

# **HUMBOLDT COUNTY**

Audit Report

## **PROPERTY TAX APPORTIONMENT AND ALLOCATION SYSTEM**

*July 1, 2003, through June 30, 2008*



**JOHN CHIANG**  
California State Controller

June 2010



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**California State Controller**

June 30, 2010

The Honorable Michael J. Giacone  
Auditor-Controller  
Humboldt County  
825 5<sup>th</sup> Street  
Eureka, CA 95501

Dear Mr. Giacone:

The State Controller's Office (SCO) audited the methods employed by Humboldt County to apportion and allocate property tax revenues for the period of July 1, 2003, through June 30, 2008. The audit was conducted pursuant to the requirements of Government Code section 12468.

Our audit disclosed that, except for the items discussed in this report, Humboldt County complied with California statutes for the appropriation and allocation of property tax revenues for the period of July 1, 2003, through June 30, 2008.

Subsequent to the issuance of our draft audit report dated August 19, 2009, the county submitted information relating to its property tax apportionment computations for fiscal year 2009-10. We reviewed the information and determined that the county's property tax apportionment system computed negative property tax revenues from two jurisdictions, even though significant property tax revenue was generated within the jurisdictions' service area. Although we noted this discrepancy in only two jurisdictions, it indicates a larger problem wherein tax revenues that should be distributed to these two jurisdictions are instead distributed to other jurisdictions. We are, therefore, compelled to bring this to the county's attention so that it can implement corrective measures to ensure equitable and reliable property tax distributions to all jurisdictions under its control.

If you have any questions, please contact Steven Mar, Chief, Local Government Audits Bureau, at (916) 324-7226.

Sincerely,

*Original signed by*

**JEFFREY V. BROWNFIELD**  
Chief, Division of Audits

JVB/vb

# Contents

## **Audit Report**

<b>Summary</b> .....	1
<b>Background</b> .....	2
<b>Objective, Scope, and Methodology</b> .....	3
<b>Conclusion</b> .....	5
<b>Follow-Up on Prior Audit Findings</b> .....	6
<b>Views of Responsible Official</b> .....	6
<b>Restricted Use</b> .....	6
<b>Findings and Recommendations</b> .....	7
<b>Attachment—County’s Response to Draft Audit Report</b>	

# Audit Report

## Summary

The State Controller's Office (SCO) audited the methods employed by Humboldt County to apportion and allocate property tax revenues for the period of July 1, 2003, through June 30, 2008.

Our audit disclosed that, except for the items discussed in the Findings and Recommendations section of this report, Humboldt County complied with California statutes for the appropriation and allocation of property tax revenues for the period of July 1, 2003, through June 30, 2008.

During the audit, we noted that the county had not satisfactorily resolved one prior audit finding noted in our audit report issued October 18, 2005, related to the factor adjustments for a new tax rate area involved in a city annexation.

In addition, the county included the Educational Revenue Augmentation Fund (ERAF) in the unitary and operating nonunitary tax apportionment computation during this audit period. The ERAF is not a taxing agency.

During this audit period, we also reviewed the county's methodology in distributing the cost of the tax refunds after the successful assessment appeal by two major companies located in Humboldt County.

The audit disclosed that the county did not proceed correctly in imposing, in effect, the cost of the tax refunds on all taxing agencies within the county. The county excluded only the redevelopment agencies from the recalculation of the statutory allocation formula rather than making the appropriate adjustments to the affected agencies. These agencies were charged a share of the tax refund regardless of the situs of the property.

Prior to fiscal year (FY) 2006-07, counties could not impose a fee, charge, or other levy on a city, or reduce a city's allocation of ad valorem property tax revenue in reimbursement for the services performed by the county under Revenue and Taxation Code sections 97.68 and 97.70. Pursuant to Revenue and Taxation Code section 97.75, beginning with FY 2006-07, a county may impose a fee, charge, or other levy on a city for these services, but the fee, charge, or other levy cannot exceed the actual cost of providing the services.

A dispute has arisen between the counties and the cities regarding the application of Revenue and Taxation Code section 95.3 relating to the computation of Property Tax Administration Fees (PTAF). The counties generally contend that distribution factors for purposes of distributing PTAF to taxing agencies should be computed including amounts received by cities under Revenue and Taxation Code section 97.68, commonly known as the "Triple Flip," and section 97.70, commonly known as the "VLF Swap." The cities generally believed that the Triple Flip and the VLF Swap should be excluded from the computation.

We are aware of two legal actions that have been filed on this issue.

