




Office of the City Manager

INFORMATION CALENDAR

November 6, 2007

To:  Honorable Mayor and Members of the City Council

From:  Phil Kamlarz, City Manager

Submitted by: Robert Hicks, Director, Finance Department

Subject: Miscoding of City of Berkeley Business Licenses

INTRODUCTION

During a recent review of the 2007 business license renewals, Finance Department staff discovered that many businesses were coded with an incorrect business license tax rate. Upon further investigation, Finance staff determined that the most prevalent miscoding occurred on businesses coded as 'Business, personal and repair services', with a corresponding tax rate of \$1.80 per \$1,000 in gross receipts. Many of these businesses should have been coded as 'Professional/Semi-Professional' with a corresponding rate of \$3.60 per \$1,000 in reported gross receipts. Tax rate errors were found in other reporting categories as well, but not to the extent as the two mentioned. Staff found three primary reasons for a business being assigned an incorrect tax rate: (1) a business might be assigned an incorrect tax rate related to the business owner not declaring the specific type of business being performed but providing a very general description instead. For example, a business owner may have declared that they provided Consulting Services, which could be classified as a general business service, with a corresponding tax rate of \$1.80 per \$1,000 in gross receipts. But, further research may have revealed the business provided 'Software Development Consulting' services, which is a Professional service with a corresponding tax rate of \$3.60 per \$1,000 in gross receipts;

(2) Another reason a business may be assigned an incorrect tax rate is related to the replacement of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) in 1997, so that the United States, Canada, and Mexico can all use the same classification system. This change was the result of the passage of the North American Free Trade Agreement (NAFTA). The City of Berkeley's 'Business' and 'Professional/Semi-professional' classes are based on definitions in the SIC system. Under the NAICS, businesses are defined at a more granular level, thereby changing the class a business may fall into—generally from the broader 'Business' class to the more specific 'Professional' class. For example, businesses that fell into the broad SIC group Business Services (SIC series 7300) included services such as Graphic Art and Design Services. Under the NAICS, these businesses now fall into the Professional, Scientific and Technical Services category

(NAICS series 540000). Changing a business from a general class to a specific class results in a tax rate change for many businesses;

(3) The third reason a business may be assigned an incorrect tax rate was that Finance staff assigned an incorrect tax rate when a business license was established in the City's Business License Tax system, most likely due to a misunderstanding of what type of business was being performed (e.g. staff may have been unable to distinguish a retail service from a grocer, based upon the business description provided by the business owner and/or found in the old coding system).

CURRENT SITUATION AND ITS EFFECTS

Initially, Finance staff identified about 400 businesses with incorrect tax rate codes. Of the 400 businesses reviewed, 22 businesses underpaid the 2007 business license tax by \$5,000 or more; 103 businesses underpaid the 2007 business license tax between \$501 to \$4,999; the remainder underpaid the 2007 business license tax by \$500 or less (some underpaid by as little as \$7).

As a result of this analysis, the Finance Department is undertaking a project to review the tax rate code assigned to every business, initially concentrating on the 125 businesses identified with the 1argest tax payment discrepancies. Although the City could back bill businesses for the current year's underpayment (Business License tax year 2007) and an additional three years of underpayment, the City Manager and Finance staff determined the fair course of action was to only address the 2007 underpayment. In addition, only those businesses owing \$500 or more will be back billed, as pursuing businesses which underpaid by less than \$500 would cost more in billing and collection efforts than the revenue received from that effort. However, letters will be sent to any business whose tax rate is changed.

Additionally, Finance will not charge any penalties or interest on the underpayment and payment plans will be offered to those businesses requesting them.

BACKGROUND

The City began using the H.T.E. Business License Tax software system in 1992, as this tax system was an improvement over the old system. However, the software has some major shortcomings, one of which is the inability to easily link the City's business license tax rates to the SIC/NAICS coding system. This is one of the main reasons businesses were assigned incorrect tax rates, which resulted in a loss of revenues to the City. The system also does not have easy to use drop down menus with pre-defined data selections, which increases the likelihood of data entry errors. Finally, the system doesn't allow for an easy cross-referencing to State sales tax data, which would also increase City revenue..

POSSIBLE FUTURE ACTION

Finance staff has reviewed several different business license tax software packages and have identified several products of interest. After reviewing the available software packages, a Request for Bid (RFP) may be issued and new software acquired.

FISCAL IMPACTS OF POSSIBLE FUTURE ACTION

Initially, Finance staff identified about 400 businesses with incorrect business license tax rates. As a result, the City is not receiving the revenue that it should when these businesses renew their annual business license. Finance estimates that by undertaking a project to: 1) review the tax rate assigned to every business; 2) correct the tax rate of any business found to be in error; 3) notify every business whose tax rate is changed; and 4) bill all those businesses that underpaid their 2007 business license tax by \$500 or more, the City could realize approximately \$400,000 in one-time business license tax (General Fund) revenue. Once the tax rate is corrected, the on-going increase in Business License tax revenue would be approximately \$450,000 annually.

The additional costs associated with this project should be less than \$20,000 in FY08 and includes: staff overtime to perform the license reviews, update accounts as necessary, notify businesses whose tax rate is changed, bill any business that owes \$500 or more in 2007 business license tax, answer customer calls and correspondence, supplies, and postage costs.

Additionally, the cost to purchase new business license tax software is unknown at this time (but is expected to exceed \$100,000), as are the costs related to 'scrubbing' existing data before it is migrated to any new software system.

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