



**OFFICE OF THE
CITY AUDITOR**

**AN AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES**

- THE CITY MAY BE ABLE TO COLLECT \$7.3 MILLION IN BACK BUSINESS LICENSE TAXES, PENALTIES, AND INTEREST FROM REAL ESTATE BROKERS AND AGENTS, COSMETOLOGISTS, INSURANCE BROKERS, AND SALES TAX PERMIT HOLDERS AND INCREASE ANNUAL BUSINESS LICENSE TAXES BY \$1.6 MILLION
- THE FINANCE DEPARTMENT DID NOT OBTAIN MUNICIPAL CODE-REQUIRED CITY COUNCIL APPROVAL BEFORE WAIVING \$4,542 IN LATE PAYMENT PENALTIES ON DELINQUENT BUSINESS LICENSE TAXES

**A REPORT TO THE
SAN JOSE
CITY COUNCIL**

JUNE 1994

94-03



CITY OF SAN JOSÉ, CALIFORNIA

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June 2, 1994

Honorable Mayor and Members
of the City Council
801 North First Street, Room 600
San Jose, CA 95110

Transmitted herewith is a report on *An Audit Of The San Jose Business License Taxes*. This report is in accordance with City Charter Section 805.

An Executive Summary is presented on the blue pages in the front of this report while an Administration response is shown on the yellow pages before the Appendices.

I will present this report to the Finance Committee at its June 8, 1994, meeting. If you need additional information in the interim, please let me know. The City Auditor's staff members who participated in the preparation of this report are Nestor Baula and Fred Casuga.

Respectfully submitted,

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EXECUTIVE SUMMARY

In accordance with the City Auditor's 1993-94 Audit Workplan, we have audited the city of San Jose's (City) business license tax collection process. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

**THE CITY MAY BE ABLE TO COLLECT \$7.3 MILLION
IN BACK BUSINESS LICENSE TAXES, PENALTIES, AND INTEREST
FROM REAL ESTATE BROKERS AND AGENTS, COSMETOLOGISTS,
INSURANCE BROKERS, AND SALES TAX PERMIT HOLDERS
AND INCREASE ANNUAL BUSINESS LICENSE TAXES BY \$1.6 MILLION**

Unless specifically exempted by the San Jose Municipal Code, all persons or businesses conducting business in San Jose are required to pay an annual business license tax. Any person who fails to pay the tax on or before the due date is liable for a penalty of 25 percent of one year's tax due. Should the tax remain unpaid for a period exceeding one month beyond the due date, an additional 25 percent penalty plus interest of 1.5 percent per month is assessed. Our review of real estate brokers and agents, cosmetologists, insurance brokers, and sales tax permit holders revealed that the City may be able to (1) collect \$7.3 million in back business license taxes, penalties, and interest and (2) increase annual business license taxes by an estimated \$1.6 million. It should be noted that our estimate of additional revenues may include real estate brokers and agents, cosmetologists, and insurance brokers who are not required to pay business license taxes because they are inactive, employees, or otherwise exempt. To the extent our estimate includes such persons, our estimate of additional business license taxes will be overstated. By contacting suspected unlicensed businesses through a mass-mailing program and implementing a tax amnesty

program, the City may be able to cost-effectively recover a substantial portion of unpaid back business license taxes and increase its business license tax base. Furthermore, by using other City departments to inspect for current City business licenses, the City will be able to use existing resources to increase business license taxes. Finally, it should be noted that our estimate of additional business license taxes did not include numerous categories such as exempt branches, accounting and bookkeeping, consultants, attorneys, miscellaneous business services, restaurants, and janitorial services. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimates shown above.

**THE FINANCE DEPARTMENT DID NOT OBTAIN
MUNICIPAL CODE-REQUIRED CITY COUNCIL APPROVAL
BEFORE WAIVING \$4,542 IN LATE PAYMENT PENALTIES
ON DELINQUENT BUSINESS LICENSE TAXES**

The San Jose Municipal Code, section 4.76.505, prescribes that public market operators must pay their estimated business license taxes for the period December 1, 1993, to November 30, 1994, in three installments.

- The first installment was due on December 1, 1993;
- The second on April 1, 1994; and
- The third on June 1, 1994.

Municipal Code, section 4.76.290, empowers the City to collect penalties and interest on the taxes not paid by the due date. In addition, section 4.76.281 does not require the Director of the Finance Department to send the operator a notice of the business license tax due. Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the

Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542. By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval. The Finance Department should (1) implement procedures to ensure compliance with section 1.17.010 of the Municipal Code regarding the need to obtain City Council approval before waiving late payment penalties or postponing the late payment penalty date and (2) request a City Attorney opinion on the City's ability to collect the \$4,542 penalty previously waived.

RECOMMENDATIONS

We recommend that the Finance Department/Treasury Division:

Recommendation #1:

Use the licensee listings of real estate brokers and agents (from the California Department of Real Estate), cosmetologists (from the California Department of Consumer Affairs), insurance licensees (from the California Department of Insurance), and sales tax permit holders--especially new permit holders--(from the California State Board of Equalization) to identify and pursue suspected unlicensed San Jose businesses. (Priority 1)

Recommendation #2:

Require all insurance licensees doing business within the City to register for the business license and to pay the business license tax unless they can furnish proof that they are exempt from the tax. (Priority 1)

Recommendation #3:

Implement a mass-mailing program to contact the suspected unlicensed businesses and inform them of the City's business license tax regulations and the penalties for non-filing. The form letter should note that if the business is not liable for the business license tax the owner should present documentation justifying the exemption. (Priority 1)

Recommendation #4:

Provide training and prepare written procedures to guide the business license tax investigators in identifying and pursuing unlicensed businesses. (Priority 1)

Recommendation #5:

Implement written procedures instructing the business license tax investigators to (1) verify the number of employees business licensees report by checking their payroll tax returns and (2) require any independent contractors currently reported as employees to apply for separate business licenses. (Priority 1)

Recommendation #6:

Upon approval of Recommendations #1, #2, #3, #4, and #5, request funding for any associated costs of necessary new staff and additional operating expenses. (Priority 1)

Recommendation #7:

Implement a limited-period amnesty program to encourage unlicensed businesses to voluntarily pay their business license taxes. (Priority 1)

Recommendation #8:

Upon approval of Recommendation #7, request funding for media consultant services to implement the business license tax amnesty program and for temporary staff to handle the tax amnesty telephone calls and paperwork. (Priority 1)

Further, we recommend that the Office of the City Manager and the Finance Department:

Recommendation #9:

Implement procedures to require staff members from City departments who make regular contacts with business establishments (such as building, fire, and hazardous materials code inspectors and water meter installers or readers) to (1) check whether the business establishments they inspect have current business licenses and (2) report unlicensed businesses to the Finance Department for investigation. (Priority 1)

In addition, we recommend that the Finance Department:

Recommendation #10:

Implement procedures to ensure compliance with section 1.17.010 of the San Jose Municipal Code regarding the need to obtain City Council approval

before waiving late payment penalties or postponing the late payment penalty date. (Priority 2)

Recommendation #11:

Request a City Attorney opinion on the City's ability to collect the \$4,542 penalty the Finance Department previously waived. (Priority 2)

Recommendations Requiring Budget Action

Of the preceding recommendations, #1, #2, #3, #4, #5, #6, #7, and #8 cannot be implemented absent additional funding. Accordingly, the City Manager should request during 1994-95 that the City Council appropriate an amount sufficient to implement Recommendations #1, #2, #3, #4, #5, #6, #7, and #8.

INTRODUCTION

In accordance with the City Auditor's 1993-94 Audit Workplan, we audited the City of San José's business license tax collection process. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

BACKGROUND

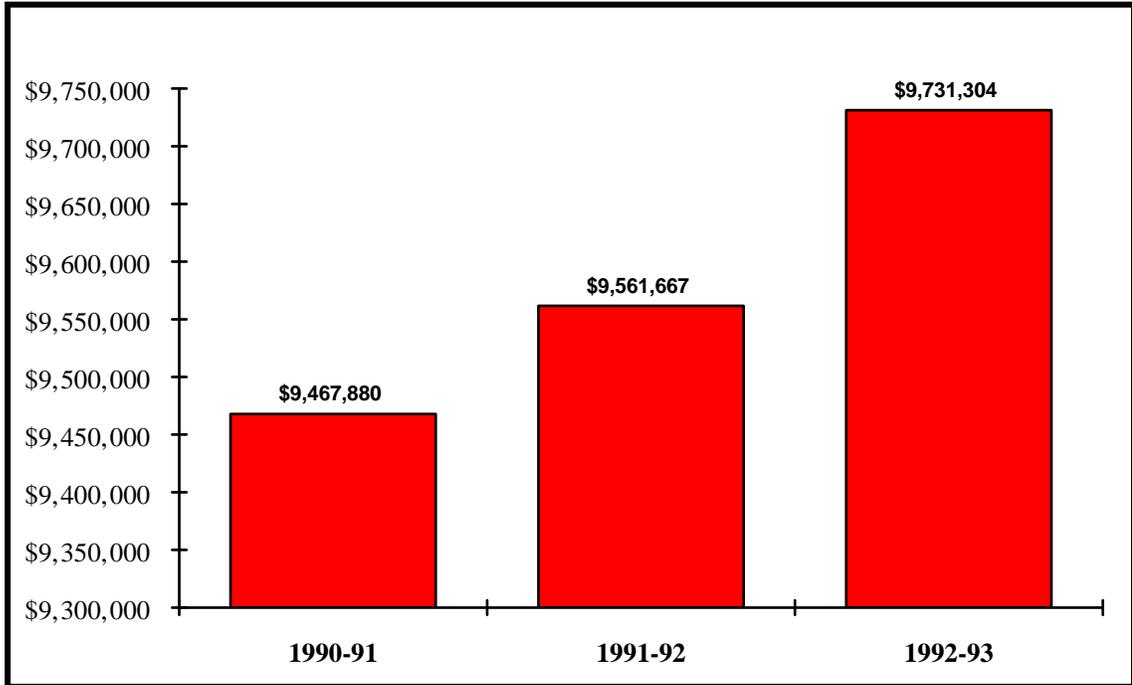
The San José Municipal Code, chapter 4.76, “Business License Taxes,” was enacted solely to raise revenue for municipal purposes and not to regulate business. The tax rates as prescribed in chapter 4.76 of the San José Municipal Code have been in effect since January 1, 1984. The business license tax is calculated based on the business’s number of employees (number of rental units for residential landlords and mobile home park owners or number of square footage owned for commercial landlords). The basic business license tax is \$150. Businesses pay additional taxes of \$18 per employee over eight for most businesses, an additional \$5 per rental unit over 30 for residential landlords, an additional \$5 per lot over 30 for mobile home park owners, or an additional \$.01 per square foot over 15,000 square feet for commercial landlords. San José is one of the few cities that still use these bases. Most other cities we surveyed collect business license taxes based on gross receipts.