- In the first action, 47 cities in Los Angeles County filed suit against the county. On June 2, 2009, the court referee determined that the method used by Los Angeles County was correct.
- In the second action, filed in Fresno County, seven cities filed suit against the county. In this action, the court ruled that the method used by Fresno County was not in accordance with statute. This is the same method approved by the referee in Los Angeles County.

The SCO will make a determination on the computation of the PTAF at such time as appeals (if any) are resolved.

## **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 8, which established the method of allocating property taxes for 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 operating nonunitary property from the AB 8 system. This revenue is now allocated and apportioned under a separate system.

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 and railroad 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, legislation (SB 418) was enacted in 1985 that requires 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 systems for apportioning and allocating property tax revenues used by the county auditor and the subsystems used by the tax collector and the assessor.

We performed the following procedures:

- Performed 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 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 property tax refunds and assessment appeals correspondence and reports prepared by the county to determine the methodology for allocating property taxes in the event of a change in any tax or assessment by refund.

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, 2003, through June 30, 2008. However, we did not audit the county's financial statements. 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.

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 disclosed that, except for the items discussed in the Findings and Recommendations section of this report, Humboldt County complied with California statutes for the apportionment and allocation of property tax revenues for the period of July 1, 2003, through June 30, 2008. The county should correct the items discussed in the Findings and Recommendations section.

Prior to FY 2006-07, counties could not impose a fee, charge, or other levy on a city, or reduce a city's allocation of ad valorem property tax revenue in reimbursement for the services performed by the county under Revenue and Taxation Code sections 97.68 and 97.70. Pursuant to Revenue and Taxation Code section 97.75, beginning with FY 2006-07, a county may impose a fee, charge, or other levy on a city for these services, but the fee, charge, or other levy cannot exceed the actual cost of providing the services.

A dispute has arisen between the counties and the cities regarding the application of Revenue and Taxation Code section 95.3 relating to the computation of Property Tax Administration Fees (PTAF). The counties generally contend that distribution factors for purposes of distributing PTAF to taxing agencies should be computed including amounts received by cities under Revenue and Taxation Code section 97.68, commonly known as the "Triple Flip," and section 97.70, commonly known as the "VLF Swap." The cities generally believed that the Triple Flip and the VLF Swap should be excluded from the computation.

We are aware of two legal actions that have been filed on this issue.

- In the first action, 47 cities in Los Angeles County filed suit against the county. On June 2, 2009, the court referee determined that the method used by Los Angeles County was correct.
- In the second action, filed in Fresno County, seven cities filed suit against the county. In this action, the court ruled that the method used by Fresno County was not in accordance with statute. This is the same method approved by the referee in Los Angeles County.

The SCO will make a determination on the computation of the PTAF at such time as appeals (if any) are resolved.

**Follow-up on Prior  
Audit Findings**

Findings noted in our prior audit, issued October 18, 2005, have been satisfactorily resolved by the county, with the exception of one finding related to the factor adjustments for a new tax rate area (TRA) involved in the City of Trinidad annexation. This finding is described in the Findings and Recommendations section of this report under Finding 1.

**Views of  
Responsible  
Official**

We issued a revised draft audit report dated April 19, 2010. Joseph Mellett, Deputy Auditor-Controller, responded by e-mail on May 11, 2010. His response is included as an attachment to this report.

**Restricted Use**

This report is solely for the information and use of Humboldt 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  
Chief, Division of Audits

June 30, 2010

# Findings and Recommendations

## **FINDING 1— Jurisdictional changes**

The county failed to satisfactorily resolve one finding related to the factor adjustments for a new tax rate area (TRA) involved in the City of Trinidad annexation; this finding was noted in the prior SCO audit, dated October 18, 2005.

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 make the proper factor adjustments for the new TRA to complete the annexation.

### County's Response

We concur with the finding and have made the necessary corrections.

## **FINDING 2— Unitary and operating nonunitary apportionment**

The county included the Educational Revenue Augmentation Fund (ERAF) in the unitary and operating nonunitary tax apportionment computation during this audit period.

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 and railroads). 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 fiscal year 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 not include the ERAF in future unitary and operating nonunitary tax apportionment computations, as the ERAF does not qualify as a “taxing jurisdiction” under Revenue and Taxation Code section 100. Thus, the ERAF is not eligible to share and its amount should be distributed proportionately among all taxing jurisdictions that contributed to the fund.

County’s Response

The County of Humboldt did not include ERAF in unitary tax apportionment calculations until 2004-05 when we were specifically directed to do so by SCO staff as part of the SB 1096 implementation. The reasons for the Controller’s change of opinion on this matter are irrelevant to us but the fact remains that clear and unambiguous guidance on this aspect of the property tax apportionment process is not present in the law.

