

SAN BENITO COUNTY

Audit Report

PROPERTY TAX APPORTIONMENT AND ALLOCATION SYSTEM

July 1, 2002, through June 30, 2008



JOHN CHIANG
California State Controller

August 2009



JOHN CHIANG
California State Controller

August 31, 2009

The Honorable Joe Paul Gonzalez
Clerk, Auditor & Recorder
San Benito County
481 Fourth Street, 2nd Floor
Hollister, CA 95023-3840

Dear Mr. Gonzalez:

The State Controller's Office audited the methods employed by San Benito County to apportion and allocate property tax revenues for the period of July 1, 2002, through June 30, 2008. The audit was conducted pursuant to the requirements of Government Code section 12468.

Our audit disclosed that the county complied with California statutes, except that it did not reimburse Educational Revenue Augmentation Fund for a prior year revenue error in the amount of \$3,854,957.

Additionally, we noted the following observation. Prior to fiscal year (FY) 2006-07, counties could not impose a fee, charge, or other levy on a city, nor reduce a city's allocation of ad valorem property tax revenues, 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 legal challenge has arisen regarding the method a county has used to impose the fee for the services provided under Revenue and Taxation Code sections 97.68 and 97.70. San Benito County has used the same method to impose the fee. The legal challenge has raised the possibility that the county may not be in compliance with the Revenue and Taxation Code. At this time, this finding does not warrant a reportable condition, but is only an observation until the legal issues are resolved. After all legal challenges are resolved, this process will be reviewed again to determine if any adjustments or corrections are warranted and the report will be modified accordingly.

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

cc: Jody Martin

 Joint Legislative Budget Committee
 Peter Detwiler, Consultant
 Senate Local Government Committee
 Elvia Dias, Assistant
 Senate Local Government Committee
 Dixie Martineau-Petty, Secretary
 Assembly Local Government Committee
 Martin Helmke, Consultant
 Senate Revenue and Taxation Committee
 Kimberly Bott, Chief Consultant
 Assembly Revenue and Taxation Committee
 Catherine Smith, Executive Director
 California Special Districts Association

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Audit Report

Summary

The State Controller's Office (SCO) audited the methods employed by San Benito County to apportion and allocate property tax revenues for the period of July 1, 2002, through June 30, 2008.

Our audit disclosed that the county complied with California statutes for the allocation and apportionment of property tax revenues, except that it did not reimburse Educational Revenue Augmentation Fund for a prior year revenue error in the amount of \$3,854,957.

Additionally, we noted the following observation. Prior to fiscal year (FY) 2006-07, counties could not impose a fee, charge, or other levy on a city, nor 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 levy cannot exceed the actual cost of providing the services.

A legal challenge has arisen regarding the method a county has used to impose the fee for the services provided under Revenue and Taxation Code sections 97.68 and 97.70. San Benito County has used the same method to impose the fee. The legal challenge has raised the possibility that the county may not be in compliance with the Revenue and Taxation Code. At the time, this finding does not warrant a reportable condition, but is only an observation until the legal issues are resolved. After all legal challenges are resolved, this process will be reviewed again to determine if any adjustments or corrections are warranted and the report will be modified accordingly.

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.

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, 2002, through June 30, 2008. 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 Finding and Recommendation section of this report, San Benito County complied with California statutes for the apportionment and allocation of property tax revenues for the period of July 1, 2002, through June 30, 2008. The county should correct the item discussed in the Finding and Recommendation section.

Additionally, we noted the following observation. Prior to FY 2006-07, counties could not impose a fee, charge, or other levy on a city, nor 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 levy can not exceed the actual cost of providing the services.

A legal challenge has arisen regarding the method a county has used to impose the fee for the services provided under Revenue and Taxation Code sections 97.68 and 97.70. San Benito County has used the same method to impose the fee. The legal challenge has raised the possibility that the county may not be in compliance with the Revenue and Taxation Code. At this time, this finding does not warrant a reportable condition, but is only an observation until the legal issues are resolved. After all legal challenges are resolved, this process will be reviewed again to determine if any adjustments or corrections are warranted and the report will be modified accordingly.

**Follow-up on Prior
Audit Findings**

Findings noted in our prior audit, issued July 28, 2005, have been satisfactorily resolved by the county, with the exception of the ERAF being underfunded as described in the Finding and Recommendation section of this report.

**Views of
Responsible
Official**

We issued a draft audit report on January 9, 2009. Joe Paul Gonzalez, County Clerk, Auditor & Recorder, responded by letter dated January 30, 2009 (Attachment), disagreeing with the audit results. The county's response and the SCO's comment are included in the Finding and Recommendation section.

In addition, in its response, the county addresses an issue regarding the exclusion of the ERAF from the unitary and operating nonunitary apportionment process. The county's comment and the SCO's response are included in the Finding and Recommendation section.

Restricted Use

This report is solely for the information and use of San Benito 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

August 31, 2009

**Schedule 1—
Summary of Underallocation to the
Educational Revenue Augmentation Fund
July 1, 2002, through June 30, 2008**

<u>Fiscal Year</u>	<u>Allocation by County</u>	<u>State Amount per Audit</u>	<u>Audit Adjustment ¹</u>
July 1, 1993, through June 30, 1997	\$ —	\$ (514,016)	\$ (514,016)
July 1, 1997, through June 30, 2001	—	3,929,689	3929,689
July 1, 2001, through June 30, 2002	—	439,284	439,284
Totals	<u>\$ —</u>	<u>\$ 3,854,957</u>	<u>\$ 3,854,957</u>

¹ See the Finding and Recommendation section.