Three-Year Business License Tax Revenue

The City’s business license taxes and penalties have increased over the past three fiscal years as shown in Chart I.

CHART I

**CITY OF SAN JOSÉ
BUSINESS LICENSE TAXES AND PENALTIES
FOR 1990-91, 1991-92, AND 1992-93**



The Treasury Division reports the following business license taxes (excluding penalties) collected in 1992-93 by type of business:

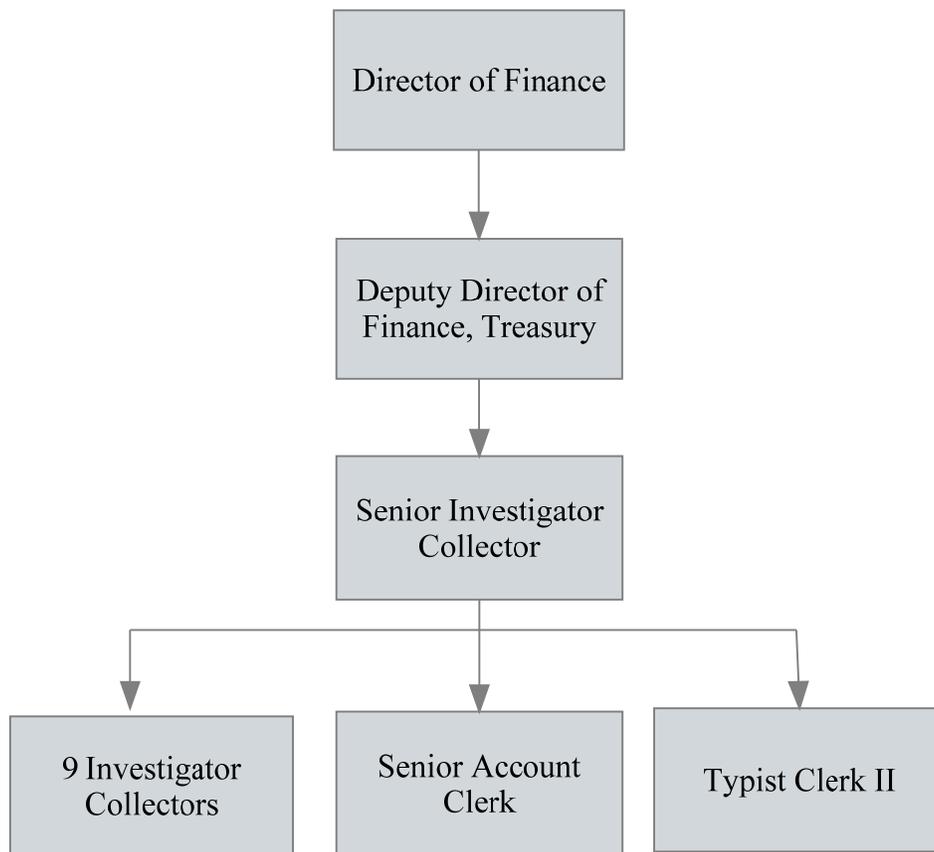
Types of Businesses	Number of Licensees	Total Revenue
Exempt Branches	8,770	\$ 0
Exempt Other	3,141	0
Insurance Brokers*	125	24,582
Psychiatrist/Therapists/Counselors	214	32,118
Engineering Services	215	44,616
Taxi Cab Drivers	396	59,400
Computer Consultants	593	93,954
Gardeners	613	93,390
Handyman	664	100,608
Real Estate Brokers*	699	118,980
Accounting/Bookkeeping	658	124,062
Beauty Parlors/Manicurists (cosmetologists)*	843	129,378
Attorneys/Lawyers	742	137,604
Food, Related Products	469	141,954
Electronics/Radio/TV/Computer	536	142,320
Cleaning/Janitorial	926	146,208
Miscellaneous Retail	1,055	181,050
Consultants	1,182	188,280
Computer/Office Machines	215	193,378
Doctors and Dentists	1,050	200,846
Miscellaneous Manufacturing	275	222,906
Miscellaneous Business Services	1,288	238,362
Restaurants/Deli	1,300	305,844
Electronic/Electrical	305	307,490
Residential Landlords	2,932	557,720
Contractors	4,892	801,449
Commercial Landlords	2,633	919,730
Other	15,083	3,254,778
Totals	51,814	\$8,761,007

* As of January 2, 1994, the City's business license tax database showed 833 licensed cosmetologists, 704 licensed real estate brokers, and 128 licensed insurance brokers.

Organization Chart

The following is the organization chart of the Finance Department/
Treasury Division, Licenses and Permits section, which is responsible for the
administration of the business license tax.

CHART II



A senior investigator collector supervises the Finance Department/ Treasury Division's Licenses and Permits section. This section performs the following functions:

1. Administer billing and collection of the general business license tax
2. Administer issuance of regulatory permits and collection of fees
3. Enforce tax, license, and regulatory ordinances by conducting field investigations

Each of the nine investigator collectors is assigned to a specific business district for the billing and collection of business license taxes. The investigators identify businesses to be taxed, send the necessary forms, and bill and collect the appropriate tax and any penalties and interest due. Investigators get a daily report on accounts that are paid or closed and reports on delinquent accounts for follow up. In addition to taking turns working at the counter helping customers, the nine investigators also update the City's business license tax database.

Department's Major Accomplishments

Appendix I shows the Finance Department's major accomplishments in the administration of the City's business license taxes. Among other things, during 1992-93 and 1993-94 the Finance Department has

- Permanently assigned two investigator collectors to the business tax counter.
- Began cross training business tax investigators in sewer service and use and in accounts receivable collections.
- Improved education and outreach efforts undertaken to expose as many of the business communities as possible to the business tax requirements in the city of San José.

- Resolved a multi-year backlog of over 1,600 pending “lead” accounts, resulting in collection of approximately \$360,000.
- Resolved a multi-year backlog of uncollected delinquent accounts and implemented procedures to prevent a recurrence.
- In coordination with ISD, developed computer matches of commercial and residential property owners using County Assessor records with the business tax database to identify business tax leads.
- Audited all branch accounts to insure their accuracy. Adjusted accounts based on the updated information provided by the owners and from investigator collectors’ research.
- Audited all residential, commercial, and industrial landlord business tax accounts to verify the accuracy of current and future billings.
- Mailed notices to all exempt accounts expiring in September and December 1993 and in March 1994 to verify the exemptions were still valid.
- Revised procedures for application for handbill permits.
- Revised and updated the business tax procedures manual from cover to cover and distributed to all investigator collectors and other personnel in the Treasury Division.
- Initiated research and collection efforts to improve compliance with business tax requirements by distributors of home-party-based products such as Herbal Life, Amway, Avon, etc.
- Implemented monthly reporting format for investigator collectors to monitor collection activity, performance, and workload.
- Refined weekly investigator collector staff meetings to review codes and collection techniques and provide regular training in specific areas needing improvement.

- Began participation in the state of California offset program to effect collection of unpaid business tax accounts for which the City has received judgments.
- Assigned investigator collectors to participate in City training classes to develop and/or improve skills in teambuilding, negotiations, effective meetings, forecasting, communications, computer skills, and TQM.
- Implemented procedures to review all City billing databases for other delinquent accounts owed to the City by the same customer and to file small claims action simultaneously for all money owed by the customer.
- Formed focus groups to investigate such issues as:
 - Sales tax procedures
 - Automated collection systems
 - Reclassification of the investigator collector series

SCOPE AND METHODOLOGY

This is the first report on the audit of business license taxes. This report focuses on our review of the City's business license tax database as compared to lists of licensees obtained from the California Department of Real Estate, California Department of Consumer Affairs, California Department of Insurance, and sales tax permit holders from the California State Board of Equalization.

Our audit objectives were to

- Determine whether there are persons or businesses that should be, but are not, paying the City's business license tax;
- Determine the steps the City has taken to ensure that persons or businesses operating in the City are paying the business license tax; and
- Determine what other cities do to identify and pursue unlicensed businesses within their jurisdictions.

In addition to these state licensing agencies, we contacted and obtained membership lists from the San José Real Estate Board. We also contacted the business license tax units of other cities as well as members of the California Municipal Business Tax Association. The cities' staffs to which we talked were helpful in relating their strategies and procedures for identifying and pursuing unlicensed businesses within their jurisdictions.

During our review, we referred to the City's business license tax database, which the Information Systems Department maintains. The Finance Department/Treasury Division's Licenses and Permits section updates the database and uses it to prepare business license tax billings and renewals as well as investigators' reports of (1) business profiles, (2) business license tax payments, (3) delinquent accounts, and (4) closed accounts. We compared the database to lists of

businesses that the above-mentioned state licensing agencies provided to us. We performed only limited testing to determine the accuracy and reliability of the information in the database. Such testing included observing and walking through database updating procedures at the Treasury Division. We did not review the Information Systems Department's general and specific application controls for the database.

