SACRAMENTO COUNTY

Reissued Audit Report

ALLOCATION AND APPORTIONMENT OF PROPERTY TAX REVENUES

July 1, 2010, through June 30, 2016

BETTY T. YEE
California State Controller

December 2018

BETTY T. YEE
California State Controller

December 19, 2018

Ben Lamera, Director of Finance
Department of Finance
Sacramento County
700 H Street, Suite 3650
Sacramento, CA 95814

Dear Mr. Lamera:

The State Controller's Office audited the methods employed by Sacramento County to allocate and apportion property tax revenues for the period of July 1, 2010, through June 30, 2016. The audit was conducted pursuant to the requirements of Government Code section 12468.

This reissued audit report, which updates our previous audit report dated December 28, 2017, corrects the audit period and clarifies the findings.

Our audit found instances of noncompliance with California statutes for the allocation and apportionment of property tax revenues for the audit period. We determined that Sacramento County:

- Incorrectly computed the supplemental apportionment factors;
- Incorrectly apportioned unitary and operating nonunitary apportionment factors;
- Incorrectly computed the regulated railway apportionment factors;
- Incorrectly computed the property tax administrative fee factors; and
- Incorrectly computed the Vehicle License Fee growth computation.

Due to a pending appellate court decision, our audit scope excluded making a determination on the validity of the county's methodology for apportioning the residual balance from the Redevelopment Property Tax Trust Fund, as described in the Observation section of this reissued audit report.

If you have any questions, please contact Lisa Kurokawa, Chief, Compliance Audits Bureau, by telephone at (916) 327-3138.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/as

Attachment

cc: Susan Peters, Chair
Sacramento County Board of Supervisors
Joyce Renison, Assistant Auditor-Controller
Department of Finance
Sacramento County
Jeff Emslie, Senior Accounting Manager
Department of Finance
Sacramento County
Shih-Der “Stephanie” Huang, Accounting Manager
Department of Finance
Sacramento County
Chris Hill, Principal Program Budget Analyst
Local Government Unit
California Department of Finance

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Reissued Audit Report

Summary

The State Controller's Office (SCO) audited the methods employed by Sacramento County to allocate and apportion property tax revenues for the period of July 1, 2010, through June 30, 2016.

Our audit found instances of noncompliance with California statutes for the allocation and apportionment of property tax revenues for the audit period. We determined that Sacramento County:

- Incorrectly computed the supplemental apportionment factors;
- Incorrectly apportioned unitary and operating nonunitary apportionment factors;
- Incorrectly computed the regulated railway apportionment factors;
- Incorrectly computed the property tax administrative fee factors; and
- Incorrectly computed the Vehicle License Fee (VLF) growth computation.

Due to a pending appellate court decision, our audit scope excluded making a determination on the validity of the county's methodology for apportioning the residual balance from the Redevelopment Property Tax Trust Fund (RPTTF), as described in the Observation section of this reissued audit report.

Background

After the passage of Proposition 13 in 1978, the California State Legislature (Legislature) enacted new methods for allocating and apportioning property tax revenues to local government agencies, school districts, and community college districts. The main objective was to provide local government agencies, school districts, and community college districts with a property tax base that would grow as assessed property values increased. The method has 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.

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 allocated and apportioned to local government agencies, school districts, and community college districts using prescribed formulas and methods defined in the Revenue and Taxation Code.

The AB 8 process involves several steps, including the transfer of revenues from school and community college districts to local government agencies (AB 8 shift) and the development of the tax rate area (TRA) annual tax increment (ATI) apportionment 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 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 from the AB 8 process revenues generated by unitary and nonunitary properties, regulated railway companies, and qualified electric (QE) properties. 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 school and community college districts by the county auditor according to instructions received from the county superintendent of schools or chancellor of the California community colleges.

Revenues generated by the different types of property tax are allocated and apportioned to local government agencies, school districts, and community college districts 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, which are primarily maintained by the county assessor. Tax rolls contain an entry for each parcel of land, including parcel number, owner's name, and value. The types of property tax rolls are:

- *Secured Roll*—Property that, in the opinion of the assessor, has sufficient value to guarantee payment of the tax levies and that, if taxes are unpaid, the obligation can be satisfied by the sale of the property by the tax collector.

