LAKE COUNTY

Audit Report

PROPERTY TAX APPORTIONMENT AND ALLOCATION SYSTEM

July 1, 2006, through June 30, 2013

JOHN CHIANG
California State Controller

September 2014

JOHN CHIANG
California State Controller

September 26, 2014

The Honorable Cathy Saderlund
Auditor-Controller/County Clerk
Lake County
255 North Forbes Street
Lakeport, CA 95453

Dear Ms. Saderlund:

The State Controller's Office audited the methods employed by Lake County to apportion and allocate property tax revenues for the period of July 1, 2006, through June 30, 2013. The audit was conducted pursuant to the requirements of Government Code section 12468.

The county complied with California statutes, except that it:

- Incorrectly calculated the unitary growth for FY 2007-08 forward
- Overstated the ERAF contribution amounts carried forward from the prior audit period
- Used incorrect assessed values when calculating the Vehicle Licensing Fee growth.

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

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/kw

cc: 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
Richard J. Chivaro, Chief Legal Counsel
State Controller's Office

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Audit Report

Summary

The State Controller's Office (SCO) audited the methods employed by Lake County to apportion and allocate property tax revenues for the period of July 1, 2006, through June 30, 2013.

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

- Incorrectly calculated the unitary growth for FY 2007-08 forward
- Overstated the ERAF contribution amounts carried forward from the prior audit period
- Used incorrect assessed values when calculating the Vehicle Licensing fee growth.

Additionally, we made the following observation:

The county computed total net administrative costs including Sales and Use Tax/Vehicle Licensing Fee (SUT/VLF) until FY 2011-12. The county removed SUT/VLF from the administrative cost calculation for FY 2012-13 forward.

SUT/VLF is not to be included in the administrative costs computation and the amount of excess costs charged are to be computed and returned to cities. The county has settled with one city and is in the process of correcting the disputed amount with another city. The county needs to complete and fully document the refund.

This issue will be kept open for follow-up in the next audit.

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 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, 2006, through June 30, 2013. 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 service levies on voter-approved debt, fees, and assessments levied by the county or a city. The scope of our audit concerned 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, Lake County complied with California statutes for the apportionment and allocation of property tax revenues for the period of July 1, 2006, through June 30, 2013. The county should correct the items discussed in the Findings and Recommendations section.

Additionally, we made the following observation:

The county computed total net administrative costs, including vehicle license fee/sales and use tax (VLF/SUT), up to fiscal year (FY) 2011-12. As a result, the administrative pro-rata share of costs was overstated, substantially increasing the amount of proportionate costs to cities. VLF/SUT is not to be included in the administrative costs computation.

Follow-up on Prior Audit Findings

The county has satisfactorily resolved the findings noted in our prior audit report, issued March 30, 2007.

Views of Responsible Officials

We issued a draft audit report on July 30, 2014. Cathy Saderlund, Auditor-Controller, responded by letter dated August 18, 2014 (Attachment).

Restricted Use

This report is solely for the information and use of Lake 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

September 26, 2014

Findings and Recommendations

FINDING 1— Unitary and operating nonunitary apportionment

In FY 2007-08 through FY 2012-13, the county used incorrect AB 8 revenue amounts when allocating unitary revenues in excess of 102% of prior year revenues. The VLF amounts used also were incorrect.

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

During fieldwork, the county provided corrected calculations. The county should use the corrected amounts going forward.

County's Response

> The county concurs with this finding and as stated in your draft report has provided the corrected calculations. The corrections were processed in fiscal year 2014. The county will use the corrected calculations going forward.

SCO's Comment

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

FINDING 2— Educational Revenue Augmentation Fund

The county carried forward incorrect AB 8 base revenue and ERAF contribution amounts from the prior audit period ending June 30, 2006.