FINDING I

THE CITY MAY BE ABLE TO COLLECT \$7.3 MILLION IN BACK BUSINESS LICENSE TAXES, PENALTIES, AND INTEREST FROM REAL ESTATE BROKERS AND AGENTS, COSMETOLOGISTS, INSURANCE BROKERS, AND SALES TAX PERMIT HOLDERS AND INCREASE ANNUAL BUSINESS LICENSE TAXES BY \$1.6 MILLION

Unless specifically exempted by the San José Municipal Code, all persons or businesses conducting business in the city of San José (City) are required to pay an annual business license tax. Any person who fails to pay the tax on or before the due date is liable for a penalty of 25 percent of one year's tax due. Should the tax remain unpaid for a period exceeding one month beyond the due date, an additional 25 percent penalty plus interest of 1.5 percent per month is assessed. Our review of real estate brokers and agents, cosmetologists, insurance brokers, and sales tax permit holders revealed that the City may be able to (1) collect \$7.3 million in back business license taxes, penalties, and interest and (2) increase annual business license taxes by an estimated \$1.6 million. It should be noted that our estimate of additional revenues may include real estate brokers and agents, cosmetologists, and insurance brokers who are not required to pay business license taxes because they are inactive, employees, or otherwise exempt. To the extent our estimate includes such persons, our estimate of additional business license taxes will be overstated. By contacting suspected unlicensed businesses through a mass-mailing program and implementing a tax amnesty program, the City may be able to cost-effectively recover a substantial portion of unpaid back business license taxes and increase its business license tax base. Furthermore, by using other City departments to inspect for current City business licenses, the City will be able to use existing resources to increase business license taxes. Finally, it should be noted that our estimate of additional business license taxes did not include numerous categories

such as exempt branches, accounting and bookkeeping, consultants, attorneys, miscellaneous business services, restaurants, and janitorial services. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimates shown above.

The Business License Tax

Unless specifically exempted by the San José Municipal Code, all persons or businesses conducting business in the city of San José are required to pay an annual business license tax. The basic annual business license tax rate is \$150. Businesses other than residential and commercial landlords and mobile home parks owners pay an additional \$18 tax for each employee in excess of eight employees. Residential and commercial landlords and mobile home park owners pay incremental taxes based on the number of Municipal Code-specified units. Table I shows the City’s business license tax rates.

TABLE I
CITY OF SAN JOSÉ
BUSINESS LICENSE TAX RATES

	Basic	Increment	Maximum Tax
General License Tax (Most businesses)	\$150	\$18 per employee over 8	\$25,000
Residential Landlords	\$150	\$5 per rental unit over 30	\$5,000
Commercial Landlords	\$150	\$0.01 per sq. ft. over 15,000 sq. ft.	\$5,000
Mobile Home Park Owners	\$150	\$5 per lot over 30	\$5,000

Back Taxes, Penalties, And Interest

Any person who fails to pay the tax on or before the due date is liable for a penalty of 25 percent of one year's tax due. Should the tax remain unpaid for a period exceeding one month beyond the due date, an additional 25 percent penalty of one year's tax plus interest of 1.5 percent per month is assessed. If a person fails to obtain a valid certificate, the business license tax due may be up to three years of back taxes together with applicable penalties and interest, as well as the current year's tax.

Municipal Code, section 4.76.290, states,

- A. *Any person who fails or refuses to pay any business tax required to be paid pursuant to this chapter on or before the due date shall pay penalties and interest as follows:*
 - 1. *A penalty equal to twenty-five percent of the amount of the tax in addition to the amount of the tax, plus interest on the unpaid tax calculated from the due date of the tax at a rate established by resolution of the city council; and*
 - 2. *An additional penalty equal to twenty-five percent of the amount of the tax if the tax remains unpaid for a period exceeding one calendar month beyond the due date, plus interest on the unpaid tax and penalties calculated at the rate established by resolution of the city council.*

- D. *If any person has failed to apply for and secure a valid certificate, the business tax due shall be that amount due and payable from the first date on which the person was engaged in business in the city together with applicable penalties and interest*

Our Review Of Real Estate Brokers And Agents, Cosmetologists, Insurance Brokers, And Sales Tax Permit Holders Revealed That The City May Be Able To Collect \$7.3 Million In Back Business License Taxes, Penalties, And Interest

Our review of businesses subject to the business license tax revealed that certain businesses which are subject to the business license tax have been operating in San José without City business licenses. We identified the unlicensed businesses by comparing lists of licensees from the California Department of Real Estate, California Department of Consumer Affairs, California Department of Insurance, and sales tax permit holders from the California State Board of Equalization to the City’s business license tax database. Table II summarizes the estimated unlicensed businesses, annual taxes, and three years’ taxes plus penalties and interest due. The City Auditor’s Office estimates total potential collections of \$7,275,138 in three years’ back business license taxes, penalties, and interest.

TABLE II
UNLICENSED BUSINESSES,
ESTIMATED ANNUAL TAXES, AND
THREE YEARS’ TAXES PLUS PENALTIES AND INTEREST

	City Auditor’s Estimates		
	Estimated Unlicensed Businesses	Annual Taxes	Three Years’ Taxes¹ Plus Penalties and Interest
Real Estate Brokers and Agents	3,897	584,550	\$2,837,388
Cosmetologists	4,540	681,000	3,305,328
Insurance Brokers	1,084	162,600	788,859
Sales Tax Permit Holders	914	137,100	343,563
Total	10,435	\$1,565,250	\$7,275,138

¹ For purposes of calculating the three years' back taxes, we included the current year's taxes, which is the City's of customary practice.

Real Estate Brokers And Agents

According to the California Department of Real Estate, as of March 1994, there were 8,498 real estate brokers and agents whose business addresses were within the cities of San José, Campbell, Cupertino, Gilroy, Morgan Hill, Milpitas, Santa Clara, and San Martin (unincorporated). Our review of the City's business license tax database indicated that only 704 real estate brokers held current City business licenses as of January 1994. Furthermore, the City's business license tax database did not include any of the real estate agents in the list the California Department of Real Estate provided to us. According to the City Attorney, the City should treat real estate salespersons (agents) as independent contractors for business tax purposes unless it can be established, on a case-by-case basis, that a true "employer/employee" relationship exists between the broker and salesperson.

In a letter dated August 19, 1992, (Appendix E) the City Attorney stated,

The City's business tax is imposed on all persons doing business in the City of San José. The amount of the tax is based on, with limited exception, the number of employees. An "Employee" is defined as "each and every person engaged in the operation or conduct of any business, whether as owner, member of the owner's family, partner, associate, agent, manager or solicitor " Independent contractor's are not included as employees. . . .

For purposes of unemployment insurance, section 650 of the Unemployment Insurance Code provides that a real estate salesperson who receives compensation solely on a commission basis is not an "employee." Most significantly, for purposes of federal income taxes, Internal Revenue Code section 3508 provides that in case of services performed by a qualified real estate agent the individual performing such services shall not be treated as an employee

The City should therefore treat real estate sales persons as independent contractors for business tax purposes unless it can be established, on a case by case basis, that a true "employer/employee" relationship exists between the broker and salesperson.

Of the 8,498 real estate brokers and agents whose business addresses are within the cities of San José, Campbell, Cupertino, Gilroy, Morgan Hill, Milpitas, Santa Clara, and San Martin (unincorporated), we estimate that 7,794 have not paid the City's business license tax. Of the latter number, we estimate that 50 percent, or 3,897, are located within the city of San José.² Therefore, the City could collect additional business license taxes from the estimated 3,897 real estate brokers and agents whose offices are located within the City. The following shows the computation of three years of back taxes plus penalties and interest:

TABLE III
UNLICENSED REAL ESTATE BROKERS AND AGENTS

	Current	1993	1992	1991	Total
Unlicensed Real Estate Brokers & Agents	7,794				
Less 50% for Out-of-Town Businesses	(3,897)				
Estimated Unlicensed Local Businesses	3,897	3,897	3,543	3,221	
10% Yearly Increase		354	322	293	
Net Unlicensed Real Estate Brokers & Agents	3,897	3,543	3,221	2,928	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$584,550	\$531,450	\$483,150	\$439,200	\$2,038,350
Potential Additional Business License Taxes and Penalties	\$876,825	\$531,450	\$483,150	\$439,200	\$2,330,625
Interest	\$ 0	\$ 95,661	\$173,934	\$237,168	\$ 506,763
Total Potential Additional Business License Taxes, Penalties, and Interest	\$876,825	\$627,111	\$657,084	\$676,368	\$2,837,388

² The San José Real Estate Board's 1993-94 membership directory shows that about 50 percent of its members have San José addresses. In addition, 52 percent of the houses that its members sold in 1993 were located in San José.

It should be noted that, although we excluded them from our calculations, real estate brokers and agents who are located outside of San José but who do business in San José may be required to pay the City's business license tax. Specifically, the City charges out-of-town persons or businesses a prorated business license tax based on the number of days the persons or businesses worked in San José during the year as follows:

5 days or less	\$0
6 to 29 days	\$37.50
30 to 89 days	\$56.25
90 to 119 days	\$75.00
120 days or more	\$150.00

Therefore, to the extent that prorated business license taxes could be collected from real estate brokers and agents who are located outside of San José but who do business in San José, our estimate of additional business license taxes will be understated.

Cosmetologists

According to the California Department of Consumer Affairs, as of March 1994, there were 5,373 licensed cosmetologists whose business addresses were within the city of San José. Of this number, we estimate that 4,540 have not paid the City's business license tax. Our review of the City's business license tax database indicated that only 833 cosmetologists held current City business licenses as of January 1994.

We estimate that the City could collect business license taxes from an additional 4,540 cosmetologists whose businesses are located within the City.

Table IV shows the computation of three years of back taxes plus penalties and interest.