- *Unsecured Roll*—Property that, in the opinion of the assessor, does not have sufficient "permanence" or other intrinsic qualities to guarantee payment of taxes levied against it.

- *State-Assessed Roll*—Utility properties composed of unitary and nonunitary value assessed by the State Board of Equalization (BOE).

- *Supplemental Roll*—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 allocation and apportionment of property taxes, Senate Bill 418, which requires the State Controller to audit counties' allocation and apportionment methods and report the results to the Legislature, was enacted in 1985.

Allocation and apportionment of property taxes can result in revenues to an agency or agencies being overstated, understated, or misstated.

Misstated revenues occur when at least one taxing agency receives more revenue than it was entitled to, while at least one taxing agency receives less revenue than it was entitled to.

The agency that received less tax revenue than its statutory entitlement would have standing to require that adjustments be made by the county, either on a retroactive or prospective basis. SCO does not have enforcement authority or standing to require the county to take corrective action with respect to misallocation of tax revenues, unless the misallocation resulted in overpaid state funds (funds intended for the ERAF, school districts, or community college districts). SCO has authority to recover misallocations resulting in overpaid state funds pursuant to Government Code (GC) sections 12410, 12418, and 12419.5.

GC section 12410 provides the State Controller with broad authority to "superintend the fiscal concerns of the state." GC section 12418 provides the State Controller with the authority to "direct and superintend the collection of all money due the State, and institute suits in its name" against all debtors of the State. GC section 12419.5 provides the State Controller with the authority to offset any amounts due the State against any amounts owing the debtor by the State.

Revenue and Taxation Code (RTC) section 96.1(b) allows a reallocation of current audit findings and unresolved prior audit findings.

RTC section 96.1(c)(3) limits a cumulative reallocation or adjustment to one percent of the total amount levied at a one-percent rate of the current year's original secured tax roll. For reallocation to the ERAF, school districts, or community college districts, a reallocation must be completed in equal increments within the following three fiscal years, or as negotiated with the State Controller.

Objective, Scope, and Methodology

The objective of our audit was to determine whether the county complied with Revenue and Taxation Code, Health and Safety Code, and Government Code requirements pertaining to the allocation and apportionment of property tax revenues.

The audit period was July 1, 2010, through June 30, 2016.

To achieve our objective, we:

- Interviewed key personnel to gain an understanding of the county's process for allocating and apportioning property tax revenues;
- Reviewed the county's written procedures for allocating and apportioning property tax revenues;
- Performed analytical reviews to assess the reasonableness of property tax revenues; and
- Judgmentally selected a non-statistical sample of five from approximately 147 taxing jurisdictions within the county for all fiscal years in the audit period (the actual number of taxing jurisdictions, which include the ERAF, can vary from year to year based on

jurisdictional changes). Errors found were not projected to the intended population. Then, we:

- Recomputed allocation and apportionment reports to verify computations used to develop property tax apportionment factors;
- Tested TRA reports to verify that the correct TRA factors are used in the computation of the ATI;
- Reviewed supplemental property tax administrative costs and fees to determine whether recovery costs associated with administering supplemental taxes were based on actual costs and did not exceed five percent of revenues collected, as prescribed in statute;
- Verified computations used to develop supplemental property tax apportionment factors;
- Verified unitary and operating nonunitary and regulated railway computations used to develop apportionment factors;
- Reviewed RPTTF deposits and distributions;
- Reviewed property tax administration cost reports and recomputed administrative costs associated with work performed for allocating and apportioning property tax revenues to local government agencies, school districts, and community college districts;
- Reviewed ERAF reports and verified computations used to determine the shift of property taxes from local government agencies to the ERAF and, subsequently, to school and community college districts;
- Reviewed the Sales and Use Tax letter and recomputed VLF computations used to verify the amount transferred from the ERAF to counties and cities to compensate for the diversion of these revenues; and
- Reviewed BOE jurisdictional change filing logs and their impact on the tax allocation and apportionment system.

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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We limited our review of the county’s internal controls to gaining an understanding of the transaction flow to develop appropriate auditing procedures. We did not evaluate the effectiveness of internal controls relevant to the allocation and apportionment of property tax revenues. We did not audit the county’s financial statements.