The County of Humboldt is indifferent as to whether or not ERAF should be included in unitary apportionments – the dollar amounts involved in this County are immaterial. We recommend that the SCO work with the State Association of County Auditors to promulgate some uniform standards on this issue that all the counties can follow rather than use audit findings to promote unwritten policies on a county-by-county basis. Once uniform printed standards are worked out we will comply with whatever guidance those standards provide.

SCO’s Comment

Our finding and recommendation remain unchanged.

The response states that Humboldt County is indifferent as to whether or not the ERAF should be included in unitary apportionments. However, the ERAF is a fund, an accounting entity, and not a taxing jurisdiction. Revenue and Taxation Code section 100 requires that taxes from unitary and operating nonunitary property be allocated to taxing jurisdictions. As the ERAF is not a taxing jurisdiction, it is not eligible to receive unitary and operating nonunitary taxes.

**FINDING 3—  
Property tax refunds  
and assessment appeals**

A taxpayer may appeal the taxes levied against property owned if the taxpayer feels that the assessment is in error and has resulted in the taxpayer paying too much property tax. It has been the policy of Humboldt County, when there is a successful assessment appeal by a taxpayer, to require the resulting property tax refund to be paid proportionately by all agencies in the county, including redevelopment agencies that receive property taxes through the county’s AB 8 tax allocation process. The result is that agencies that did not receive property taxes from the tax rate area where the successful appellant resided must repay a share of the refund from taxes levied and collected from other tax rate areas.

During this audit period, there were two large assessment appeals that were resolved in the taxpayers' favor, resulting in a refund of property taxes to the taxpayers. Several redevelopment agencies in the county did not believe that it was proper for the county to "charge" them for a portion of the refund, as they did not receive property taxes from the tax rate areas where the successful appellants were located. They consequently requested that the SCO review the matter.

Upon completion of the review, we concluded that only agencies within the tax rate areas of the successful appellants should be charged for the refund. Nevertheless, the county still charged all agencies a share of the refund. County personnel stated that its refund methodology has since been changed to exclude redevelopment agencies, but that it will still charge all other agencies for a share of the refund. We believe this methodology is still incorrect.

The basis of the property tax system is *situs*, that is, where the property is located. Property is assessed by its location and local agencies receive a share of the taxes generated if services are provided to that location. By charging agencies outside the taxpayer's area in order to repay a portion of the taxes levied in the taxpayer's area, the county is essentially transferring property taxes levied for, and paid to, agencies outside the taxpayer's area to agencies within the taxpayer's area. We are unaware of any statute that would allow such a transfer.

County personnel also stated that the redevelopment agencies had agreed to this methodology during this audit period after the county informed them that they had been paid too much property tax for certain years, and that if they wanted to be excluded from the refund, they would also have to pay back the overpayment. County personnel stated that this overpayment resulted because the county had collected more taxes than was used in the computations. It is unclear how the redevelopment agencies could be overpaid if the county is a "Teeter" county, in which all agencies essentially receive their proportionate share of taxes levied, not taxes collected. In addition, redevelopment agencies are to receive the taxes only from the tax increment generated within its area. If the redevelopment agency received more than the generated tax increment, then other agencies within the county did not receive enough property taxes. Again, the county may have transferred property taxes between areas and agencies within the county.

Revenue and Taxation Code section 4701 et seq. provides an alternative for the distribution of property tax levies on the secured roll made by the counties. In the event of a change in any tax or assessment by correction, cancellation, or refund, section 4707 expressly provides for a "pro rata adjustment for the amount of such change . . . in each of the funds to which apportionment previously has been made."

#### Recommendation

The county should change its methodology for distributing the cost of the tax refunds by making the appropriate adjustments only to the affected agencies, rather than all agencies. These agencies were charged a share of the tax refund regardless of the situs of the property.

### County's Response

We are guided by Revenue and Taxation Code Section 4707, which requires that any refunding adjustment to the tax roll be apportioned in the same manner that the tax revenue was originally apportioned, i.e. create a negative apportionment to adjust the earlier positive apportionment of tax revenues. In Humboldt County all \$1.00 property tax apportionments are distributed to every taxing agency in the County, not just to the agencies in the tax rate areas where the tax dollars originate. Therefore, our policy has been to allocate the cost of any refund to the entire tax pool when we are required to adjust the rolls.

However, we do understand the nature of the Controller's recommendation and it presents some concerns for us. Our primary concern is that the schools' ERAF fund exists only at the jurisdictional level in this County. If we were to allocate the cost of refunds at the TRA level we would have to create a methodology for recouping overpaid tax revenue from the ERAF fund. If we did not recoup tax refunds from ERAF we would violate R&T 4707. ERAF takes about twenty percent of the tax revenue from the countywide AB8 distribution but its impact varies among the different agencies. ERAF takes forty-three percent of the County General fund's revenue but much less from other agencies so any calculation taking ERAF down to the TRA level would have to accommodate those disparities.