TABLE IV
UNLICENSED COSMETOLOGISTS

	Current	1993	1992	1991	Total
Estimated Unlicensed Cosmetologists	4,540	4,540	4,127	3,752	
10% Yearly Increase		413	375	341	
Net Unlicensed Cosmetologists	4,540	4,127	3,752	3,411	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$681,000	\$619,050	\$562,800	\$511,650	\$2,374,500
Potential Additional Business License Taxes and Penalties	\$1,021,500	\$619,050	\$562,800	\$511,650	\$2,715,000
Interest	\$ 0	\$111,429	\$202,608	\$276,291	\$ 590,328
Total Potential Additional Business License Taxes, Penalties, and Interest	\$1,021,500	\$730,479	\$765,408	\$787,941	\$3,305,328

Insurance Licensees

According to the California Department of Insurance, as of March 1994, there were 2,650 insurance licensees whose business addresses were within the city of San José. Of this number, we estimate that 1,084 have not paid the City's business license tax. Our review of the City's business license tax database indicated that only 128 insurance brokers held current business licenses as of January 1994. According to the City Attorney, although agents of insurance corporations are exempt from local taxes under the state constitution, cities can impose local business taxes upon insurance brokers.

In a letter dated October 9, 1992, (Appendix F) the City Attorney stated,

Article XIII, Section 28 (f) of the California Constitution exempts insurers from all state and local taxes or licenses [T]his exemption from local taxes applies to agents of insurance corporations. . . .

However, subsequent cases and the California Insurance Code distinguish an insurance broker from an insurance agent. While an agent is authorized by an insurer to transact insurance for the insurer and to contractually bind the insurer, a broker only is authorized to transact insurance with, not on behalf of, an insurer and has no authority to bind an insurer. Therefore, California courts have reasoned that, unlike agents, insurance brokers are not exempt under the state Constitution from local taxes, and cities may impose business taxes on insurance brokers.

Of the 2,522 insurance state licensees who do not pay the City's business license tax, we estimate that the City could collect business license taxes from 1,084 (43 percent). We base our estimate on the experience of the city of Pleasanton in which 30 of the 70 insurance licensees registered by Pleasanton were paying the business license tax.

Unlike the city of San José, the city of Pleasanton requires all insurance businesses, whether exempt or not, to register. To gain an exemption from paying the business license tax, the insurance licensee must submit acceptable proof of exemption, such as a certificate of authority from the California Department of Insurance. In the case of a self-employed insurance agent, he or she must respond to a questionnaire to determine his or her exemption eligibility. If the agent does not qualify for exemption based on the questionnaire, the agent may furnish additional proof that he or she is an agent of an exempt insurance company in order to be granted an exemption. Insurance businesses that are not granted specific exemption according to Pleasanton's requirements will have to pay the business license tax.

In addition to Pleasanton, we surveyed the cities of Berkeley, Los Angeles, Milpitas, Oxnard, Redwood City, San Leandro, Santa Clara, Stockton, and Sunnyvale regarding their practices in licensing insurance businesses. We found that all of these cities require all insurance brokers to pay. In San José, the

Licenses and Permits section of the Finance Department/Treasury Division does not have a program requiring all insurance agents and brokers to register with the City. As mentioned previously, 128 insurance brokers currently pay the City's business license tax. In addition, another 221 insurance agents have tax-exempt business licenses. However, these insurance businesses are a small fraction of the 2,650 insurance state licensees located in San José.

In our opinion, if San José follows Pleasanton's and other cities' practice of registering all insurance agents and brokers and granting exemption only to those who submit acceptable proof of exemption, the City could collect business license taxes from an additional 1,084 insurance state licensees whose offices are located in San José.

It should be noted that the San José Municipal Code already requires that any person desiring to claim exemption from paying the business license tax must furnish information showing eligibility for exemption. Section 4.76.610 states,

Any person desiring to claim exemption from the payment of a license tax shall make application therefor upon forms prescribed by the director of finance and shall furnish such information and make such affidavit as may be required. Upon the determination being made that the applicant is entitled to exemption from the payment of license taxes for any reason set forth in this chapter, the director of finance shall issue a free license to such person which shall show upon its face that the license is tax exempt.

In our opinion, based on the above provision, the City should require all insurance state licensees to register and to pay the business license tax unless they can furnish proof that they are exempt from the tax. Table V shows the computation of three years of back taxes plus interest and penalties.

TABLE V

UNLICENSED INSURANCE LICENSEES

	Current	1993	1992	1991	Total
Unlicensed Insurance Brokers	1,084	1,084	985	895	
10% Yearly Increase		99	90	81	
Net Unlicensed Insurance Brokers	1,084	985	895	814	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$162,600	\$147,750	\$134,250	\$122,100	\$566,700
Potential Additional Business License Taxes and Penalties	\$243,900	\$147,750	\$134,250	\$122,100	\$648,000
Interest	\$ 0	\$ 26,595	\$ 48,330	\$ 65,934	\$140,859
Total Potential Additional Business License Taxes, Penalties, and Interest	\$243,900	\$174,345	\$182,580	\$188,034	\$788,859

Sales Tax Permit Holders

The California State Board of Equalization (SBE) sends to the City's Finance Department a magnetic tape of San José sales tax collections which shows the names and addresses of sales tax permit holders. We reviewed the list for the quarter ended September 30, 1993, which showed the names and addresses of 21,573 permit holders. Of this number, we selected a sample which consisted of all 1,252 new permit holders and 5,559 from the established permit holders for a total sample of 6,811. By tracing our audit sample to the City business license tax database, we were able to identify 654 sales tax permit holders who did not have current City business licenses. Of the 654 that we identified as unlicensed, 556 were new permit holders as of the quarter ended September 30, 1993.

Further, by extrapolating our audit sample of established sales tax permit holders, we estimate that a total of 358 established sales tax permit holders did not have current City business licenses.

Therefore, based on our audit sample, we estimate that 358 unlicensed established sales tax permit holders and 556 unlicensed new sales tax permit holders did not have current business licenses. In Table VI, our computation shows that the City could collect approximately \$343,563 (\$260,163 plus \$83,400) in business license taxes, penalties, and interest from the estimated 914 (358 plus 556) unlicensed sales tax permit holders.

TABLE VI

UNLICENSED ESTABLISHED SALES TAX PERMIT HOLDERS

	Current	1993	1992	1991	Total
Unlicensed Established ³ Sales Tax Permit Holders	358	358	325	295	
10% Yearly Increase		33	30	27	
Net Unlicensed Sales Tax Permit Holders	358	325	295	268	
Basic Annual Business License Tax	\$150	\$150	\$150	\$150	
Potential Additional Business License Taxes	\$53,700	\$48,750	\$44,250	\$40,200	\$186,900
Potential Additional Business License Taxes and Penalties	\$80,550	\$48,750	\$44,250	\$40,200	\$213,750
Interest	\$ 0	\$ 8,775	\$15,930	\$21,708	\$ 46,413
Total Potential Additional Business License Taxes, Penalties, and Interest	\$80,550	\$57,525	\$60,180	\$61,908	\$260,163

³"Established" sales tax permit holders are those who appeared in the SBE list in at least one quarter prior to the quarter ended September 30, 1993.

TABLE VII

UNLICENSED NEW SALES TAX PERMIT HOLDERS

	Current	1993	1992	1991	Total
Unlicensed New ⁴ Sales Tax Permit Holders	556				
Basic Annual Business License Tax	\$150				
Potential Additional Business License Taxes	\$83,400				\$83,400
Total Potential Additional Business License Taxes	\$83,400				\$83,400⁵

It should be noted that of the 1,252 new sales tax permit holders for the quarter ended September 30, 1993, we identified that 556, or 44 percent, did not have City business licenses. Accordingly, in our opinion, the Finance Department should regularly review the SBE's quarterly magnetic tape of sales tax collections for new sales tax permit holders who do not have City business licenses. The Finance Department should then determine if any permit holders so identified should have a business license and, if so, take appropriate action.

**Our Estimate Of Additional Revenues May Include
Real Estate Brokers And Agents, Cosmetologists, And Insurance Brokers
Who Are Not Required To Pay Business License Taxes**

In our computations of additional revenues we may have included some state-licensed real estate brokers and agents, cosmetologists, and insurance brokers who have been inactive in their professions during the year or who may have been employees rather than independent contractors. Such individuals

⁴"New" sales tax permit holders are those who appeared in the SBE list for the first time for the quarter ended September 30, 1993.

⁵Our computation does not include penalties or interest for new sales tax permit holders.

would not be required to pay the City's business license tax. To the extent our estimate includes such persons, our estimate of additional business license taxes, penalties, and interest will be overstated.

The Finance Department estimates that of the unlicensed businesses shown in Table II on page 14 of this report 754 real estate agents, 1,468 cosmetologists, and 638 insurance brokers are not subject to the City's business license tax because they may have been inactive in their professions during the period or may have been employees rather than independent contractors. As a result, in Appendix H, the Finance Department estimates that the City would be able to collect \$4,967,036 in additional business license taxes, penalties, and interest from real estate brokers and agents, cosmetologists, insurance brokers, and sales tax permit holders and would be able to increase annual business license taxes by \$1,382,196.

**Business License Tax Investigators Should Verify
The Number Of Employees Businesses Report
By Checking Their Payroll Tax Returns**

According to the Finance Department, the business license application form does not require businesses to substantiate the number of employees they report. In our opinion, the Finance Department/Treasury Division should implement procedures instructing the City's business license tax investigators to verify the number of employees business licensees report by checking their payroll tax returns. By so doing, the Finance Department can confirm whether real estate brokers and agents, cosmetologists, insurance brokers, and other professionals working for the business licensees are actually employees rather than independent contractors who would be subject to the City's business license tax. Furthermore, the Finance Department should require any independent

contractors currently reported as employees to apply for separate business licenses.

