

City of Berkeley



Office of the City Auditor
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Business License Tax Program Audit Report

For Fiscal Year Ending June 30, 2003

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BUSINESS LICENSE TAX AUDIT PROGRAM REPORT

For the Fiscal Year Ended June 30, 2003

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I. PURPOSE AND OBJECTIVES

The purpose of this report is to present the results of the City Auditor's Business License Tax Audit Program for fiscal year 2003.

The objectives of the Business License Tax Audit Program were to:

- Identify persons/entities engaged in business in Berkeley that have not obtained the required license.
- Ascertain if licensed businesses have accurately reported their gross receipts and paid the appropriate license fees.

II. SCOPE AND METHODOLOGY

During fiscal year 2003, the auditors reviewed businesses for Business License tax compliance for calendar years 2000, 2001 and 2002. The businesses selected for review included:

- 1) Various types of businesses suspected of underreporting. These businesses were selected based on a review of information in the City's Occupational License (OL) database and the telephone book.
- 2) Business License taxpayers that had not responded to renewal notices from the Finance Department.
- 3) Dentists selected from the telephone book.

Additionally, some of the audits initiated in the previous fiscal year were completed during fiscal year 2003.

The City depends largely on the accurate disclosure of information by the reporting entity to determine the amount of Business License Tax due each year. Because of this, Business License revenues collected may or may not reflect the true facts of the taxpayer's business.

Entities subject to the Business License tax were selected and traced to the City's OL database to determine whether they were registered as a licensed business. Businesses that were not in the database were presumed unlicensed. Licensed businesses were subjected to audit if their Business License tax appeared to be delinquent or if it appeared that their gross receipts used to calculate the tax had been underreported.

Business owners selected for audit were requested to provide information about their gross receipts. We requested and accepted as documentation income tax returns, lease agreements,

and/or financial statements. Based on the information provided, we billed these businesses for unpaid Business License taxes, 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. We have now changed the contents of our report, excluding the audit findings and recommendations. 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.

With the exceptions noted above, our work was performed in accordance with Government Auditing Standards as prescribed by the Comptroller General of the United States and was limited to those areas specified in the Scope and Methodology section of this report.

III. BACKGROUND

The Business License tax requirement is codified in the 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 Service division of the Finance Department by BMC 9.04.070 and BMC 9.04.250. The City's accounting system, FUNDS\$, reports that the actual amount of Business License tax, penalties, and interest revenue for fiscal year 2003 was \$10,760,970. During fiscal year 2003, the City Auditor's Office identified revenues amounting to \$393,295.

BMC section 9.04.035 requires all persons/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. 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 April 1, a penalty of 50 percent of the license tax is added. Interest accrues at the rate of 1 percent per month on the unpaid taxes and penalties, and will continue to accrue until paid. Newly established businesses are required to obtain a Business License within 30 days of commencing business.

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 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.

In 1982, the Auditor's Office collaborated with the Finance Department and began a citywide systematic audit of Business Licenses. Based on the adopted budget for fiscal years 2000 and 2001, Finance formed a temporary Business License Project Team (Special Project) consisting of two Field Representatives and one Office Assistant to increase efforts to identify and collect Business License taxes. Business License tax revenue was anticipated to offset the cost of funding this Special Project.

IV. SUMMARY OF PROGRAM RESULTS

A. Audits Initiated

During fiscal year 2003, the City Auditor's Office reviewed persons / entities believed to be engaged in business in Berkeley in the following three general groupings for non-renewal or underreporting.

A.1 Various Business Types Audited for Underreporting

An estimated 50 businesses were reviewed for underreporting. We reviewed the City's OL database and the telephone directory for businesses that appeared to be reporting much lower gross receipts than similar businesses in the same industry. Nineteen businesses were selected for audit. The same owner or company owned some of these businesses. Each business location requires a separate Business License. An audit case was established for each business. Fifteen audit notification letters were sent requesting the documentation needed to audit the nineteen businesses. Of the 19 audit cases established, 12 owed tax and were billed, three were in compliance, and four were still in the process of being audited, as of June 30, 2003.

A.2 Businesses Audited for Not Responding to Multiple Renewal Notices From Finance and Appearing to Have Delinquent Business License Accounts

Delinquent Business Licenses are licenses that are not renewed. The auditors reviewed 75 businesses from a Finance Department list of 176 suspected delinquent Business Licenses. Finance had sent these businesses six renewal notices, and had not received a response.

