for rental properties (\$25

⁸ If a NAICS code was not provided by the business, the auditor assigned the code based on the available information and calculated business license tax owed.

registration fee plus \$77.00 minimum license fee). The information provided by the business was used as the basis for assessing BLT. Initially, special project cases covered the three most recent BLT years (2007-2009). In April 2010, a change in policy endorsed a four year period (2007 – 2010).

The Auditor's special project cases were billed without verification of taxpayer information, but selected cases may be audited later. Generally Accepted Government Auditing Standard 7.55 requires verification. Taxpayer self-reported information was used without validation or reliability testing to ensure that taxpayers obtained and paid for their licenses promptly. Validation of taxpayer information would be part of any future under-reporting audits for these taxpayers.

Performance Audits - Accuracy of Reported Gross Receipts

Auditee compliance with the BLT ordinance in this group was determined by obtaining sufficient and appropriate documentation to calculate the correct amount of tax due. Examples of such evidence include income tax returns, sales tax returns, rental agreements, rent-rolls and financial statements. Based on information provided and/or compiled, entities and individuals were billed for unpaid BLT, plus penalties and interest, in accordance with Berkeley Municipal Code (BMC) Section 9.04.

Sixty audit cases in this group were carried over from prior year(s). The audit period for these cases was the three most recent BLT years at the time the audits were initiated. An additional BLT year(s) may have been incorporated into the review every March 1 (due date for business license) if the audit case had not been completed by this date.

Government Audit Standards

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS) except as noted above. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.