We conducted this audit under the authority of GC sections 12410 and 12468, which require SCO to audit the allocation and apportionment of property tax revenues. A property tax bill contains the property tax levied at a one percent 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 is concerned with the distribution of the one percent 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.

Conclusion

Without consideration of the legal issue described in the Observation section of this audit report, our audit found instances of noncompliance with the requirements outlined in the Objective, Scope, and Methodology section of this audit report.

We determined that Sacramento County:

- Incorrectly computed the supplemental apportionment factors;
- Incorrectly apportioned unitary and operating nonunitary apportionment factors;
- Incorrectly computed the regulated railway apportionment factors;
- Incorrectly computed the property tax administrative fee factors; and
- Incorrectly computed the VLF growth computation.

These instances of noncompliance are described in the Revised Findings and Recommendations section of this reissued audit report.

Follow-up on Prior Audit Findings

The county has satisfactorily resolved the findings noted in our prior audit report, issued June 10, 2011, for the period of July 1, 2006, through June 30, 2010.

Views of Responsible Officials

We issued a draft audit report on September 1, 2017. Ben Lamera, Director of Finance, responded by letter dated September 15, 2017, agreeing with the audit results. The county's response is included as an attachment to this audit report.

On October 9, 2018, we informed Jeff Emslie, Senior Accounting Manager, of this reissued audit report and the reason for reissuance.

Reason for Reissuance

This audit report has been reissued to correct the ending audit period from June 30, 2015, to June 30, 2016, and clarify the findings.

Restricted Use

This reissued audit report is solely for the information and use of Sacramento County, the Legislature, and 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 reissued audit report, which is a matter of public record and is available on the SCO website at www.sco.ca.gov.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

December 19, 2018

Revised Findings and Recommendations

FINDING 1—Supplemental Property Tax Apportionment

During testing of the county's supplemental property tax apportionment process, we found that the county incorrectly calculated the apportionment factors for FY 2014-15 and FY 2015-16. Specifically, the county included the VLF adjustments in the calculation, which resulted in the county under-allocating $7,988,822 to the ERAF (see the Schedule).

The miscalculation occurred because county staff were not aware of the California Supreme Court ruling in *City of Alhambra v. County of Los Angeles* (55 Cal. 4^{th} 707, 149 Cal. Rptr. 3d 247, 288 P.3d 431, 12 Cal. Daily Op. Serv. 12,771, 2012 Daily Journal D.A.R. 15,617), which required the elimination of the VLF adjustment from the apportionment factors calculation beginning in FY 2014-15.

Supplemental property tax revenues enable counties to tax a property retroactively for the period when a change in ownership or completion of new construction occurs. RTC sections 75.60, 75.71, and 100.2 provide the legal requirements for the allocation and apportionment of the supplemental property tax revenue.

<u>Recommendation</u>

We recommend that the county:

- Review the aforementioned Revenue and Taxation Code sections and court ruling, and update its policies and procedures to exclude the VLF adjustment from its calculation of the supplemental apportionment factors;
- Correctly compute the supplemental apportionment factors in subsequent fiscal years; and
- Reallocate $7,988,822 to the ERAF for FY 2014-15 and FY 2015-16.

<u>County's Response</u>

The county concurs with the finding and has made the recommended changes. The county also requested that it be allowed to repay the ERAF over a five-year period, as permitted by RTC section 96.1(c)(3).

<u>SCO Comment</u>

RTC section 96.1(c)(3) requires the reallocation be completed in equal increments within the following three fiscal years, or as negotiated with the State Controller. The county's request to repay the ERAF in equal installment over a five-year period, commencing in FY 2017-18, is approved.

FINDING 2—Unitary and Operating Nonunitary Apportionment

During testing of the county's unitary and operating nonunitary apportionment process, we found that the county incorrectly apportioned unitary and operating nonunitary revenues to the ERAF for FY 2015-16. This error resulted in underallocated revenues to the taxing entities. We have determined that the error, while procedurally incorrect, is not material. The miscalculation occurred due to a clerical error. County staff are aware that the ERAF should have been excluded, but mistakenly apportioned the unitary and operating nonunitary revenue to the ERAF during the distribution.

