MERCED COUNTY

Audit Report

PROPERTY TAX APPORTIONMENT AND ALLOCATION SYSTEM

July 1, 2009, through June 30, 2014

BETTY T. YEE
California State Controller

March 2016

BETTY T. YEE
California State Controller

March 18, 2016

The Honorable Lisa Cardella-Presto
Auditor-Controller
Merced County
2222 M Street
Merced, CA 95340

Dear Ms. Cardella-Presto:

The State Controller's Office audited the methods employed by Merced County to apportion and allocate property tax revenues for the period of July 1, 2009, through June 30, 2014. The audit was conducted pursuant to the requirements of Government Code section 12468.

Our audit found that the county complied with California statutes, except that it:

- Had errors when computing the countywide apportionment (AB 8) factors
- Had computation and transfer errors in the jurisdictional changes sampled
- Had errors when computing the unitary and unitary railroad apportionment
- Incorrectly computed the Educational Revenue Augmentation Fund growth
- Incorrectly computed the Vehicle Licensing Fee Swap growth

If you have any questions, please contact Elizabeth González, Chief, Local Government Compliance Bureau, at (916) 324-0622.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/as

Attachment

cc: Sylvia Sanchez, Supervising Accountant
Merced County
Phil Orth, Auditor-in-Charge
State Controller's Office

Contents

Audit Report

Summary

The State Controller's Office (SCO) audited the methods employed by Merced County to apportion and allocate property tax revenues for the period of July 1, 2009, through June 30, 2014.

Our audit found that the county complied with California statutes for the allocation and apportionment of property tax revenues, except that it:

- Had errors when computing the countywide apportionment (AB 8) factors
- Had computation and transfer errors in the jurisdictional changes sampled
- Had errors when computing the unitary and unitary railroad apportionment
- Incorrectly computed the Educational Revenue Augmentation Fund (ERAF) growth
- Incorrectly computed the Vehicle Licensing Fee (VLF) Swap growth

Background

After the passage of Proposition 13 in 1978, the California State Legislature enacted new methods for allocating and apportioning property tax revenues to local government agencies and public schools. The main objective was to provide local government agencies with a property tax base that would grow as assessed property values increased. These methods have been further refined in subsequent laws passed by the Legislature.

One key law was Assembly Bill (AB) 8, Chapter 282, Statutes of 1979, which established the method of allocating property taxes for fiscal year (FY) 1979-80 (base year) and subsequent fiscal years. The methodology is commonly referred to as the AB 8 process or the AB 8 system.

The property tax revenues that local government agencies receive each fiscal year are based on the amount received in the prior year, plus a share of the property tax growth within their boundaries. Property tax revenues are then apportioned and allocated to local agencies and schools using prescribed formulas and methods defined in the Revenue and Taxation Code.

The AB 8 base process involved numerous steps, including the transfer of revenues from schools to local agencies (AB 8 shift) and the development of the tax rate area annual tax increment apportionment factors (ATI factors), which determine the amount of property tax revenues to be allocated to each jurisdiction.

The total amount to be allocated to each jurisdiction is then divided by the total amount to be allocated to all entities to determine the AB 8 apportionment factor (percentage share) for each entity for the year. The AB 8 factors are computed each year for all entities, using the revenue amounts established in the prior year. These amounts are adjusted for growth annually, using ATI factors.

Subsequent legislation removed revenues generated by unitary and nonunitary properties, regulated railway companies, and qualified electric properties from the AB 8 process. These revenues are now allocated and apportioned under separate processes.

Other legislation established an Educational Revenue Augmentation Fund (ERAF) in each county. Most local government agencies are required to transfer a portion of their property tax revenues to the fund. The fund is subsequently allocated and apportioned to schools by the county auditor according to instructions received from the county superintendent of schools or the State Chancellor of Community Colleges.

Revenues generated by the different types of property tax are apportioned and allocated to local agencies and schools using prescribed formulas and methods, as defined in the Revenue and Taxation Code. Taxable property includes land, improvements, and other properties that are accounted for on the property tax rolls maintained primarily by the county assessor. Tax rolls contain an entry for each parcel of land, including the parcel number, the owner's name, and the value. Following are the types of property tax rolls:

- *Secured Roll*—This roll contains property that, in the opinion of the assessor, has sufficient value to guarantee payment of the tax levies and that, if necessary, can be sold by the tax collector to satisfy unpaid tax levies.