Requirements for the local agency shift of property tax revenues to the Educational Revenue Augmentation Fund (ERAF) are found primarily 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 generally was determined by:

1. Reducing the FY 1992-93 ERAF shift by the FY 1992-93 per capita shift;

2. Adjusting the result for growth; and

3. 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:

1. 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;

2. Adjusting this amount by subtracting the FY 1992-93 shift to the ERAF;

3. If the above amount is greater than zero, adjusting this amount for FY 1993-94 growth (zero is used for negative amounts); and

4. 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:

1. Deducting the FY 1992-93 ERAF shift for the district from the FY 1992-93 property tax allocation;

2. Multiplying the result by the SDAF factor for the district effective on June 13, 1993 (net current-year bailout equivalent);

3. 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;

4. Adjusting this amount for growth; and

5. 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 fieldwork, the county provided corrected calculations, resulting in a net overpayment to the ERAF of $691,282 (see Schedule 1).

The county should make the necessary adjustments to correct this error, and use the corrected calculations going forward.

County's Response

> The county concurs with this finding and as stated in your draft report has provided the corrected calculations. The corrections were processed in fiscal year 2014 up to the amount allowed pursuant to Revenue and Taxation Code 96.1. The county will use the corrected calculations going forward.

SCO's Comment

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

FINDING 3— Vehicle Licensing Fee and Sales and Use Tax adjustments

The county used incorrect assessed values to compute the VLF growth for the county and cities in FY 2006-07 through FY 2012-13.

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 calculates 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 (TRAs) 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 Sales and Use Tax Compensation Fund, and eventually to each designated county and cities within each county.

Recommendation

During fieldwork, the county provided corrected VLF calculations, resulting in a net underpayment to the cities and county from the ERAF of $216,722 (see Schedule 1).

The county should make the necessary adjustments to correct this error, and use the corrected calculations going forward.

County's Response

> The county concurs with this finding and as stated in your draft report has provided the corrected calculations. The corrections were processed in fiscal year 2014 up to the amount allowed pursuant to Revenue and Taxation Code 96.1. The county will use the corrected calculations going forward.

SCO's Comment

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

Schedule 1— Summary of Misallocations to the Educational Revenue Augmentation Fund (ERAF) July 1, 2006, through June 30, 2013

Finding No.	Fiscal Years Affected	Amount Due (owed from) the ERAF
2	2006-07–2012-13	$ (691,282)
3	2006-07–2012-13	(216,722)
Total		$ (908,004)

Note: Revenue and Taxation Code section 96.1 limits the maximum amount of cumulative reallocation to 1% of the 1% tax levied on the current fiscal year (2013-14) secured assessed value. This amount for Lake County is $665,357.

Attachment—
County's Response to Draft Audit Report

COUNTY OF LAKE
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Cathy Saderlund
Auditor-Controller/ County Clerk
Richard Ford
Assistant Auditor-Controller

Ref. No. 15L-017

August 18, 2014

State Controller's Office
Elizabeth Gonzalez, Chief
PO Box 942850
Sacramento CA 954250-5874

Dear Ms. Gonzalez,

Thank you for the draft audit report pertaining to our property tax allocation and apportionment for the period of July 1, 2006 through June 30, 2013. We received the draft report on August 11, 2014. Our response is as follows:

Finding 1—Unitary and operating non-unitary apportionment

The county concurs with this finding and as stated in your draft report has provided the corrected calculations. The corrections were processed in fiscal year 2014. The county will use the corrected calculations going forward.

Finding 2—Educational Revenue Augmentation Fund

The county concurs with this finding and as stated in your draft report has provided the corrected calculations. The corrections were processed in fiscal year 2014 up to the amount allowed pursuant to Revenue and Taxation Code 96.1. The county will use the corrected calculations going forward.

Finding 3—Vehicle Licensing Fee and Sales and Use Tax adjustments

The county concurs with this finding and as stated in your draft report has provided the corrected calculations. The corrections were processed in fiscal year 2014 up to the amount allowed pursuant to Revenue and Taxation Code 96.1. The county will use the corrected calculations going forward.

We would like to extend our appreciation to your staff auditor, Don Rose, for his cooperative and conscientious manner during the performance of this audit.

Sincerely,

Cathy Saderlund

Cathy Saderlund
Auditor-Controller

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http://www.sco.ca.gov