

SANTA CLARA COUNTY

Audit Report

PROPERTY TAX APPORTIONMENT AND ALLOCATION SYSTEM

July 1, 2003, through June 30, 2007



JOHN CHIANG
California State Controller

December 2009



JOHN CHIANG
California State Controller

December 31, 2009

John V. Guthrie, Director of Finance
Santa Clara County
County Government Center, East Wing
70 West Hedding Street, 2nd Floor
San Jose, CA 95110

Dear Mr. Guthrie:

The State Controller's Office audited the methods employed by Santa Clara County to apportion and allocate property tax revenues for the period of July 1, 2003, through June 30, 2007. 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 included the Educational Revenue Augmentation Fund in the unitary tax apportionment computation during this audit period.

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 Santa Clara County to apportion and allocate property tax revenues for the period of July 1, 2003, through June 30, 2007.

Our audit disclosed that the county complied with California statutes for the allocation and apportionment of property tax revenues, except that it included the Educational Revenue Augmentation Fund (ERAF) in the unitary tax apportionment computation during this audit period.

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 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. Santa Clara 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.

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 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 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 reports and computations prepared by the county to determine any increases in property tax revenues due cities having low or non-existent property tax amounts.

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, 2007. 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 Finding and Recommendation section of this report, Santa Clara County complied with California statutes for the apportionment and allocation of property tax revenues for the period of July 1, 2003, through June 30, 2007. The county should correct the item discussed in the Finding and Recommendation section.

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 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. Santa Clara 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**

The county has satisfactorily resolved the findings noted in our prior audit report, issued January 13, 2005.

**Views of
Responsible
Official**

We issued a draft audit report on November 13, 2009. Vinod Sharma, Controller-Treasurer, responded by letter dated December 4, 2009 (Attachment). He disagreed with the audit results.

Restricted Use

This report is solely for the information and use of Santa Clara 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

December 31, 2009

Finding and Recommendation

FINDING— Unitary and operating nonunitary apportionment

The county included the Educational Revenue Augmentation Fund (ERAF) in the unitary 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 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

For all future unitary tax apportionment computations, the ERAF should not be included in the calculation because the ERAF does not qualify as an affected taxing agency under the Revenue and Taxation Code. Thus, the ERAF is not eligible to share in the unitary apportionment. Any amount calculated for the ERAF should be proportionately shared among all taxing jurisdictions that contributed to the ERAF.

Auditee’s Response

Your draft audit report has one finding pertaining to the inclusion of Educational Revenue Augmentation Fund (“ERAF”) in unitary tax apportionment. We disagree with the audit finding for the following reasons.

The definition of a school entity per R&T Code Section 95(f) includes ERAF. The R&T Code Sections §100.95(a)(3)(A)(i) which deal with Unitary, refer to this Code Section for definition of school entity. Therefore, ERAF should get a share in unitary apportionment.

The second reason for our disagreement is that the methodology used by the County of Santa Clara was previously accepted by the State Controller’s Office. Please note that the State Controller in the audit of Marin and Tehama counties cited them for not including ERAF in unitary apportionment. The current audit finding of the State Controller’s Office is contradicting to the previous position [*sic*].

The third reason for the disagreement with the audit finding is our current practice is to follow the guideline methodology set in Property Tax Manager's Reference Manual. The State Association of County Auditors has also recommended that counties should continue to follow the Tax Manager's Reference manual until this issue is resolved by the State legislature in clear and unambiguous terms. Our statewide survey on this topic revealed majority of counties consistently include ERAF in unitary apportionment [*sic*].

SCO's Comment

The county is correct. Revenue and Taxation Code section 95(f) does include the ERAF in the definition of school entities. However, in defining jurisdictions, in Revenue and Taxation Code section 95(b), the ERAF is not included, although school districts and community college districts are included. The ERAF, as its name implies, is a fund, an accounting entity, and not a jurisdiction.

The county's reference to Revenue and Taxation Code section 100(a)(C)(i) does not exist, the correct Revenue and Taxation Code citation should be section 100.11(a)(2)(C)(i). Revenue and Taxation Code section 100.11(a)(2)(C)(i) reads in part:

(C) The revenues derived from the application of these rates to this value shall be allocated in the manner described in subdivisions (c) and (d) of Section 100, which manner shall be modified as follows:

(i) School entities, as defined in subdivision (f) of Section 95, in a county shall be allocated an amount equivalent to the same percentage the school entities received in the prior fiscal year from the property tax revenues paid by the regulated railway company in the county.

