NEVADA COUNTY

Audit Report

PROPERTY TAX APPORTIONMENT AND ALLOCATION SYSTEM

July 1, 2002, through June 30, 2010

JOHN CHIANG
California State Controller

August 2011

JOHN CHIANG
California State Controller

August 17, 2011

The Honorable Marcia L. Salter
Auditor-Controller
Nevada County
950 Maidu Avenue
Nevada City, CA 95959-8617

Dear Ms. Salter:

The State Controller's Office (SCO) audited the methods employed by Nevada County to apportion and allocate property tax revenues for the period of July 1, 2002, through June 30, 2010. 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 include the base year annexation adjustment amounts in the growth percentage calculation in fiscal year (FY) 2007-08 and FY 2009-10, thereby causing errors in the Educational Revenue Augmentation Fund (ERAF) shift amounts, Assembly Bill (AB) 8 revenues, and AB 8 apportionment factors for some agencies;

- Incorrectly computed the unitary and operating non-unitary property tax apportionment factors and allocations since FY 2002-03. In addition, it included the ERAF in the tax apportionment process;

- Miscalculated the growth percentages, and did not correctly carry forward some of the agencies' ERAF shift amounts (with growth) from the prior year, thereby causing errors in the ERAF shift amounts since FY 2003-04.

During the audit fieldwork, and with assistance from the SCO, the county re-computed the AB 8 system and made the proper adjustments to all but one of the affected areas. The county included the ERAF in the unitary and operating non-unitary tax apportionment process.

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/sk

cc: The Honorable Ed Scofield, Chair
Board of Supervisors, Nevada County
Jody Martin, Principal Consultant
Joint Legislative Budget Committee
Peter Detwiler, Staff Director
Senate Local Government Committee
Elvia Dias, Committee Assistant
Senate Local Government Committee
Dixie Martineau-Petty, Secretary
Assembly Local Government Committee
Gayle Miller, Staff Director
Senate Revenue and Taxation Committee
Oksana Jaffe, Chief Consultant
Assembly Revenue and Taxation Committee
Neil McCormick, Executive Director
California Special Districts Association

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Audit Report

Summary

The State Controller's Office (SCO) audited the methods employed by Nevada County to apportion and allocate property tax revenues for the period of July 1, 2002, through June 30, 2010.

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

- Did not include the base year annexation adjustment amounts in the growth percentage calculation in fiscal year (FY) 2007-08 and FY 2009-10, thereby causing errors in the Educational Revenue Augmentation Fund (ERAF) shift amounts, Assembly Bill (AB) 8 revenues, and AB 8 apportionment factors for some agencies.
- Incorrectly computed the unitary and operating non-unitary property tax apportionment factors and allocations since FY 2002-03. In addition, it included the ERAF in the tax apportionment process.
- Miscalculated the growth percentages, and did not correctly carry forward some of the agencies' ERAF shift amounts (with growth) from the prior year, thereby causing errors in the ERAF shift amounts since FY 2003-04.

During the audit fieldwork, and with assistance from the SCO, the county re-computed the AB 8 system and made the proper adjustments to all but one of the affected areas. The county included the ERAF in the unitary and operating non-unitary tax apportionment process.

Additionally, we made 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, for FY 2006-07 and thereafter, a county may impose a fee, charge, or other levy on a city for these services, but the fee, charge, or other levy shall not 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 believe 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 (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 system. These revenues are now allocated and apportioned under separate systems.

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, 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.

Therefore, our audit was conducted in accordance with Government Code section 12468.

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:

- 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 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 under the authority of Government Code sections 12468 and 12410. We did not audit he 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, 2002, through June 30, 2010. 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 may also 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 disclosed that, except for the items discussed in the Findings and Recommendations section of this report, Nevada County complied with California statutes for the apportionment and allocation of property tax revenues for the period of July 1, 2002, through June 30, 2010. The county should correct the items discussed in the Findings and Recommendations section.

Additionally, we made 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, for FY 2006-07 and thereafter, a county may impose a fee, charge, or other levy on a city for these services, but the fee, charge, or other levy shall not 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 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 believe 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 December 2003, have been satisfactorily resolved by the county, with the exception of the base revenue adjustments between the City of Grass Valley and the Consolidated Fire District. The county inadvertently removed $3,499 from Ophir Hill Fire District and transferred this base to the City of Grass Valley.

During the audit fieldwork, the county corrected the noted error and made the appropriate transfer to reflect the correct exchange of property tax revenues according to the resolutions. No further action is required.

Views of Responsible Official

We issued a draft audit report on May 18, 2011. Marcia L. Salter, Auditor-Controller, responded by letter dated June 10, 2011 (Attachment). She agreed with the audit results with the exception of the second part of Finding 2, the inclusion of ERAF in the unitary and operating nonunitary apportionment.

Restricted Use

This report is solely for the information and use of Nevada 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 17, 2011

Findings and Recommendations

FINDING 1— Calculation and distribution of ATI

In fiscal year (FY) 2007-08 and FY 2009-10, the county did not include the base year annexation adjustment amounts in the growth percentage calculation, thereby causing errors in the Educational Revenue Augmentation Fund (ERAF) shift amounts, Assembly Bill (AB) 8 revenues, and AB 8 apportionment factors for some agencies.