Another concern is for the complexity of administering a TRA-based refunding system. We probably couldn't justify the staff time involved in performing the calculations described above for every little refund, so we would have to set a dollar threshold above which we employ the TRA-based system. By contrast, our current system of applying refunds to the entire AB8 pool is very simple and makes no distinction for the size of the refund.

Resolving these concerns requires that we do more research before we can commit to changing our current policy. We will consult with other counties to see what they are doing with refunds and what systems they have in place to accurately allocate the cost of refunds. We will keep the Controller informed as to what our future policy is going to be regarding this matter.

### SCO's Comment

Our finding and recommendation remain unchanged.

A property tax concept is that property taxes on real property are determined by the situs of the property. Under the county's procedure of adjusting apportionments of all taxing agencies, the intent is to spread the refund burden to all agencies. The effect, however, is to force agencies that did not receive revenues from the erroneously assessed properties to subsidize the other taxing agencies that did benefit from the excessive assessments. This result is inconsistent with the provisions and intent of Revenue and Taxation Code section 4707, and with the statutory formula governing the allocation of property taxes.

If an apportionment was made to a taxing agency that included a portion of revenues derived from an incorrect assessment valuation, then a pro rata adjustment should be made in the agency's apportionment. But if a taxing agency did not receive revenues attributable to the erroneous valuation assessments, then there is no purpose or reason for adjusting its allocation of property tax revenues.

**Attachment—  
County's Response to  
Draft Audit Report**

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**County of Humboldt**  
**Response to State Controller's Audit Findings**  
**For the period from July 1, 2003 through June 30, 2008**

**Finding 1** – That incorrect factors were used in a new tax rate area in Trinidad.

**Response** – We concur with the finding and have made the necessary corrections.

**Finding 2** – That the County of Humboldt improperly includes the ERAF fund in unitary tax apportionment computations.

**Response** – The County of Humboldt did not include ERAF in unitary tax apportionment calculations until 2004-05 when we were specifically directed to do so by SCO staff as part of the SB 1096 implementation. The reasons for the Controller's change of opinion on this matter are irrelevant to us but the fact remains that clear and unambiguous guidance on this aspect of the property tax apportionment process is not present in the law.

The County of Humboldt is indifferent as to whether or not ERAF should be included in unitary apportionments – the dollar amounts involved in this County are immaterial. We recommend that the SCO work with the State Association of County Auditors to promulgate some uniform standards on this issue that all the counties can follow rather than use audit findings to promote unwritten policies on a county-by-county basis. Once uniform printed standards are worked out we will comply with whatever guidance those standards provide.

**Finding 3** – That the County of Humboldt improperly distributes the cost of \$1.00 rate tax refunds to the entire \$1.00 rate pool instead of confining those refunds to the agencies operating in the tax rate area where the refunded property is sited.

**Response** – We are guided by Revenue and Taxation Code Section 4707, which requires that any refunding adjustment to the tax roll be apportioned in the same manner that the tax revenue was originally apportioned, i.e. create a negative apportionment to adjust the earlier positive apportionment of tax revenues. In Humboldt County all \$1.00 property tax apportionments are distributed to every taxing agency in the County, not just to the agencies in the tax rate areas where the tax dollars originate. Therefore our policy has been to allocate the cost of any refund to the entire tax pool when we are required to adjust the rolls.

However, we do understand the nature of the Controller's recommendation and it presents some concerns for us. Our primary concern is that the schools' ERAF fund exists only at the jurisdictional level in this County. If we were to allocate the cost of refunds at the TRA level we would have to create a methodology for recouping overpaid tax revenue from the ERAF fund. If we did not recoup tax refunds from ERAF we would

violate R&T 4707. ERAF takes about twenty percent of the tax revenue from the countywide AB8 distribution but its impact varies among the different agencies. ERAF takes forty-three percent of the County General fund's revenue but much less from other agencies so any calculation taking ERAF down to the TRA level would have to accommodate those disparities.

Another concern is for the complexity of administering a TRA-based refunding system. We probably couldn't justify the staff time involved in performing the calculations described above for every little refund, so we would have to set a dollar threshold above which we employ the TRA-based system. By contrast, our current system of applying refunds to the entire AB8 pool is very simple and makes no distinction for the size of the refund.

Resolving these concerns requires that we do more research before we can commit to changing our current policy. We will consult with other counties to see what they are doing with refunds and what systems they have in place to accurately allocate the cost of refunds. We will keep the Controller informed as to what our future policy is going to be regarding this matter.

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