Unitary properties are those properties on which BOE "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). RTC section 723.1 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 allocating and apportioning the unitary and operating nonunitary property tax revenues. The system created the unitary and operating nonunitary base-year and developed formulas to compute the distribution factors for the fiscal years that followed. RTC section 100 provides the legal requirements for the allocation and apportionment of the unitary and operating nonunitary property tax revenues.

Recommendation

We recommend that the county:

- Implement policies and procedures to exclude the ERAF when apportioning the unitary and operating nonunitary revenues;
- Correct the unitary and operating nonunitary apportionment factors for FY 2015-16;
- Use the corrected factors going forward; and
- Make necessary adjustments to the ERAF and affected entities.

County's Response

The county concurs with the finding and will work on implementing the recommended changes.

FINDING 3— Regulated Railway Apportionment

During testing of the county's regulated railway apportionment process, we found that the county made the following errors in its computation of the apportionment factors for each fiscal year in the audit period:

- Used incorrect prior-year railway revenues to compute for current-year factors;
- Used incorrect prior-year AB 8 revenues to compute for in-excess factors; and
- Apportioned in-excess revenues separately.

These miscalculations occurred due to clerical errors.

In addition, the county incorrectly included the VLF adjustment in its computation of the regulated railway apportionment factors for FY 2014-15 and FY 2015-16. This error occurred because county staff was not aware of the California Supreme Court ruling in *City of Alhambra v. County of Los Angeles,* which required the elimination of the VLF adjustment from the apportionment factors calculation beginning in FY 2014-15.

As a result of these four errors, the county misallocated revenues to the ERAF and taxing entities. Due to the complexity of the regulated railway computation, we are unable to quantify the effect of these errors.

RTC section 723 defines unitary regulated railway properties and RTC section 100.11 outlines the requirements for the allocation of unitary regulated railway property tax revenue.

Recommendation

We recommend that the county:

- Review the aforementioned Revenue and Taxation Code sections and court ruling, and update its policies and procedures to properly compute the regulated railway apportionment factors;
- Correct the regulated railway apportionment factors for each fiscal year in the audit period;
- Use the corrected factors going forward; and
- Make necessary adjustments to the ERAF and affected entities.

County's Response

The county concurs with the finding and will work on implementing the recommended changes.

FINDING 4— Property Tax Administrative Fee Factors

During testing of the county's property tax administrative process, we found that the county incorrectly used prior-year, instead of current-year, unitary and operating nonunitary and regulated railway revenues in the computation of the fee factors for FY 2012-13 through FY 2014-15.

As a result, the county did not receive the appropriate amount of reimbursable costs from the affected entities. We have determined that the error, while procedurally incorrect, is not material. The miscalculation occurred due to clerical error. County staff members were aware of how the administrative factors should have been calculated, but do not know the specific cause of the error.

The County Assessor, the County Tax Collector, the Assessment Appeals Board, and the Auditor-Controller all incur administrative costs associated with the allocation and apportionment of property tax revenues. As outlined in RTC section 95.3, the county can, depending on the fiscal year and the corresponding exclusions, be reimbursed for these administrative fee factors.

<u>Recommendation</u>

We recommend that the county:

- Update and implement its policies and procedures in computing the property tax administrative fee factors; and
- Use the current-year revenues in the computation of the property tax administrative fee factors for all future years.

<u>County's Response</u>

The county concurs with the finding and will work on implementing the recommended changes.

FINDING 5— Vehicle License Fee Adjustments

During testing of the county's VLF adjustment process, we found that the county incorrectly computed the VLF growth and shift amount for the City of Folsom for FY 2013-14 because it included the current-year annexation assessed values. As a result, the county underallocated $94,485 to the ERAF for FY 2013-14 through FY 2015-16 (see the Schedule). The miscalculation occurred due to a clerical error. County staff are aware of how the VLF adjustment is calculated, but mistakenly included the current-year annexation assessed values in the growth calculation.

The VLF adjustment permanently provided additional property tax revenues to cities and counties in lieu of the discretionary VLF revenues that these agencies previously received. RTC section 97.70 provides the legal requirements for VLF adjustments.