Finding and Recommendation

FINDING— Underallocation to Educational Revenue Augmentation Fund

In a previous SCO audit, issued December 11, 1998, we determined that the Educational Revenue Augmentation Fund (ERAF) was underfunded by \$514,016. The county did not reimburse the ERAF for this amount. In our subsequent audit issued on July 28, 2005, the same amount had grown to \$3,929,689. Per Revenue and Taxation Code section 96.81, the \$514,016 is forgiven but the difference of \$3,415,673 must be returned to the ERAF. Also, in the subsequent audit (July 28, 2005), new audit findings were discovered but are subject to a limit imposed by the Revenue and Taxation Code. The limit imposed by the Revenue and Taxation Code reduced this additional finding to \$439,284.

Requirements for the local agency shift of property tax revenues to the ERAF are primarily found in Revenue and Taxation Code sections 97.1 through 97.3. Beginning in fiscal year (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 was generally 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 was generally 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, was generally 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 was generally 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.

Recommendation

Although the property tax system has been fully corrected, the county must still reimburse the ERAF in the amount of \$3,854,957.

County's Response

We continue to be in disagreement with the interpretation by the State Controller's Office of Revenue and Taxation Code 96.1(b) and 96.1(c)(3) for the findings of the under-allocations of the Educational Revenue Augmentation Fund (ERAF) occurring in the prior periods of July 1, 1993 through June 30, 2001 and July 1, 2001 through June 30 2002.

SCO's Comment

As noted in the above finding, the county has not complied with Revenue and Taxation Code section 96.1 as referenced, and has not made the necessary adjustment. Therefore, the finding remains as stated.

**OTHER ISSUE—
Exclusion of the ERAF
from the unitary and
operating nonunitary
apportionment process**

In its response letter, the county raised an additional issue regarding the exclusion of the ERAF from the unitary and operating nonunitary apportionment process. The county's comment and the SCO's response are as follows.

County's Comment

During the course of this audit we were informed by your audit staff, that the State Controller's Office legal counsel had opined ERAF should not be used as part of the unitary tax formula. We disagree with that interpretation. The State Association of County Auditors (SACA) Property Tax Guidelines specifically includes ERAF in the Unitary Tax formula. Under protest and treat of listing this issue as an official audit finding we reluctantly recalculated and redistributed the amount from the ERAF shift back to the contributing agencies. Since the State Association of County Auditor's Property Tax Guidelines were approved by the State Controller's Office, the California State Association of Counties, the League of California Cities and the California Department of Finance, we believe that for consistent and equitable unitary tax revenue treatment that the SACA Property Tax Guidelines should be followed by the current State Controller's Administration.

SCO's Response

Revenue and Taxation Code section 100(c)(1) requires the allocation of unitary and operating nonunitary taxes to taxing jurisdictions. The ERAF is a fund—an accounting entity—not a taxing jurisdiction, and with respect to the allocation and apportionment of unitary and operating nonunitary taxes the California State Legislature has not defined it as a taxing jurisdiction.

Revenue and Taxation Code section 100(e)(3) includes a redevelopment agency as a taxing jurisdiction. This demonstrates that the Legislature can include non-taxing entities in the definition of a tax jurisdiction if it so chooses. In this case, the Legislature omitted the ERAF from the definition of taxing jurisdiction.

It is also important to point out that the State Controller's Office has never approved the Property Tax Guidelines.

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

JOE PAUL GONZALEZ
CLERK, AUDITOR & RECORDER



OFFICE OF THE COUNTY AUDITOR

481 Fourth Street, Second Floor
Hollister, California 95023

Telephone: (831) 636-4090
Facsimile: (831) 635-9340

COUNTY OF SAN BENITO

January 30, 2009

Mr. Steven Mar
Chief, Local Government Audits Bureau
State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

Dear Mr. Mar:

Please accept this as the County of San Benito's response to the State Controller's Office draft Audit Report on Property Tax Apportionment and Allocation System for the period of July 1, 2002 through June 30, 2008.

County's Response

During the course of this audit we were informed by your audit staff, that the State Controller's Office legal counsel had opined ERAF should not be used as part of the unitary tax formula. We disagree with that interpretation. The State Association of County Auditors (SACA) Property Tax Guidelines specifically includes ERAF in the Unitary Tax formula. Under protest and threat of listing this issue as an official audit finding we reluctantly recalculated and redistributed the amount from the ERAF shift back to the contributing agencies. Since the State Association of County Auditor's Property Tax Guidelines were approved by the State Controller's Office, the California State Association of Counties, the League of California Cities and the California Department of Finance, we believe that for consistent and equitable unitary tax revenue treatment that the SACA Property Tax Guidelines should be followed by the current State Controller's Administration.

We continue to be in disagreement with the interpretation by the State Controller's Office of Revenue and Taxation Code 96.1(b) and 96.1(c)(3) for the findings of the under-allocations of the Educational Revenue Augmentation Fund (ERAF) occurring in the prior periods of July 1, 1993 through June 30, 2001 and July 1, 2001 through June 30, 2002.

If you have any questions, please contact me at (831) 636-4090.

Sincerely,

Joe Paul Gonzalez
County Clerk, Auditor & Recorder

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

<http://www.sco.ca.gov>