Revenue and Taxation Code section 100.11 pertains to the allocation of property tax revenues paid by regulated railway companies and not the unitary and operating nonunitary revenues allocated pursuant to Revenue and Taxation Code section 100.

Similarly, Revenue and Taxation Code section 100.95(a)(3)(A)(i) pertains to the allocation of property tax revenue from certain qualified property which is defined in section (c)(1) as:

(c) For purposes of this section, all of the following apply:

(1) "Qualified property" means all plant and associated equipment, including substation facilities and fee-owned land and easements, placed in service by the public utility on or after January 1, 2007, and related to the following:

(A) Electrical substation facilities that meet either of the following conditions:

(i) The high-side voltage of the facility's transformer is 50,000 volts or more.

(ii) The substation facilities are operated at 50,000 volts or more.

(B) Electric generation facilities that have a nameplate generating capacity of 50 megawatts or more.

(C) Electrical transmission line facilities of 200,000 volts or more.

It should be noted that these are not the unitary and operating nonunitary revenues allocated pursuant to Revenue and Taxation Code section 100. In addition, when performing certain computations under Revenue and Taxation Code section 100, Revenue and Taxation Code section 100(c)(3) specifically excludes revenues under Revenue and Taxation Code section 100.95.

The SCO acknowledges that its past position allowed the ERAF to receive unitary and operating nonunitary revenues. However, at the request of another county, the SCO revisited the issue and determined that the ERAF was not a taxing jurisdiction and therefore was not eligible to receive unitary and operating nonunitary revenues.

Finally, regardless of the methodology described in the Property Tax Manager's Reference Manual, 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. Since the ERAF is not a taxing jurisdiction it is not eligible to receive unitary and operating nonunitary taxes. The finding remains as written.

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

County of Santa Clara



Finance Agency Controller-Treasurer Department

County Government Center
70 W. Hedding Street, East Wing, 2nd Floor
San Jose, California 95110-1705
(408) 299-5200 FAX (408) 289-8629

December 4, 2009

Mr. Jeffrey V. Brownfield
Chief, Division of Audits
State Controller Office
State of California
P.O. Box 942850
Sacramento, CA 94250-5874

Dear Mr. Brownfield,

We received your letter on November 20, 2009 enclosing the draft audit report for our County for the period of July 1, 2003 through June 30, 2007. We are pleased to see that, with the exception of one finding discussed below, the audit report validates Santa Clara County's compliance with California statutes for the apportionment and allocation of property tax revenues.

Your draft audit report has one finding pertaining to the inclusion of Educational Revenue Augmentation Fund ("ERAF") in unitary tax apportionment. We disagree with the audit finding for the following reasons.

The definition of a school entity per R&T Code Section 95(f) includes ERAF. The R&T Code Sections §100(a)(C)(i) & §100.95(a)(3)(A)(i) which deal with Unitary, refer to this Code Section for definition of school entity. Therefore, ERAF should get a share in unitary apportionment.

The second reason for our disagreement is that the methodology used by the County of Santa Clara was previously accepted by the State Controller's Office. Please note that the State Controller in the audit of Marin and Tehama counties cited them for not including ERAF in unitary apportionment. The current audit finding of the State Controller's Office is contradicting to the previous position.

Board of Supervisors: Donald F. Gage, George Shirakawa, Dave Cortese, Ken Yeager, Liz Kniss
County Executive: Jeffrey V. Smith

The third reason for the disagreement with the audit finding is our current practice is to follow the guideline methodology set in Property Tax Manager's Reference Manual. The State Association of County Auditors has also recommended that counties should continue to follow the Tax Manager's Reference manual until this issue is resolved by the State legislature in clear and unambiguous terms. Our statewide survey on this topic revealed majority of counties consistently include ERAF in unitary apportionment.

If you have any questions or need further information, please contact Jacelyn Ma at 408-299-5260 or Jacelyn.ma@fin.sccgov.org.

Sincerely,



Vinod K. Sharma
Controller-Treasurer
County of Santa Clara

Cc. Irene Lui, Division Manager, Disbursement & Property Tax, Santa Clara County

**State Controller's Office
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