<u>Recommendation</u>

We recommend that the county:

- Update its policies and procedures to properly compute the VLF growth and shift amounts to exclude current-year annexation assessed values;
- Correctly compute the VLF growth and shift amounts for the City of Folsom in subsequent fiscal years; and
- Reallocate a total of $94,485 to the ERAF for FY 2013-14 through FY 2015-16.

<u>County's Response</u>

The county concurs with the finding and has made the recommended changes.

Observation

OBSERVATION— Redevelopment Property Tax Trust Fund

On May 26, 2015, the Sacramento County Superior Court ruled in Case No. 34-2014-80001723-CU-WM-GDS between the cities of Chula Vista, El Cajon, Escondido, Poway, San Diego, San Marcos, and Vista (petitioners) and the San Diego County Auditor-Controller (respondent) regarding the methodology for apportioning the residual balance from the RPTTF.

The Court stated, in part:

> (1) that a cap on the residual amount each entity can receive be imposed in an amount proportionate to its share of property tax revenue in the tax area; and (2) the calculation of the residual share an entity is entitled to receive must be done by considering the property tax available in the Redevelopment Property Tax Trust Fund after deducting only the amount of any distributions under paragraphs (2) and (3) of subdivision (a) of Section 34183.

On September 17, 2015, the respondent appealed the ruling to the Court of Appeal of the State of California Third Appellate District.

As the appellate court has not decided on the case, we will follow up on this issue in a subsequent audit.

Corrected Schedule— Summary of Misallocations to the Educational Revenue Augmentation Fund July 1, 2010, through June 30, 2016

Finding No.	Years Affected	Amount Due to the Educational Revenue Augmentation Fund
1	FY 2014-15 through FY 2015-16	$ 7,988,822 [1]
5	FY 2013-14 through FY 2015-16	94,485
		$ 8,083,307

[1] This amount is based on current-year secured and unsecured apportionments only.

Attachment—
County's Response to Draft Audit Report

Department of Finance
Ben Lamera
Director

Auditor-Controller Division
Joyce Renison
Assistant Auditor-Controller

County of Sacramento

September 15, 2017

Jim L. Spano, CPA
Assistant Division Chief
State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

Dear Mr. Spano,

Please find below our responses to your draft audit report dated September 2017:

FINDING 1 – SUPPLEMENTAL PROPERTY TAX APPORTIONMENT

Auditee's Response
The County concurs with this finding. The County has corrected the supplemental apportionment factors by excluding the VLF adjustment for fiscal years 2014-15, 2015-16 and 2016-17. For fiscal year 2016-17, supplemental revenue distributions were made using the corrected apportionment factors. We have calculated the amount of the corrections for the prior fiscal years of 2014-15 and 2015-16 during fieldwork by the SCO auditor. The County hereby requests that these corrections be made over a period of 5 fiscal years in accordance with Revenue and Taxation Code Section 96.1(c)(3).

FINDING 2 – UNITARY AND OPERATING NONUNTARY APPORTIONMENT

Auditee's Response
The County concurs with this finding. The County has corrected the unitary and nonunitary apportionment factors and has made the necessary adjustments to the affected entities during fieldwork by the SCO auditor.

FINDING 3 – REGULATED RAILWAY APPORTIONMENT

Auditee's Response
The County concurs with this finding. The County has corrected the Regulated Railway apportionment factors and has made the necessary adjustments to the affected entities during fieldwork by the SCO auditor.

FINDING 4 – PROPERTY TAX ADMISTRATIVE FACTOR

Auditee's Response
The County concurs with this finding. The County has corrected the property tax administrative fee factors and has made the necessary adjustments to the affected entities.

FINDING 5 – VEHICLE LICENSING FEE ADJUSTMENT

Auditee's Response

The County concurs with this finding. The County has corrected the VLF growth and shift amounts for the City of Folsom and has made the necessary adjustments to the City of Folsom. In addition, the County has forwarded these corrections to the California State Controller, Division of Accounting and Reporting.

Sincerely,

Ben Lamera
Director of Finance

cc: Joyce Renison, Assistant Auditor-Controller
Jeffrey A. Emslie, Senior Accounting Manager
Shih-Der "Stephanie" Huang, Accounting Manager

State Controller's Office
Division of Audits
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