- *Unsecured Roll*—This roll contains property that, in the opinion of the assessor, does not have sufficient "permanence" or have other intrinsic qualities to guarantee payment of taxes levied against it.

- *State-Assessed Roll*—This roll contains public utility, railroad, and qualified electric properties, assessed as either unitary or nonunitary property by the State Board of Equalization.

- *Supplemental Roll*—This roll contains property that has been reassessed due to a change in ownership or the completion of new construction, where the resulting change in assessed value is not reflected in other tax rolls.

To mitigate problems associated with the apportionment and allocation of property taxes, Senate Bill 418 was enacted in 1985 requiring the State Controller to audit the counties' apportionment and allocation methods and report the results to the California State Legislature.

Objective, Scope, and Methodology

Our audit objective was to review the county's apportionment and allocation of property tax revenues to local government agencies and public schools within its jurisdiction to determine whether the county complied with Revenue and Taxation Code requirements.

To meet the objective, we reviewed the county's procedures for apportioning and allocating property tax revenues used by the county auditor and the processes used by the tax collector and the assessor.

We performed the following procedures:

- Conducted tests to determine whether the county correctly apportioned and allocated property tax revenue.
- Interviewed key personnel and reviewed supporting documentation to gain an understanding of the county's property tax apportionment and allocation processes.
- Reviewed apportionment and allocation reports prepared by the county showing the computations used to develop the property tax distribution factors.
- Reviewed tax rate area (TRA) reports to verify that the annual tax increment was computed properly.
- Reviewed county unitary and operating nonunitary reports and Board of Equalization reports and verified the computations used by the county to develop the unitary and operating nonunitary property tax distribution factors.
- Reviewed redevelopment agency (RDA) reports prepared by the county and verified the computations used to develop the project base amount and the tax increment distributed to the RDA.
- Reviewed RDA Successor Agency Recognized Obligation Payment Schedules (ROPS) and county apportionment and allocation reports addressing the Redevelopment Property Tax Trust fund (RPTTF).
- Reviewed property tax administration cost reports prepared by the county and verified administrative costs associated with procedures used for apportioning and allocating property tax to local government agencies and school districts.
- Reviewed ERAF reports prepared by the county and verified the computations used to determine the shift of property taxes from local agencies to the ERAF and, subsequently, to public schools.
- Reviewed Sales and Use Tax (SUT) and VLF reports and computations used to verify the amount of ERAF transferred to counties and cities to compensate for the diversion of these revenues.

We conducted this performance audit under the authority of Government Code sections 12468 and 12410. We did not audit the county's financial statements. We conducted this performance audit in accordance with generally accepted government auditing standards. 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. The audit covered the period of July 1, 2009, through June 30, 2014. Our audit scope was limited to:

- Reviewing operational procedures and significant applicable controls over the apportionment and allocation process;

- Examining selected property tax apportionment and allocation records; and
- Reviewing related property tax revenue data used to determine the apportionment and allocation computation process.

A property tax bill contains the property tax levied at a 1% tax rate pursuant to the requirement of Proposition 13. A bill also may contain special taxes, debt services levies on voter-approved debt, fees, and assessments levied by the county or a city. The scope of our audit is concerned with the distribution of the 1% tax levy. Special taxes, debt service levies on voter-approved debt, fees, and assessments levied by the county or a city are beyond the scope of our audit and were not reviewed or audited.

We limited our review of the county's internal controls to gaining an understanding of the transaction flow in order to develop appropriate auditing procedures. We did not evaluate the effectiveness of all internal controls.

In addition, we tested transactions used to apportion and allocate property taxes and performed other procedures deemed necessary. This report relates solely to the method used by the county to apportion and allocate property taxes.

Conclusion

Our audit found that, except for the items discussed in the Findings and Recommendations section of this report, Merced County complied with California statutes for the apportionment and allocation of property tax revenues for the period of July 1, 2009, through June 30, 2014. The county should correct the items discussed in the Findings and Recommendations section.

Follow-up on Prior Audit Findings

The county has satisfactorily resolved the findings noted in our prior audit report, issued June 2010.

Views of Responsible Officials

We issued a draft audit report on December 31, 2015. Lisa Cardella-Presto, Auditor-Controller, responded by letter dated February 3, 2016 (Attachment), and with a subsequent email on February 3, 2016.