Of the 75 businesses reviewed, 20 were selected for audit. Of the 20 businesses audited, three owed tax and were billed, two were in compliance, and 15 were still in the process of being audited as of June 30, 2003. On July 30, 2003, (Fiscal Year 2004) 13 of the 15 were referred to Finance for follow-up because they would not provide the documentation requested by the auditors to perform the audit.

A.3 Dentists Audited for Underreporting

Businesses in this category were identified using the phone book. The auditors reviewed 119 businesses, and 60 were sent audit notices. As a result of auditing one of these dental businesses, an additional three dentists and a dental building lease were audited, for a total of 64 audit cases.

Of the 64 audit cases, 20 owed taxes and were billed, 34 were in compliance, four were owed refunds, and six were in the process of being audited. Based on fiscal year 2003 audit information, it appears that 66% of dentists are in compliance with Business License tax requirements.

B. Audit Assessments

During fiscal year 2003, 47 businesses were assessed (billed) a total of \$393,295 for unpaid taxes. Total dollars assessed during fiscal year 2003 was comprised of 13 audit cases initiated in fiscal year 2002 that were billed in fiscal year 2003, and 34 audit cases that were initiated and billed during fiscal year 2003.

Particulars	Amount
Unpaid Business License taxes	\$227,397
Penalty Assessments	\$109,470
Interest Charges	\$56,431
Adjustments	(\$3)
TOTAL	\$393,295

Categories	Unlicensed	Under-reported	Delinquent	Total # of Assessments
Administrative Headquarters	1	2		3
Business and Repair	1	2		3
Construction Contractors		1		1
Manufacturing			2	2
Motor Vehicle Sales		4		4
Professionals	1	20		21
Rental Property	5		5	10
Retail		1	1	2
Wholesale		1		1
Total	8	31	8	47

C. Audits Dropped

Based on our review of auditee documentation and information available in City records, 53 audit cases were dropped (closed without a billing) for the following reasons:

- 39 In Compliance
- 4 Overpayment / Refund
- 3 Business closed
- 3 Exempt from Business License Tax
- 4 Other, such as undeliverable audit notices

Total: 53

D. 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. Seven audit cases were appealed by three business owners. One company owned four of the businesses (four audit cases) and another owned two. A total of \$2,133 was waived for two audit cases. Tax waived totaled only \$77. The remaining \$2056 that was waived was penalties and interest.

E. Projected Business License Tax Revenue

In fiscal year 2003, the City Auditor’s Office was budgeted about 1.5 full time equivalent (FTE) auditors to perform Business License tax audits. Revenue of at least \$125,000 per assigned auditor was projected, or \$187,500 for the 1.5 FTE. Revenue identified exceeded the \$187,500 target. The FTE, including supervisory time, was 2.08 FTE.

The General Audit division spent \$84,036.40 less than what was budgeted for fiscal year 2003. The auditors believe that, in future years, revenue targets will continue to be met or exceeded, based on past experience, current staff capabilities, and the planned implementation of newly acquired technology for more effective revenue identification.

During fiscal year 2003, for every dollar spent on salaries, fringe benefits, and the administration of the Business License Tax Program, the auditors identified and billed approximately \$2.5 in Business License tax, penalties, and interest.

<u>Total Revenue</u>	<u>Auditor Salaries*</u>	<u>Ratio</u>
\$393,295	\$159,886	2.5 : 1
<p>*Auditor Salaries = (auditor salaries + supervisory salaries + fringe benefits) / .8 estimated non-administrative time</p>		

F. Collections

Total payments received during fiscal year 2003 from Business License tax audits were \$336,349. Of this, \$19,395 was collected from prior fiscal year billings.

As of June 30, 2003, the accounts receivable balance for the Business License Tax Audit Program was \$94,927.