**The City May Be Able To Cost-Effectively Recover
A Substantial Portion Of Unpaid Back Business License Taxes
And Increase Its Annual Business License Tax Base**

The City could cost-effectively increase the City's annual business license tax base by (1) implementing a mass-mailing program for suspected businesses and persons operating without City business licenses; (2) implementing a tax amnesty program for such businesses and persons; and (3) using other City departments to review for current City business licenses.

Mass-Mailing Program For Suspected Unlicensed Businesses

By contacting suspected unlicensed businesses through a mass-mailing program, the City may be able to cost-effectively increase the business license tax base. Finance Department/Treasury Division already has a form letter that it uses to contact business owners who may be liable but have not applied for the business license.⁶ Other cities, such as Vacaville, also use form letters to inform unlicensed businesses regarding their business license tax regulations.

In the form letter for the mass mailing, the City should state that according to the San José Municipal Code, section 4.76.290.D, the unlicensed business owes business license taxes "*from the first date on which the person was engaged in business in the city together with applicable penalties and interest.*" The form

⁶ See Appendix D for a copy of the Finance Department/Treasury Division's form letter.

letter should also note that if the business is not liable for the business license tax the owner should present documentation justifying the exemption.

By implementing a mass-mailing program, the City can contact the numerous suspected businesses and persons operating without City business licenses without incurring the costs of an investigator's personal visit. During this audit, the City Auditor's Office was able to obtain the owners' names and addresses of businesses potentially subject to the City's business license tax. The Finance Department is welcome to use these lists in conducting the mass-mailing program.

The City Auditor's Office recognizes that the Finance Department/Treasury Division will require additional resources to conduct a mass-mailing program together with ongoing follow up. Accordingly, the Department should request funding in the 1994-95 budget year for any associated costs of new staff and additional operating expenses.

Tax Amnesty Program For Unlicensed Businesses

By implementing a tax amnesty program, the City also may be able to cost-effectively recover a substantial portion of unpaid back business license taxes and increase its annual business license tax base. In 1987, the City conducted an amnesty program for business license taxes in which the City netted more than \$835,000 out of an expected \$1 million. During the two-month amnesty period (October and November 1987), the City suspended late payment penalties and interest. The businesses that applied for the amnesty still had to pay the back taxes owed. Excluding the lost revenue due to waiver of penalties and interest,

the amnesty program cost the City approximately \$69,000 to implement. Appendix B describes the 1987 San José Business License Tax Amnesty program.

The city of Los Angeles also implemented a tax amnesty program. Los Angeles' program, from October through December 1985, collected \$13.9 million and cost \$2.5 million in cash expenditures and lost revenue due to assignment of income-producing staff to the amnesty program. Under the program, Los Angeles waived \$6.8 million in penalties and criminal prosecution of delinquent taxpayers who met certain requirements. The requirements included paying all principal taxes and interest due, making a statement of gross receipts or other tax measure, and filing an application for amnesty. Los Angeles considered its amnesty program a success because it collected five times the estimated amount and added 1,500 new accounts to its tax base. Appendix C describes the Los Angeles amnesty program in detail.

By implementing a business license tax amnesty program similar to the program the City conducted in 1987 or the program the city of Los Angeles conducted in 1985, the City could collect substantial unpaid business license taxes from unlicensed businesses while adding new accounts to the business license tax base. Because the business license tax penalties waived under a tax amnesty program could be as much as 50 percent of one year's tax owed and three years of interest on unpaid taxes could be about 36 percent of the tax owed, a tax amnesty program that would generate \$5.3 million in tax collections may result in waived penalties of \$741,000 and waived interest of \$1.3 million. In addition, the Finance Department may need media consultant services and additional temporary staff to handle the telephone calls and paperwork connected with a business license tax amnesty program.

Using Other City Departments To Review For Current Business Licenses

The City does not have a formal strategy or plan to identify unlicensed businesses when various City staff members visit business establishments in their regular inspection visits. City departments whose staffs have regular contacts with business establishments (such as building, fire, and hazardous materials code inspectors and water meter installers or readers) do not have policies or procedures that require their staffs to (1) check whether the business establishments they inspect have current business licenses and (2) report unlicensed businesses to the Finance Department for investigation.

The city of Pleasanton requires its inspectors to check business licenses and report unlicensed businesses to their finance departments. Pleasanton instructs its utility meter readers and other city employees to report to its Finance Department the “House For Sale” signs of out-of-town realtors. The Pleasanton Finance Department then informs these realtors that they need to pay their business license taxes. If the realtors still refuse to pay, the city pursues the taxes through the small claims court. According to Pleasanton’s business license coordinator, the city has been successful in these small claims cases.

Before the city of Campbell transferred its fire inspection function to the Santa Clara County Central Fire District, Campbell fire code inspectors verified that the firm’s business license was current before they inspected the firm’s premises. The inspectors would then report any unlicensed businesses to the city clerk, whose functions included collecting the business license tax.

Since the City inspectors are already contacting businesses as part of their duties, using the City departments to review for current business licenses would

be a cost-effective way to ensure that businesses operating in the City have current business licenses.

Potential Additional Revenues

It should be noted that our estimate of additional business license taxes did not include numerous categories such as exempt branches, accounting and bookkeeping, consultants, attorneys, miscellaneous business services, restaurants, and janitorial services. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimated \$7.3 million in back business license taxes, penalties, and interest and \$1.6 million in annual increased business license taxes shown in this report.

CONCLUSION

Our review of business license taxes revealed that certain businesses and persons who are subject to the City's business license tax have been operating in San José without City business licenses. We identified these businesses and persons by comparing lists of licensees from the California Department of Real Estate, California Department of Consumer Affairs, California Department of Insurance, and sales tax permit holders from the California State Board of Equalization to the City's business license tax database. Our review also revealed that City departments whose staffs make regular contacts with business establishments do not have policies or procedures that require their staffs to check whether the business establishments they inspect have current business licenses or to report unlicensed businesses to the Finance Department for investigation. By using the business listings from these state licensing agencies to

identify businesses and persons who should have City business licenses but do not, the City may be able to (1) collect \$7.3 million in business license taxes, penalties, and interest and (2) increase annual business license taxes by an estimated \$1.6 million. Furthermore, by contacting suspected businesses and persons through a mass-mailing program, implementing a tax amnesty program, and using other City departments to inspect for current business licenses, the City may be able to cost-effectively recover unpaid taxes and increase its business license tax base. Finally, it should be noted that our estimate of additional business license taxes did not include numerous business categories. To the extent these excluded categories include persons or businesses that should be paying business license taxes but are not, the City is losing additional revenue over and above the estimates in this report.

RECOMMENDATIONS

We recommend that the Finance Department/Treasury Division:

Recommendation #1:

Use the licensee listings of real estate brokers and agents (from the California Department of Real Estate), cosmetologists (from the California Department of Consumer Affairs), insurance licensees (from the California Department of Insurance), and sales tax permit holders--especially new permit holders--(from the California State Board of Equalization) to identify and pursue suspected unlicensed San José businesses. (Priority 1)

Recommendation #2:

Require all insurance licensees doing business within the City to register for the business license and to pay the business license tax unless they can furnish proof that they are exempt from the tax. (Priority 1)

Recommendation #3:

Implement a mass-mailing program to contact the suspected unlicensed businesses and inform them of the City's business license tax regulations and the penalties for non-filing. The form letter should note that if the business is not liable for the business license tax the owner should present documentation justifying the exemption. (Priority 1)

Recommendation #4:

Provide training and prepare written procedures to guide the business license tax investigators in identifying and pursuing unlicensed businesses. (Priority 1)

Recommendation #5:

Implement written procedures instructing the business license tax investigators to (1) verify the number of employees business licensees report by checking their payroll tax returns and (2) require any independent contractors currently reported as employees to apply for separate business licenses. (Priority 1)

Recommendation #6:

Upon approval of Recommendations #1, #2, #3, #4, and #5, request funding for any associated costs of necessary new staff and additional operating expenses. (Priority 1)

Recommendation #7:

Implement a limited-period amnesty program to encourage unlicensed businesses to voluntarily pay their business license taxes. (Priority 1)

Recommendation #8:

Upon approval of Recommendation #7, request funding for media consultant services to implement the business license tax amnesty program and for temporary staff to handle the tax amnesty telephone calls and paperwork. (Priority 1)

Further, we recommend that the Office of the City Manager and the Finance Department:

Recommendation #9:

Implement procedures to require staff members from City departments who make regular contacts with business establishments (such as building, fire, and hazardous materials code inspectors and water meter installers or readers) to (1) check whether the business establishments they inspect have current business licenses and (2) report unlicensed businesses to the Finance Department for investigation. (Priority 1)

Recommendations Requiring Budget Action

Of the preceding recommendations, #1, #2, #3, #4, #5, #6, #7, and #8 cannot be implemented absent additional funding. Accordingly, the City Manager should request during 1994-95 that the City Council appropriate an amount sufficient to implement Recommendations #1, #2, #3, #4, #5, #6, #7, and #8.

FINDING II

THE FINANCE DEPARTMENT DID NOT OBTAIN MUNICIPAL CODE-REQUIRED CITY COUNCIL APPROVAL BEFORE WAIVING \$4,542 IN LATE PAYMENT PENALTIES ON DELINQUENT BUSINESS LICENSE TAXES

The San José Municipal Code, section 4.76.505, prescribes that public market operators must pay their estimated business license taxes for the period December 1, 1993, to November 30, 1994, in three installments.

- The first installment was due on December 1, 1993;
- The second on April 1, 1994; and
- The third on June 1, 1994.

Municipal Code, section 4.76.290, empowers the City to collect penalties and interest on the taxes not paid by the due date. In addition, section 4.76.281 does not require the Director of the Finance Department to send the operator a notice of the business license tax due. Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542. By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval. The Finance Department should (1) implement procedures to ensure compliance with section 1.17.010 of the Municipal Code regarding the need to obtain City Council approval before waiving late payment penalties or postponing the late payment penalty date and (2) request a City Attorney opinion on the City's ability to collect the \$4,542 penalty previously waived.