Restricted Use

This report is solely for the information and use of Merced County, the California Legislature, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

March 18, 2016

Findings and Recommendations

FINDING 1— Annual Tax Increment understated and misallocated

In fiscal year (FY) 2010-11 through FY 2013-14, the county understated the Educational Revenue Augmentation Fund (ERAF) base when computing the countywide apportionment (AB8) factors. This error caused a misallocation to the ERAF base revenue.

Requirements for the apportionment and allocation of the Annual Tax Increment (ATI) are found in Revenue and Taxation Code sections 96 through 96.5. The annual increment of property tax, which is the change in assessed value from one year to the next, is allocated to tax rate areas (TRA) on the basis of each TRA's share of the incremental growth in assessed valuations. The tax increment is then multiplied by the jurisdiction's annual tax increment apportionment factors for each TRA. These factors were developed in the 1979-80 base year and are adjusted for jurisdictional changes. The tax increment is then added to the tax computed for the prior fiscal year to develop the apportionment for the current fiscal year.

<u>Recommendation</u>

The county should correct the error in the ERAF base revenue.

<u>County's Response</u>

> The County concurs with this finding. The understated Education Revenue Augmentation Fund base revenue in the amount of $3,117 was reallocated for the fiscal year 2010-11 and subsequent years.

<u>SCO's Comment</u>

The SCO agrees with the county's corrective action. The SCO will review the implementation of the corrections during the next audit.

FINDING 2— Jurisdictional changes

In FY 2011-12, the county made an error in its jurisdictional changes calculation by not including Atwater City and Atwater City Fire in the new Tax Rate Area 001-031 under Board of Equalization Tax Rate Area Change Notice No. 2011-010. As a result, some jurisdictions received an incorrect apportionment of revenue.

The legal requirements for jurisdictional changes are found in Revenue and Taxation Code section 99. A jurisdictional change involves a change in the organization or boundaries of a local government agency or school district. Normally, these are service area or responsibility changes between the local jurisdictions. As part of the jurisdictional change, the local government agencies are required to negotiate any exchange of base year property tax revenue and annual tax increment. After the jurisdictional change, the local agency whose responsibility increased receives additional annual tax increment, and the base property tax revenues are adjusted according to the negotiated agreements.

Recommendation

The county should review and correct the error in its jurisdictional changes calculation.

County's Response

> The County concurs with this finding. The Tax Rate Area 001-031 was adjusted to include the Atwater City and Atwater Fire incremental factors for distribution.

SCO's Comment

The SCO agrees with the county's corrective action. The SCO will review the implementation of the corrections during the next audit.

FINDING 3— Unitary and Operating Nonunitary apportionments

The county made the following errors in its calculation of unitary and operating nonunitary apportionment factors:

- In FY 2009-10 and FY 2011-12, there was an incorrect calculation of the unitary excess factors.
- In FY 2010-11 and FY 2013-14, incorrect prior year unitary factors were carried forward.

This resulted in misallocated property tax revenues to all jurisdictions that receive unitary property tax.

Requirements for the apportionment and allocation of unitary and operating nonunitary property taxes are found in Revenue and Taxation Code section 100.

Unitary properties are those properties on which the Board of Equalization "may use the principle of unit valuation in valuing properties of an assessee that are operated as a unit in the primary function of the assessee" (i.e., public utilities, railroads, or qualified electric properties). The Revenue and Taxation Code further states, "Operating nonunitary properties are those that the assessee and its regulatory agency consider to be operating as a unit, but the board considers not part of the unit in the primary function of the assessee."

In FY 1988-89, the Legislature established a separate system for apportioning and allocating the unitary and operating nonunitary property taxes. The Legislature established the unitary and operating nonunitary base year and developed formulas to compute the distribution factors for the fiscal years that followed.

Recommendation

The county should re-compute the unitary factors for all fiscal years noted above.

County's Response

> The County concurs with this finding. The County is in the process of recalculating excess factors and the carry forward for the fiscal year 2009-10 and subsequent years. The distributions will be adjusted to reflect the change in factors.

SCO's Comment

The SCO agrees with the county's corrective action. The SCO will review the implementation of the corrections during the next audit.

FINDING 4— Unitary railroad apportionment

The county made the following errors in its calculation of unitary railroad apportionment:

- In FY 2009-10, incorrect railroad factors were used in the allocation of property tax revenues, equal to 102% of prior year.
- In FY 2009-10 through FY 2011-12, and FY 2013-14:
    - Incorrect computations of the unitary railroad excess factors were used.
    - Some jurisdictions didn't receive unitary railroad excess allocation amounts.

