

# MERCED COUNTY

Audit Report

## ALLOCATION AND APPORTIONMENT OF PROPERTY TAX REVENUES

*July 1, 2014, through June 30, 2017*



**BETTY T. YEE**  
California State Controller

January 2019



**BETTY T. YEE**  
California State Controller

January 16, 2019

The Honorable Lisa Cardella-Presto, CPA, Auditor-Controller  
Merced County  
2222 M Street  
Merced, CA 95340

Dear Ms. Cardella-Presto:

The State Controller's Office audited the methods employed by Merced County to allocate and apportion property tax revenues for the period of July 1, 2014, through June 30, 2017. We conducted the audit pursuant to the requirements of Government Code section 12468.

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 the county:

- Incorrectly calculated supplemental property tax apportionment factors;
- Did not document actual supplemental property tax administrative fee costs; and
- Incorrectly calculated Redevelopment Property Tax Trust Fund (RPTTF) increment revenues.

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 RPTTF, as described in the Observation section of this 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*

JIM L. SPANO, CPA  
Chief, Division of Audits

JLS/as

The Honorable Lisa Cardella-Presto, CPA,   -2-  
Auditor-Controller

January 16, 2019

cc: Jerry O'Banion, Chairman  
    Board of Supervisors  
    Merced County  
Sylvia Sanchez, Accountant Supervisor/Property Tax Manager  
    Auditor-Controller  
    Merced County  
Chris Hill, Principal Program Budget Analyst  
    Local Government Unit  
    California Department of Finance

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# Audit Report

## Summary

The State Controller's Office (SCO) audited the methods employed by Merced County to allocate and apportion property tax revenues for the period of July 1, 2014, through June 30, 2017.

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 the county:

- Incorrectly calculated supplemental property tax apportionment factors;
- Did not document actual supplemental property tax administrative fee costs; and
- Incorrectly calculated Redevelopment Property Tax Trust Fund (RPTTF) increment revenues.

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 RPTTF, as described in the Observation section of this 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 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, school districts, and community college districts 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 the 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 the 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 operating 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 tax revenues, Senate Bill 418 was enacted in 1985 requiring the State Controller to audit the counties' allocation and apportionment methods and report the results to the Legislature.

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 the 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 taxes.

The audit period was July 1, 2014, through June 30, 2017.

To achieve our objective, we:

- Interviewed key personnel to gain an understanding of the county’s property tax allocation and apportionment processes;
- Reviewed the county’s written procedures for allocating and apportioning property tax revenues;
- Performed analytical reviews to assess the reasonableness of property tax revenues;
- Judgmentally selected a non-statistical sample of five from approximately 96 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 were 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 redevelopment agency (RDA) reports and verified computations used to develop the project base amount and the tax increment distributed to the RDA;
- 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 Vehicle License Fee computations used to verify the amount of ERAF transferred 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 the following instances of noncompliance with the requirements outlined in the Objective, Scope, and Methodology section:

- Incorrectly calculated supplemental property tax apportionment factors;
- Undocumented actual supplemental property tax administrative fee costs; and
- Incorrectly calculated RPTTF increment revenues.

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

## **Follow-up on Prior Audit Findings**

Findings noted in our prior audit, issued March 18, 2016, have been satisfactorily resolved by the county, with the exception of the ERAF growth computation. The county has completed the recalculation of ERAF growth; however, it has not yet made monetary adjustments to the ERAF and affected taxing entities (see the Uncorrected Prior Audit Finding section).

## **Views of Responsible Officials**

We issued a draft audit report on October 19, 2018. Lisa Cardella-Presto, CPA, Auditor-Controller, responded by letter dated November 2, 2018 (Attachment), agreeing with the audit results. The county's response is included as an attachment to this final audit report.

## **Restricted Use**

This audit report is solely for the information and use of Merced 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 final audit report, which is a matter of public record and is available on the SCO website at [www.sco.ca.gov](http://www.sco.ca.gov).

*Original signed by*

JIM L. SPANO, CPA  
Chief, Division of Audits

January 16, 2019

# Uncorrected Prior Audit Finding

**UNCORRECTED  
PRIOR AUDIT  
FINDING—  
ERAF Growth**

In our prior audit, dated March 18, 2016, we found that the county incorrectly computed the ERAF growth percentage, as follows:

- Incorrect RDA increment values were used in computing the ERAF growth percentages for FY 2009-10 through FY 2013-14; and
- The ERAF base tax was not carried forward correctly from the prior year gross tax for FY 2011-12.

Our current audit found that the county has corrected the ERAF growth percentage for FY 2009-10 through FY 2013-14; however, the county has not yet made any monetary adjustments to the ERAF (which is approximately \$2.4 million) and to the other affected taxing entities. County staff stated that they had not made any monetary adjustments because they were waiting for the SCO to verify the recalculation during the current audit.

Recommendation

We recommend that the county make monetary adjustments to ERAF and the affected taxing entities.

County's Response

The calculations for ERAF growth has been completed and verified. Monetary adjustments to ERAF and to other affected taxing entities will be made pursuant to Revenue and Taxation Code section 96.1 (c) (3).

# Findings and Recommendations

## **FINDING 1— Supplemental Property Tax Apportionment**

During testing of the supplemental property tax apportionment process, we found that the county misallocated supplemental property tax revenues to all affected taxing entities for each fiscal year in the audit period. Specifically, the county:

- Incorrectly removed RDAs;
- Did not redistribute Turlock Elementary School and Turlock High School’s supplemental revenues to non-basic aid and average daily attendance K-12 schools; and
- Omitted the Los Banos Fire District and the City of Merced Fire District.

Due to the various errors affecting the computation and apportionment, we did not quantify the monetary impact for each affected taxing entity. The error occurred because the county misinterpreted the requirements outlined in the Revenue and Taxation Code.