Business License Tax Payment Schedule For Public Market Operators

Ordinance No. 24211 amending the San José Municipal Code, chapter 4.76, prescribes that public market operators must pay their estimated business license taxes for the period December 1, 1993, to November 30, 1994, in three installments. The first installment was due on December 1, 1993; the second on April 1, 1994; and the third on June 1, 1994. Section 4.76.505 states,

- A. *A public market operator shall pay, in advance, the tax required by Section 4.76.500 F, based on the estimated reserved space average for that fiscal year. . . .*
- b. *The tax for the period December 1, 1993 to November 30, 1994 shall be due and payable in three equal installments and remitted to the City on December 1, 1993, April 1, 1994 and June 1, 1994.*
- B. *Any delinquent payment of the estimated tax shall bear penalties and interest as set forth in Section 4.76.290.*

Late Payment Penalties Are Due If The Business License Tax Is Not Paid On Time

The Municipal Code prescribes a late payment penalty of up to 50 percent of one year's tax if the public market operator did not pay his business license tax on time. Section 4.76.290 states,

Any person who fails or refuses to pay any business tax required to be paid pursuant to this chapter on or before the due date shall pay penalties and interest as follows:

- 1. *A penalty equal to twenty-five percent of the amount of the tax in addition to the amount of the tax, plus interest on the unpaid tax calculated from the due date of the tax at a rate established by resolution of the city council; . . .*
- 2. *An additional penalty equal to twenty-five percent of the amount of the tax if the tax remains unpaid for a period exceeding one calendar month beyond the due date, plus interest on the unpaid tax and*

penalties calculated at the rate established by resolution of the city council.

**The Finance Department Did Not Have To Send
The Operator A Notice Of The Business License Tax Due**

The Municipal Code does not require the Finance Department to issue billing notices to collect business taxes. Section 4.76.281 states,

The director of finance is not required to send a renewal, delinquency or other notice or bill to any person subject to the provisions of this chapter and failure to send such notice or bill shall not affect the validity of any tax or penalty due under the provisions of this chapter.

**By Allowing A Retroactive Extension Of The Filing Deadline,
The Finance Department Waived The \$4,542
In Late Payment Penalties Owed By A Public Market Operator**

Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542.

According to the Finance Department/Treasury Division, due to an error on the master business tax activity calendar, Finance staff did not send to the public market operator the billing for the December 1, 1993, installment until December 10, 1993 (see Appendix G). In the billing notice, the Finance Department required the public market operator to pay within seven days of the date of the billing notice and postponed the penalty date until the new deadline. Section 1.17.010 states,

Fees, deposits, bonds or charges for permits, licenses, activities or services provided for by this code may not be waived unless the waiver is otherwise specifically provided for in this code or unless waived by ordinance.

By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval.

CONCLUSION

Our review indicated that a public market operator failed to pay his December 1, 1993, installment on time and that the Finance Department did not assess and the operator did not pay the required 25 percent penalty of \$4,542. By allowing a retroactive extension of the filing deadline, the Finance Department waived the late payment penalty without first obtaining Municipal Code-required City Council approval.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #10:

Implement procedures to ensure compliance with section 1.17.010 of the San José Municipal Code regarding the need to obtain City Council approval before waiving late payment penalties or postponing the late payment penalty date. (Priority 2)

Recommendation #11:

Request a City Attorney opinion on the City's ability to collect the \$4,542 penalty the Finance Department previously waived. (Priority 2)

CITY OF SAN JOSÉ - MEMORANDUM

To: Gerald Silva
City Auditor

From: John V. Guthrie
Director of Finance

Subject: **RESPONSE TO AUDIT OF THE SAN JOSE
BUSINESS LICENSE TAXES** Date: May 19, 1994

Approved by: *J. Williams* Date: *5/19/94*

The Finance Department has reviewed the *Audit of the San Jose Business License Taxes*. The Department agrees with most of the recommendations contained in the audit but has some disagreement with Recommendations 7, and 11. This disagreement is based in part upon a philosophical difference of opinion regarding the optimum frequency of effective tax amnesty programs and secondarily on the tax assessment for one individual business tax account associated with the temporary tax on public marketers. The Finance Department's response to each recommendation is provided below.

Recommendation #1:

Use the licensee listings of real estate brokers and agents (from the California Department of Real Estate), cosmetologists (from the California Department of Consumer Affairs), insurance licensees (from the California Department of Insurance), and sales tax permit holders--especially new permit holders--(from the California State Board of Equalization) to identify and pursue suspected unlicensed San José businesses. (Priority 1)

The Department agrees with this recommendation. These licensee listings are good sources of business tax leads, as are licensee and professional listings for other business categories. However, the four lists mentioned above together comprise over 14,000 names. Implementation of this recommendation is contingent on a more complete analysis of the most efficient and cost-effective way to contact and review these potential leads.

Finance staff's preliminary research indicates that many of these licensees will have either already paid the San Jose business tax, are out of business, are included in our tax base as someone else's employee, or are not actively pursuing a career in the field in which they have been licensed. The Auditor's Office report qualifies that revenue estimates do not calculate the number of these licensees that are inactive state licensees or employees. To

**RESPONSE TO AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES
Page 2, May 18, 1994**

determine this will require detailed collection efforts. However, to the extent that the estimate includes these, the estimate is overstated. From the preliminary investigation the Finance Department conducted in this area, we would estimate that the revenue potential is significantly less than indicated in the report. For example per Exhibit A, investigation of 40 real estate leads provided by the City Auditor's Office revealed that 25% were already licensed in San Jose, 15% were out of business, and 5% were inactive and conducting no business in San Jose.

Additionally, while the Finance Department agrees philosophically with the report, we believe that the practical collectability of these categories would be significantly less than the revenue estimate totals. Nonetheless, we believe there is potential revenue owed the City and we need to explore processes, technology and staffing needs to efficiently maximize these collections.

Recommendation #2:

Require all insurance licensees doing business within the City to register for the business license and to pay the business license tax unless they can furnish proof that they are exempt from the tax. (Priority 1)

The Finance Department agrees with this recommendation in that it will help maximize business tax revenue from licensed insurance brokers. However, implementation of this recommendation to register all insurance licensees (including agents who are not subject to the City's business tax) will require using the Department's limited collection resources on accounts that may not generate revenue to the City, potentially diluting other revenue-producing collection efforts. Implementation of this recommendation is contingent on a more complete analysis of the most efficient and cost-effective way to contact and review these insurance licensees. The Auditor's Office estimates in this category do not calculate the number of these licensees that are inactive state licensees or employees. To the extent that the estimate includes these, the estimate is overstated. We have reviewed the models with the Auditor's Office and we both acknowledge there is no factor for inactive licensees since we cannot determine the correct percentage until we actively contact these licensees. Implementation will be undertaken as part of the Finance Department's overall strategic planning for maximizing tax collections. Full implementation of this recommendation would require additional staffing and technological enhancements.

Additionally, the Auditor's Office business license estimate for insurance licensees is

**RESPONSE TO AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES**

Page 3, May 18, 1994

based on a percentage calculated from the City of Pleasanton's experience. The 43% is the percentage of business license taxes collected to the total number of insurance licensees registered in the City of Pleasanton. According to the Auditor's Office, the City of Pleasanton obtains their list of registered insurance licensees from reviewing the California Department of Insurance (CDI) list of licensees, the telephone book, and field investigations. However, the Auditor's Office applies this percentage to the list received from the (CDI) for the City of San Jose. To make this an equitable comparison, the City Auditor would need to gain the same CDI list for the City of Pleasanton. This list should then be compared to the City of Pleasanton's number of registered insurance licensees to determine an applicable percentage for the City of San Jose. As the Department of Insurance's list would more likely contain inactive insurance agents or employees, we believe that the percentage would be lower. For this reason, the revenue estimate would again be overstated.

Recommendation #3:

Implement a mass-mailing program to contact the suspected unlicensed businesses and inform them of the City's business license tax regulations and the penalties for non-filing. The form letter should note that if the business is liable for the business license tax, the owner should present documentation justifying the exemption. (Priority 1)

The Finance Department agrees conceptually with this recommendation. Mass mailings can be an effective tool in a strategic plan for maximizing tax collections. However, implementation of this recommendation is contingent on a more complete analysis of the most efficient and cost effective means to contact and review these potential leads. As mass mailings can be a labor-intensive process, the Department will first proceed with a limited test mailing to determine optimum work efforts. Results of these tests may indicate a need for additional staffing and technological enhancements. When you conduct a mass mailing, you must be prepared to do rigorous follow-up. This could include multiple activities: phone calls and letters to be responded to, payments to be processed, data entry to update or correct account information, returned mail investigations, skip-tracing activities, and enforcement and collection activities such as phone calls, field inspections, citations and small claims court appearances. Both additional collection and support staff will be required to implement an effective mass-mailing program. In addition, the Finance Department believes that a position with computer and analytical skills to generate quality lead lists from various and diverse data

**RESPONSE TO AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES
Page 4, May 18, 1994**

bases (eg. State of California licensees, Franchise Tax Board listings, and State Board of Equalization lists, professional associations, reverse directories, yellow pages, etc.) would be recommended. This position would be able to develop computer programs to screen out already licensed accounts, generate mass mailings, and prioritize the resulting lists in accordance with the Department's collection plans (eg. prioritize leads by potential dollar amount, target particular business categories or geographical areas, etc.). This position would have a multiplier effect on collection staff by being a catalyst for quality new account leads. This position would maximize the Department's use of any new technological advancements related to collection management.