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.

Recommendation

During the audit fieldwork, the county re-computed the AB 8 system and made the proper adjustments to the base year amounts and growth percentages. The county then provided the SCO with copies of the corrected AB 8 documents. We will review the tax allocations again during the next audit to ensure that the county implemented the correction for FY 2010-11 and each fiscal year thereafter.

County's Response

> The County does concur with this finding and will implement the correction.

FINDING 2— Unitary and operating nonunitary apportionment

The unitary and operating non-unitary property tax apportionment factors and allocations have not been computed correctly since FY 2002-03. In addition, the ERAF was included in the tax apportionment process.

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 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

During the audit fieldwork, the county corrected the unitary and operating non-unitary property tax apportionment factors and made the appropriate adjustments to the affected agencies. The county then provided the SCO with copies of the corrected unitary property tax documents. We will review the unitary and operating non-unitary allocations again during the next audit to ensure that the county implemented the correction for FY 2010-11 and each fiscal year thereafter.

The county should not include the ERAF in future unitary and operating non-unitary 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 does concur that the unitary and operating non-unitary apportionment factors and allocations were not computed correctly since 2002-03. This correction will be implemented.
>
> The County respectively disagrees with the finding that the Educational Revenue Augmentation Fund (ERAF) should be excluded from the unitary and non-unitary tax apportionment computations. This finding is not consistent with the results of our prior tax audit for the period of July 1, 1997 through June 30, 2002. In our prior audit, the ERAF computation was included in the same manner and a finding noted that it had been under allocated by $91,755. We have consistently followed the methodology of the computation as outlined in the Tax Manager's Reference Manual as approved by the State Association of County Auditors. We consider this methodology to be in accordance with the R&T Code section 100.

SCO's Comment

Our finding and recommendation relating to the inclusion of the ERAF in the unitary and operating nonunitary apportionment remain unchanged.

The ERAF is a fund—an accounting entity—not a taxing jurisdiction. Revenue and Taxation Code section 100 requires that taxes from unitary and operating 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.

The county states that the Finding is not consistent with the prior SCO audit from July 1, 1997, through June 30, 2002. We acknowledge that the county's methodology was found to be in compliance in previous audits, because in our audit reports issued prior to FY 2004-05, we stated that the ERAF should receive unitary and operating nonunitary revenues. However, at the request of another county, the SCO revisited the issue and determined that because the ERAF was not a taxing jurisdiction, it was not eligible to receive unitary and operating nonunitary revenues.

Additionally, the county also stated that it will continue to follow the guidelines from the Tax Managers Reference Manual to allocate unitary and operating nonunitary tax to the ERAF. While we acknowledge the fact that the Tax Managers' Reference Manual is a guide, we audit to applicable statutes.

FINDING 3— Educational Revenue Augmentation Fund (ERAF)

The errors in the AB 8 system, identified in Finding 1, and the failure to carry forward the correct ERAF shift amounts (with growth) from the prior year, caused the ERAF shift amounts for some agencies to be incorrect since FY 2003-04.

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 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

During the audit fieldwork, the county corrected the growth percentages and ERAF shift amounts. The county then provided the SCO with copies of the corrected ERAF shift documents. We will review the ERAF shift amounts again during the next audit to ensure that the county implemented the correction for FY 2010-11 and each fiscal year thereafter.

County's Response

> The County does concur with the finding and will implement the corrections.

Attachment— County's Response to Draft Audit Report

State of California
COUNTY OF NEVADA
MARCIA L. SALTER – Auditor-Controller

Auditor-Controller
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June 10, 2011

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

Dear Mr. Mar,

I have reviewed your draft audit report of the Nevada County's Property tax revenue audit for the period of July 1, 2002 through June 30, 2010. Below you will find my response on the findings specific to the County's activities.

Finding 1 – Calculation and distribution of ATI
The County does concur with this finding and will implement the correction.

Finding 2 – Unitary and operating non-unitary apportionment
The County does concur that the unitary and operating non-unitary apportionment factors and allocations were not computed correctly since 2002-03. This correction will be implemented.

The County respectively disagrees with the finding that the Educational Revenue Augmentation Fund (ERAF) should be excluded from the unitary and non-unitary tax apportionment computations. This finding is not consistent with the results of our prior tax audit for the period July 1, 1997 through June 30, 2002. In our prior audit, the ERAF computation was included in the same manner and a finding noted that it had been under allocated by $91,755. We have consistently followed the methodology of the computation as outlined in the Tax Manager's Reference Manual as approved by the State Association of County Auditors. We consider this methodology to be in accordance with the R&T Code section 100.

Finding 3 – Edcuation Revenue Augmentation Fund (ERAF)
The County does concur with the finding and will implement the corrections.

I would like to thank Janice Ang, formerly of your staff for her time and effort on completing this audit. My staff and I found her to be very knowledgeable, professional, and extremely helpful.

Sincerely,

Marcia L. Salter

Marcia L. Salter
Auditor-Controller

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Division of Audits
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