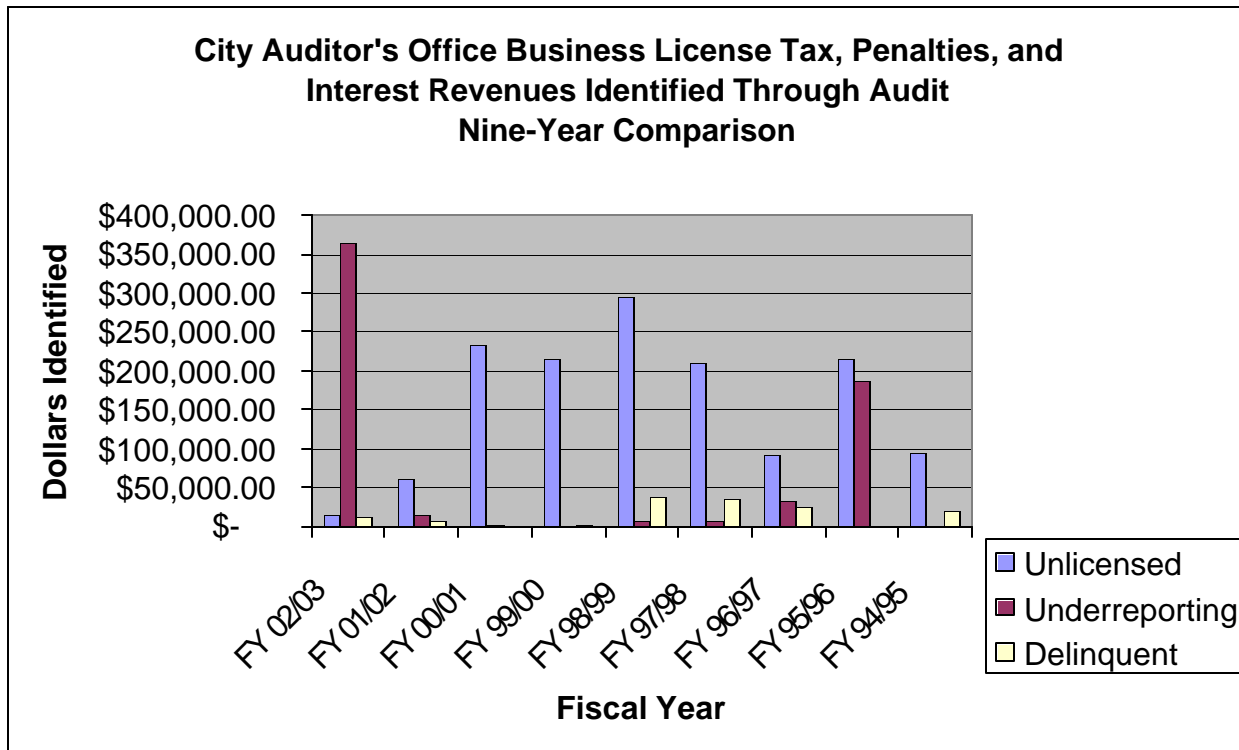
G. Cumulative Statistical Information

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.

**City Auditor's Office
Business License Tax, Penalties and Interest Revenues
Identified through Audit**

Period	Unlicensed Businesses	Under-reporting Of Gross Receipts	Delinquent License	TOTAL	No. Of Hours Spent	% Of FTE @ 80% Productive Time*			
FY 02/03	8	\$15,162	31	\$364,782	8	\$13,351	\$393,295	3457	2.08
FY 01/02	54	59,701	8	15,020	1	7,653	82,374	2,236	1.34
FY 00/01	115	233,571	2	934	0	0	234,505	1,915	1.15
FY 99/00	112	214,361	0	0	2	1,875	216,236	1,553	0.93
FY 98/99	186	295,323	5	7,283	3	36,591	339,197	2,536	1.52
FY 97/98	152	209,723	9	6,466	14	36,175	252,364	835	0.50
FY 96/97	25	91,798	16	32,468	15	23,769	148,035	783	0.47
FY 95/96	60	215,249	59	186,901	0	0	402,150	689	0.41
FY 94/95	45	95,189	0	0	13	18,474	113,663	522	0.31
TOTALS	757	\$1,430,077	130	\$613,854	56	\$137,888	\$2,181,819	14,526	

* Productive Time is calculated based on 2080 hours @ 80% (Hours Spent/(2080 x 80%))



V. CONCLUSION

During the last nine years, the City Auditor’s Business License Tax Audit Program has identified 943 businesses that owed the City \$2,181,819 in Business License tax, penalties, and interest. Since inception of the program in 1982, the revenues identified from the City Auditor’s Office Business License tax audits have totaled \$4,412,518. 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 60% is tax, while 40% 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 \$20,000 (\$60,000 / 3 years) in tax for each succeeding year can be expected, as long as the audited businesses are generating consistent gross sales.

This year’s focus on auditing unlicensed businesses was significantly less due to the Auditor’s Office change in focus to businesses that underreport Business License Tax information.

Results of audits of various business types indicated that some businesses were significantly understating their gross receipts when reporting to the City. The auditors will continue efforts to identify these types of businesses in the future. This may result in significant future increases in revenue with the use of auditing software and other available data.