Recommendation #4:

Provide training and prepare written procedures to guide the business license tax investigators in identifying and pursuing unlicensed businesses. (Priority 1)

The Finance Department agrees with this recommendation and plans to complete implementation by September, 1994. The Finance Department has written procedures in place regarding the identification of unlicensed businesses. The Department will review these procedures and revise them if needed. The Department will continue to conduct training in this area on at least an annual basis, and more often as needed.

Recommendation #5:

Implement written procedures instructing the business license tax investigators to (1) verify the number of employees business licensees report by checking their payroll tax returns and (2) require any independent contractors currently reported as employees to apply for separate business licenses.

The Finance Department agrees that checking payroll tax returns will be a valuable audit tool if it is legal to request them. However, preliminary discussion with the City Attorney's Office indicates this may not be doable if these tax returns are legally considered confidential information. The Department will request a written opinion from the City Attorney as to the legality of implementing this recommendation.

Recommendation #6:

Upon approval of Recommendations #1, #2, #3, #4 and #5, request funding for

**RESPONSE TO AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES
Page 5, May 18, 1994**

any associated costs of necessary new staff and additional operating expenses. (Priority 1)

The Finance Department does not totally recommend that Recommendations #1, #2, #3, #4 and #5 be approved in their entirety at this time. As we have not had sufficient time to develop a plan for implementation, we do not know what additional staff or resources will be needed. If the recommendations are approved by the Finance Committee, the Department will test samples from which to develop an overall strategy. Based on these results, the department will develop a staff and resource plan and a cost estimate for review and referral to the mid-year budget process.

Recommendation #7:

Implement a limited period amnesty program to encourage unlicensed businesses to voluntarily pay their business license taxes. (Priority 1)

The Finance Department disagrees with this recommendation for the following reasons:

1) In order for amnesty programs to be effective, they should not be frequent enough to be predictable. An amnesty program should be part of a greater strategic plan. To maximize business license tax revenues, amnesty programs should be used sparingly (ideally, no more than once every 10 years). The City's last business tax amnesty program was conducted in the Fall of 1987, less than 7 years ago. All other aspects of gaining compliance should be used first (eg. education, public relations, and enforcement.) Amnesty programs that are conducted too close together create voluntary compliance problems. Taxpayers begin to expect another amnesty period and don't voluntarily comply with the business tax requirements. They begin to take their chances to see if they will get caught. With less voluntary compliance from the business community, aggressive enforcement becomes the key to maintaining compliance. If Business Tax collection staff must rely more and more on aggressive enforcement procedures in order to gain compliance from the business community, the City's desired positive image as a good place to do business may become compromised. The most economical method of compliance is voluntary. Thorough education, outreach to various groups, word of mouth, and the use of mass media combined with effective enforcement, are the most cost effective methods of achieving voluntary compliance.

2) Amnesty programs are not equitable. They are not fair to those individuals who

**RESPONSE TO AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES
Page 6, May 18, 1994**

voluntarily comply with the business tax requirements or to those that have had to pay penalties for late payment of the tax..

3) Amnesty programs reduce the amount of revenue that can be collected by forgiving penalties and interest during the amnesty period. Using the numbers generated by the Auditor, the forgiveness of penalties and interest would result in 38% less collections or \$2,276,121 in foregone revenues.

The Department recommends that all other efforts should be actively pursued prior to implementing another amnesty program. We are embarking on new strategies to generate leads and get compliance. Why give away potential revenues that we could collect with more rigorous enforcement? The Finance Department does not believe it would be in the best interests of the City to conduct an amnesty program at this time.

Recommendation #8:

Upon approval of recommendation #7, request funding for media consultant services to implement the business license tax amnesty program and for temporary staff to handle the tax amnesty telephone calls and paperwork. (Priority 1)

The Finance Department agrees with the hiring of media consultant services even without an amnesty program. The City needs to make every effort to reach the entire business community so that business owners understand up front that they are liable for paying a business license tax if they do business in the City of San José. This ongoing outreach would be part of an overall strategic plan to maximize business tax collections. A media consultant could assist the Department in identifying and implementing the most cost-effective means of educating our business community and help design educational materials and informational brochures. We may even consider recommending that such materials be sent with WMI Commercial Garbage bills and perhaps even Recycle Plus billings.

This plan would include the staffing needs of the Department as a result of the increased phone calls and paperwork. Since this program would be ongoing, and different business areas could be targeted throughout the year, the additional staffing needs would not be temporary.

Recommendation #9:

**RESPONSE TO AUDIT OF THE
SAN JOSE BUSINESS LICENSE TAXES
Page 7, May 18, 1994**

Implement procedures to require staff members from City departments who make regular contacts with business establishments (such as building, fire and hazardous materials code inspectors, and water meter installers or readers) to, 1) check whether the business establishments they inspect have current business licenses, and 2) report unlicensed businesses to the Finance Department for investigation. (Priority 1)

The Finance Department agrees with this recommendation. With the additional eyes and ears out in the community, additional business tax leads could be found sooner. This would also help the business community incur less in penalties and interest. Also, Finance staff recommends additional training be given to enable these staff members to inspect State Board of Equalization sales tax permits. This will insure that any sales tax revenues generated by these San José businesses is credited to the City of San José instead of being erroneously credited to another community or the State of California sales tax pool.

Recommendation #10:

Implement procedures to ensure compliance with section 1.17.010 of the San Jose Municipal Code regarding the need to obtain City Council approval before waiving late payment penalties or postponing the late payment penalty date. (Priority 2)

The Finance Department agrees conceptually with this recommendation and will implement written procedures by September 30, 1994.

Recommendation #11:

Request the City Attorney's opinion on the City's ability to collect the \$4,542.00 penalty the Finance Department previously waived. (Priority 2)

The Finance Department disagrees with this recommendation because the Finance Department did not waive the \$4,542.00 penalty. Ordinance 24211 was established as the best means to gain compliance by transient marketers. Each public market operator agreed to pay the increased interim business tax and work with the City for compliance of the City's business tax laws. Payment schedules were established. During the first year of implementation, the tax was due in two equal installments on January 1, 1993 and

**RESPONSE TO AUDIT OF THE
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Page 8, May 18, 1994**

June 1, 1993. When the January 1993 payment was missed by the public market operators because of the newness of the tax, penalties were assessed and paid by both market operators. City staff agreed to send notices in the future to remind the marketers of the additional tax due under Ordinance 24211. During the second and final year of implementation, the tax payments were to be due in three installments, on December 1, 1993, April 1, 1994, and June 1, 1994. Because of staff changes within the Treasury Department, no reminder was sent out prior to the December 1993 payment due date and the marketers also failed to make a timely payment. When Department staff realized the oversight, the Department sent notices assessing the tax due from each market and requiring payment within (7) seven days or a penalty would be assessed. One market operator paid the tax installment within the required seven (7) days mentioned in the notice of tax due. The other market operator did not pay within the seven (7) day period and was subsequently billed for the full penalty and has paid both the taxed assessed and the penalty. In March 1994, the Department sent notices of the April 1 payment due date and amounts and both market operators made timely payments.

This recommendation refers to the market operator that paid the December tax installment within the seven days required in the billing notice. The decision to assess the tax installment due in writing prior to assessing penalties was based on a customer-service orientation of being responsive to our customers and treating them fairly and equally. Should the City pursue collection of this \$4,542 penalty, the proprietor will petition to appeal to the Finance Committee with good cause given the City's failure to notify them in a timely manner. In this event, the Finance Department would recommend that Finance Committee waive the penalty. We do not believe that this loop would be an efficient use of either the Committee's or staff's time.

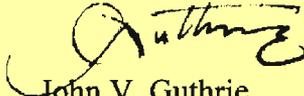

John V. Guthrie
Director of Finance

EXHIBIT A

**CITY OF SAN JOSE
FINANCE - TREASURY
SAMPLE OF AUDIT RESULTS
REAL ESTATE AGENTS**

	RESULTS OF SAMPLE	PERCENTAGE
OUT OF BUSINESS	8	15.00%
OUT OF TOWN	5	12.50%
INACTIVE-HOLD OTHER JOBS	2	5.00%
# PAID FROM LEAD LIST	4	10.00%
EXISTING LICENSE	10	25.00%
BILLED FROM LEAD LIST	5	12.50%
RETURN MAIL	5	12.50%
PENDING FURTHER INVESTIGATION	3	7.50%
TOTAL	40	100.00%
POTENTIAL LEADS ACCOUNTS (shaded above)	12	30.00%
NON-LEAD ACCOUNTS (non-shaded)	28	<u>70.00%</u>
TOTAL ACCOUNTS	40	100.00%

AMOUNT OF TIME TO WORK THE ABOVE 40 ACCOUNTS WAS ESTIMATED TO BE 14 HOURS. THIS IS A RETURN OF \$87 PER HOUR VS. CURRENT RETURN OF \$159 PER HOUR PER COLLECTOR. \$1214 WAS COLLECTED DURING THE SURVEY PERIOD.

APPENDIX A

DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Policy Manual (6.1.2) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class ¹	Description	Implementation Category	Implementation Action ³
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring. ²	Priority	Immediate
2	A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists. ²	Priority	Within 60 days
3	Operation or administrative process will be improved.	General	60 days to one year

¹ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. **(CAM 196.4)**

² For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of \$25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of \$50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens.
(CAM 196.4)

³ The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.
(CAM 196.4)

APPENDIX B

San Jose Business License Tax Amnesty.

It's a small price to pay. Today.

What is the Business License Tax?

Established in 1963, San Jose's Business License Tax provides revenue for the City of San Jose to assist in funding necessary public services which businesses utilize. These services include police, fire, street maintenance and other vital programs.

What is Business License Tax Amnesty?

This one-time program will allow businesses, property owners, and self-employed professionals to pay their unpaid and delinquent Business License Taxes without penalties or criminal prosecution. *The two-month amnesty program begins October 1, 1987 and ends November 30, 1987.*

Who is expected to pay?

All persons or companies doing business in the City of San Jose are required to pay the Business License Tax, whether they have offices located in the city or not.