This resulted in misallocated property tax revenues to all jurisdictions that receive unitary railroad property tax.

Requirements for the apportionment and allocation of unitary and operating nonunitary property taxes are found in Revenue and Taxation Code section 100.

Unitary properties are those properties on which the Board of Equalization "may use the principle of unit valuation in valuing properties of an assessee that are operated as a unit in the primary function of the assessee" (i.e., public utilities, railroads, or qualified electric properties). The Revenue and Taxation Code further states, "Operating nonunitary properties are those that the assessee and its regulatory agency consider to be operating as a unit, but the board considers not part of the unit in the primary function of the assessee."

In FY 1988-89, the Legislature established a separate system for apportioning and allocating the unitary and operating nonunitary property taxes. The Legislature established the unitary and operating nonunitary base year and developed formulas to compute the distribution factors for the fiscal years that followed.

Recommendation

The county should review and correct the railroad computations for all fiscal years noted above.

County's Response

> The County concurs with this finding. The County is in the process of recalculating excess factors and the carry forward for the fiscal year 2009-10 and subsequent years. The distributions will be adjusted to reflect the change in factors.

SCO's Comment

The SCO agrees with the county's corrective action. The SCO will review the implementation of the corrections during the next audit.

FINDING 5— Educational Revenue Augmentation Fund

The county made the following errors when computing the ERAF growth:

- From FY 2009-10 through FY 2013-14, incorrect RDA increment values were used in computing the ERAF growth percentages.
- In FY 2011-12, the ERAF Base Tax wasn't carried forward correctly from the prior year Gross Tax.

This resulted in incorrect ERAF growth percentages for all contributing agencies for all fiscal years noted above (Schedule 1).

Requirements for the local agency shift of property tax revenues to the Educational Revenue Augmentation Fund (ERAF) primarily are found in Revenue and Taxation Code sections 97.1 through 97.3. Beginning in FY 1992-93, most local agencies were required to shift an amount of property tax revenues to the ERAF using formulas detailed in the code. The property tax revenues in the ERAF are subsequently allocated to the public schools using factors supplied by the county superintendent of schools.

For FY 1992-93, the ERAF shift amount for cities was determined by adding a per capita amount to a percentage of property tax revenues received by each city. The amount for counties was determined by adding a flat amount, adjusted for growth, to a per capita amount. The amount for special districts generally was determined by shifting the lesser of 10% of that district's total annual revenues as shown in the FY 1989-90 edition of the State Controller's Report on Financial Transactions Concerning Special Districts, or 40% of the FY 1991-92 property tax revenues received, adjusted for growth. Specified special districts were exempted from the shift.

For FY 1993-94, the ERAF shift for cities and counties generally was determined by:

- Reducing the FY 1992-93 ERAF shift by the FY 1992-93 per capita shift;
- Adjusting the result for growth; and
- Adding the result to a flat amount and a per capita amount determined by the Department of Finance, adjusted for growth.

The FY 1993-94 ERAF shift for special districts, other than fire districts, generally was determined by:

- Multiplying the property tax allocation for FY 1992-93, pre-ERAF, by the Special District Augmentation Fund (SDAF) factor for the district effective on June 15, 1993;
- Adjusting this amount by subtracting the FY 1992-93 shift to the ERAF;
- If the above amount is greater than zero, adjusting this amount for FY 1993-94 growth (zero is used for negative amounts); and
- Adding this amount to the FY 1992-93 ERAF shift, adjusting for growth.

For fire districts, the FY 1993-94 ERAF shift generally was determined by:

- Deducting the FY 1992-93 ERAF shift for the district from the FY 1992-93 property tax allocation;
- Multiplying the result by the SDAF factor for the district effective on June 13, 1993 (net current-year bailout equivalent);
- For a district governed by a board of supervisors, deducting the amount received from the SDAF in FY 1992-93 from the net current-year bailout equivalent; or, for an independent district, deducting the amount received from the SDAF and the difference between the net current-year bailout equivalent and the amount contributed to the SDAF from the net current-year bailout equivalent;
- Adjusting this amount for growth; and
- Adding this amount to the FY 1992-93 ERAF shift, adjusted for growth.