RTC sections 75.60, 75.71, and 100.2 provide the legal requirements for the allocation and apportionment of the supplemental property tax revenue. 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.

### Recommendation

We recommend that the county:

- Review the aforementioned Revenue and Taxation Code sections and update and communicate procedures to properly compute supplemental property tax apportionment; and
- Recalculate the supplemental property tax apportionment for FY 2014-15 through FY 2016-17 and make adjustments as necessary.

### County’s Response

The County concurs with this finding. The supplemental property tax apportionment factors have been recalculated for FY 2014-15 through FY 2016-17. The distributions have been adjusted to reflect the change in factors.

## **FINDING 2— Supplemental Property Tax Administrative Fee**

During testing of the supplemental property tax administrative fee process, we found that the county does not have a method for identifying the actual administrative costs associated with the supplemental assessment roll; therefore, it cannot substantiate 100% of the fees that it collected during the audit period.

As the county did not document or determine its actual administrative costs, we are unable to retroactively quantify the monetary impact that this error had on the affected taxing entities. The error occurred because the county did not update its departmental cost analysis with the actual administrative costs for the supplemental rolls.

RTC section 75.60 provides the legal requirements for reimbursement of supplemental property tax administrative costs. The statute allows a county to charge an administrative fee for supplemental property tax revenues collections. This fee is not to exceed five percent of the supplemental property tax revenues collected.

#### Recommendation

We recommend that the county review the aforementioned Revenue and Taxation Code section and establish and implement procedures to ensure that supplemental administrative costs:

- Include actual costs that are supported by source documentation;
- Include direct costs for administration, data processing, collection, and appeal;
- Are incurred by the county auditor, assessor, and tax collector; and
- Are determined annually in all subsequent years.

#### County's Response

The County concurs with this finding. While the County does have a method to calculate Supplemental Property Tax Administrative Fees the method used was out of date. In 2017 the County has adopted a newer and more efficient method to support the supplemental property tax administrative fee.

### **FINDING 3— Redevelopment Property Tax Trust Fund and Recognized Obligation Payment Schedules**

During testing of the RPTTF process, we found that the county's property tax increment computations for former RDAs included several errors, which resulted in misstated RPTTF deposits for all fiscal years. The county is researching the base-assessed values for some RDAs to determine their validity; therefore, we are not able to quantify the misallocations at this time. The error occurred because the county misinterpreted the requirements outlined in the Revenue and Taxation Code.

RTC section 97.401 and Health and Safety Code sections 34182 through 34188 provide the legal requirements for administration of the RPTTF. In 2012, the Legislature passed a law dissolving the previously established RDAs. Provisions of the law included the creation of successor agencies (SAs) and oversight boards to oversee the winding-down of the defunct agencies' affairs.

Under the applicable Health and Safety Code sections, SAs will receive the tax increment previously given to RDAs to fund payments of their obligations including, but not limited to, administrative costs, pass-throughs, and debts.

Recommendation

We recommend that the county review the aforementioned Revenue and Taxation Code and Health and Safety Code sections and update its property tax computation worksheets for former RDAs to ensure that:

- Base-year frozen values do not change;
- Increments are computed for all former RDA project areas;
- Unitary assessed values are excluded; and
- Formulas are formatted properly.

County's Response

The County concurs with this finding. The Redevelopment property tax computation worksheet used was very confusing and has been simplified in 2017. The County has verified all the frozen base years are correct. One adjustment had to be made to Gustine RDA as it was discovered that HOPTR was not included in the base year. All other Frozen values have been verified. It has been verified that there are no Unitary assessed values and that all formulas are correct.

# 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 in 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.

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

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AUDITOR-CONTROLLER

Lisa Cardella-Presto, CPA  
Auditor-Controller

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Equal Opportunity Employer

November 2, 2018

Compliance Audits Bureau  
State Controller's Office  
Division of Audits  
Attn: Lisa Kurokawa  
P. O. Box 942850  
Sacramento, CA 94250

Subject: Audit of Merced County Property Tax Apportionment and Allocation System for the period July 1, 2014, through June 30, 2017.

In response to the review of the Property Tax apportionment and Allocation System of Merced County draft audit report, below are our comments addressing the findings and recommendations.

**Finding 1 – Supplemental Property Tax Apportionment**

County's Response

The County concurs with this finding. The supplemental property tax apportionment factors have been recalculated for FY 2014-15 through FY 2016-17. The distributions have been adjusted to reflect the change in factors.

**Finding 2 – Supplemental Property Tax Administrative Fee.**

County's Response

The County concurs with this finding. While the County does have a method to calculate Supplemental Property Tax Administrative Fees the method used was out of date. In 2017 the County has adopted a newer and more efficient method to support the supplemental property tax administrative fee.

**Finding 3 – Redevelopment Property Tax trust Fund and Recognized Obligation Payment Schedule.**

County's Response

The County concurs with this finding. The Redevelopment property tax computation worksheet used was very confusing and has been simplified in 2017. The County has verified all the frozen base years are correct. One adjustment had to be made to Gustine RDA as it was discovered that HOPTR was not included in the base year. All other Frozen

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values have been verified. It has been verified that there are no Unitary assessed values and that all formulas are correct.

**Prior Audit Findings**

County's Response

The calculations for ERAF growth has been completed and verified. Monetary adjustments to ERAF and to other affected taxing entities will be made pursuant to Revenue and Taxation code 96.1 (c) (3).

Our office appreciates the Controller's office's consideration of our heavy workload periods and the professionalism and courtesy displayed by the field auditor Kandy Liu. If you have any questions or require further information, please contact me at (209) 385-7511.

Sincerely,



Lisa Cardella-Presto, CPA  
Auditor Controller  
County of Merced  
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