For fiscal years subsequent to FY 1993-94, the amounts determined are adjusted for growth annually to determine the ERAF shift amounts for that year.

<u>Recommendation</u>

The county should correct the above error by re-computing the ERAF growth percentages.

<u>County's Response</u>

> The County concurs with this finding. The ERAF growth percentages have been recomputed.

<u>SCO's Comment</u>

The SCO agrees with the county's corrective action. The SCO will review the implementation of the corrections during the next audit.

**FINDING 6—
Vehicle Licensing Fee and Sales and Use Tax adjustments**

The county did not included the utility assessed values when computing the VLF Swap growth for FY 2009-10 through FY 2013-14.

This resulted in a misstatement of VLF Swap amounts for all contributing agencies for all fiscal years of the audit (Schedule 1.)

Requirements for the ERAF adjustment for the VLF and SUT are found in Revenue and Taxation Code sections 97.68-97.70.

In FY 2004-05 the county was given a VLF estimate that was to be transferred from the ERAF to the Vehicle License Fee Property Tax Compensation Fund, and eventually to the county and cities. In FY 2005-06, the county was given another estimate, including true-ups. In FY 2006-07 and subsequent years, the county calculated the VLF adjustment based on the prior year VLF adjusted for growth. The growth for the county's VLF should be based on countywide growth, not only on unincorporated parcels. The growth for each city's VLF should be based on the growth of all incorporated parcels in all Tax Rate Areas within the city.

The SUT amounts for each county and cities within the county are provided by the Department of Finance, on or before September 1 of each fiscal year. These amounts are to be transferred from the ERAF to the SUT Compensation Fund, and eventually to each designated county and cities within each county.

<u>Recommendation</u>

The county should correct the VLF growth calculation by including the utility assessed value.

In May 2015, the county corrected the above error and implemented the change to its FY 2014-15 VLF allocations.

<u>County's Response</u>

> The County concurs with this finding. The 2014-15 VLF growth calculation was corrected by including the utility assessed value and implemented the change to the 2014-15 VLF allocations.

<u>SCO's Comment</u>

The SCO agrees with the county's response.

Attachment— County's Response to Draft Audit Report

MERCED COUNTY

AUDITOR-CONTROLLER

Lisa Cardella-Presto, CPA
Auditor-Controller

2222 "M" Street
Merced, CA 95340
(209) 385-7511
(209) 725-3900 Fax
www.co.merced.ca.us

Equal Opportunity Employer

February 3, 2016

State of California
State Controller's Office
Division of Audits
Attn.: Elizabeth Gonzalez, Chief
P. O. Box 942850
Sacramento, CA 94250-5874

Subject: Audit of Merced County Property Tax Apportionment and Allocation System for the Period July 1, 2009, through June 30, 2014

In response to the review of the Property Tax Apportionment and Allocation System for Merced County draft audit report, below are our comments addressing the findings and recommendations.

Finding 1 - Annual Tax Increment Understated and Misallocated

County's Response
The County concurs with this finding. The understated Education Revenue Augmentation Fund base revenue in the amount of $3,117 was reallocated for the fiscal year 2010-11 and subsequent years.

Finding 2 – Jurisdictional changes

County's Response
The County concurs with this finding. The Tax Rate Area 001-031 was adjusted to include the Atwater City and Atwater Fire incremental factors for distribution.

Finding 3 – Unitary and Operating Nonunitary Apportionments

County's Response

The County concurs with this finding. The County is in the process of recalculating excess factors and the carry forward for the fiscal year 2009-10 and subsequent years. The distributions will be adjusted to reflect the change in factors.

Finding 5 – Education Revenue Augmentation Fund (ERAF)

County's Response

The County concurs with this finding. The ERAF growth percentages have been re-computed.

Finding 6 – Vehicle License Fee and Sales and Use Tax Adjustments

County's Response

The County concurs with this finding. The 2014-15 VLF growth calculation was corrected by including the utility assessed value and implemented the change to the 2014-15 VLF allocations.

Our office appreciates the Controller's office's consideration of our heavy workload periods and the professionalism and courtesy displayed by the field auditors. If you have any questions or require further information, please contact me at (209) 385-7511.

Sincerely,

Lisa Cardella-Presto

Lisa Cardella-Presto, CPA
Auditor-Controller

State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874

http://www.sco.ca.gov

S15-PTX-0007