Included are large corporations, small service companies, light manufacturing operations, commercial and residential landlords; as well as self-employed professionals, including doctors, attorneys, accountants and consultants.

The tax also applies to home businesses, and part-time operations.

Who is not expected to pay?

Approximately 1,500 of San Jose's businesses and organizations are exempt from the Business License Tax. They include banks, insurance companies; certain fraternal, religious, educational, and public entertainment groups; individuals selling self-produced wares; and senior citizens whose annual gross income does not exceed \$7,800.

How far back must I pay?

Businesses, property owners and self-employed professionals are liable for taxes due from October 1, 1984 to the

present. Taxes due prior to that time are being waived by the City of San Jose.

How much does the tax cost?

For the years 1984 and 1985, the basic annual tax is \$75.

Additionally, for the years 1984 and 1985, businesses must pay \$9 per employee beyond the first eight employees. Property owners are liable for additional increments of \$2.50 per residential unit beyond the first 30 units, one-half cent per square foot of non-residential floor space beyond 15,000 square feet, or \$2.50 per mobile-home lot beyond 30 lots.

For the year 1986 and beyond, the basic annual tax is \$150.

Additionally, for the year 1986 and beyond, businesses must pay \$18 per employee beyond the first eight employees. Property owners pay additional increments of \$5 per residential unit beyond the first 30 units, one cent per square foot of non-residential floor space beyond 15,000 square feet, or \$5 per mobile-home lot beyond 30 lots.

Why am I being forgiven?

The City of San Jose has initiated this program to ease the burden on businesses that are paying the business tax and, as such, are supporting the city services utilized by those that have not.

While the amnesty period will raise needed revenue for the city, it will also provide a grace period for those businesses and individuals who are unaware of the Business License Tax.

What happens after the amnesty period?

The City of San Jose's Finance Department has collected the names of companies and individuals who are not in compliance with the Business License Tax. The two-month amnesty period will be followed by dramatically increased enforcement by Finance Department Investigators.

Companies or individuals who have neglected to pay the Business License Tax during the amnesty period are subject to penalties of 50 percent of the total taxes due immediately following the amnesty period. In addition, criminal misdemeanor prosecution may result in fines of \$500 and/or six months in jail.

In other words, we mean business.

How do I apply for amnesty?

If you have received this brochure by mail, the Treasury Department will be sending your tax forms shortly. Taxes are due and payable immediately.



If you have not received this brochure by mail-- and you believe you may owe Business License Taxes-- you may call (408) 277-5955 for information and instructions.

APPENDIX C

CITY OF LOS ANGELES BUSINESS TAX AND PAYROLL EXPENSE TAX PENALTY AMNESTY PROGRAM FROM OCTOBER 1, 1985, THROUGH DECEMBER 31, 1985

The city of Los Angeles' first Business Tax and Payroll Expense Tax Penalty Amnesty Program was conducted from October 1, 1985, through December 31, 1985. The city clerk estimated that income from the program would be approximately \$2.3 million. However, the total amount of principal and interest actually collected was \$13.9 million. Total cost of program was \$2.5 million. The following is an analysis of the revenues and costs associated with the amnesty program:

Amnesty collections	\$12,485,072
Receivables from installment agreements	<u>1,366,594</u>
<i>Total collections and receivables</i>	\$13,851,666

Less: Cash and Non-cash expenditures

<i>Cash expenditures</i>	
Personnel salaries	\$ 206,188
Advertising	60,138
Mailing services	17,203
Printing	1,389
Miscellaneous	<u>5,977</u>
<i>Total cash expenditures</i>	\$ 290,895
<i>Non-cash expenditures</i>	
Lost revenue due to assignment of income-producing staff to the amnesty unit	<u>2,224,019</u>
<i>Total cash and non-cash expenditures</i>	<u>2,514,986</u>
Overall outcome/net result	<u>\$11,336,680</u>
Amount of waived penalties	\$ <u>6,831,240</u>

Prior to the amnesty program, the Los Angeles Tax & Permit Division reviewed its records of delinquent accounts. Utilizing a mail marketing service, the city then sent out approximately 53,000 letters informing the delinquent businesses of the amnesty program. In addition to this mass mailing, the city controller sent out letters to local CPAs and tax attorneys to communicate the amnesty requirements to their clients.

The publicity campaign was handled through a personal services contract with a public relations specialist. He utilized several forms of media in his approach, including billboards, newspaper ads, press releases, public service announcements, and bus signs.

To handle the paperwork and other administrative tasks related to the amnesty program, Los Angeles convened a task force consisting of one senior tax auditor, one field representative, and six temporary contract employees. However, towards the end of the amnesty period, when the deluge of amnesty applications arrived, one senior field representative, eight auditors, and nine field representatives were added to the task force.

The Los Angeles tax amnesty program also used a direct deposit system to process the numerous payments generated. Los Angeles did not originally plan on a direct deposit of checks, but when the flood of mail arrived during the latter part of the amnesty period, the City decided to use a direct deposit service to ensure timely payment deposits and minimize the chances of lost or misplaced checks. In retrospect, the amnesty staff stated that they should have utilized the direct deposit system from the beginning.

In general, Los Angeles considered its tax amnesty program a success. The amnesty staff was happy to have accomplished its two major goals. The first goal was to enlarge the city's tax base; they set up over 1,500 new accounts as a result of the amnesty. The second goal was to increase collections of currently owed taxes; they collected more than five times the estimated recovery amount.

APPENDIX D



CITY OF SAN JOSÉ, CALIFORNIA

ROOM 217, CITY HALL
801 NORTH FIRST STREET
SAN JOSE, CA 95110-1708

TELEPHONE NUMBERS (Area Code 408)
Banking & Investments 277-4181 Account Receivable 277-4184
Licenses & Permits 277-5051 Sewer Service Billings 277-5195

FINANCE DEPARTMENT
Treasury Division

May 17, 1991

Account Number:

DEAR BUSINESS OWNER:

We have information that you are conducting business in the City of San Jose.

Since our records do not show an account for your business, perhaps you are not aware of the provisions of the Municipal Code (Chapter 4.76.170) which requires payment of a business tax prior to the commencement of business. Any person/company who fails to pay the tax prior to the start of business is liable for a 25% penalty of the total tax due. Should the business tax remain unpaid for a period exceeding one calendar month beyond the start date, an additional 25% penalty is assessed (San José Municipal Code 4.76.290A). Failure to comply with the provisions of the aforementioned code sections may result in the issuance of a misdemeanor citation.

You may also require additional clearances and permits from other City Departments depending on the nature of your business.

The minimum business tax is one hundred fifty dollars (\$150.00) per year plus an additional eighteen dollars (\$18.00) per employee over eight employees. You may be liable for business taxes for the prior three (3) years and any applicable penalties.

The enclosed registration form needs to be completed and returned along with the appropriate tax due. A self addressed envelope is provided for your convenience.

Please contact the undersigned within fifteen (15) days so that we can discuss your tax liability. I can be reached at (408) 277-5051, Monday through Friday, between the hours of 8:30AM through 4:00PM.

Thank you for your cooperation in this matter.

Sincerely,

Investigator
Treasury Division

Enclosures

AUG 28 1992

CITY OF SAN JOSE - MEMORANDUM ^{Finance, Treasury}

TO: JESSICA BATINICH

FROM: RICHARD DOYLE
Sr. Dep. City Attorney

SUBJECT: Business tax - real estate agents

DATE: August 19, 1992

APPROVED

DATE

You have asked whether real estate salespersons are subject to the City's business tax.

ANALYSIS

The City's business tax is imposed on all persons doing business in the City of San Jose. The amount of the tax is based on, with limited exception, the number of employees. An "Employee" is defined as "each and every person engaged in the operation or conduct of any business, whether as owner, member of the owner's family, partner, associate, agent, manager or solicitor" Independent contractor's are not included as employees.

Real estate brokers hire real estate salespersons in the regular course of their business. Whether a real estate salesperson for a broker is an employee of the broker is not clear-cut.

In Grubb & Ellis Company v. Spengler, 143 Cal.App.3d. 890 (1983) the court discussed at length whether a real estate salesperson is an employee of the broker. The court noted that for purposes of the administration of real estate law a salesperson is the employee and agent of the broker. (See Bus. & Prof. Code sections 10132, 10137, 10151, 10160, 10177.) In addition, for purposes of establishing tort liability, California courts have held that a broker is liable for the tortious acts of a salesperson acting within the course and scope of business under an employer-employee analysis.

The court noted that for purposes of workers' compensation insurance it is unclear whether an agent is an employee. The determination of whether a salesperson is an employee for purposes of workers' compensation is a question of fact.

For purposes of unemployment insurance, section 650 of the Unemployment Insurance Code provides that a real estate salesperson who receives compensation solely on a commission basis

is not an "employee." Most significantly, for purposes of federal income taxes, Internal Revenue Code section 3508 provides that in case of services performed by a qualified real estate agent the individual performing such services shall not be treated as an employee and the person for whom such services are performed shall not be treated as an employer. Prior to enactment of Internal Revenue Code section 3508, the Treasury regulations embodied the common law rule for determining the existence of the relationship of employer and employee based largely on the amount of control exercised by the employer.

In Grubb & Ellis, supra, the court determined that the federal and state minimum wage laws were not applicable to real estate salespersons. The court determined that there was sufficient evidence at the trial court level to sustain a finding that the real estate salesperson was an independent contractor and not an employee. The court focused on the evidence presented in that case, and in particular, an agreement which specifically stated that the salesperson was an "independent contractor" and not Grubb & Ellis' employee. Very little control was exercised over the real estate agent.

Real estate brokers have taken the position that for business tax purposes, the real estate agents are to be treated as "employees". We see no reason to treat agents as independent contractors for one tax purpose (i.e. federal income tax purposes) and as employees for another tax purpose (i.e. San Jose business tax purposes). The City should therefore treat real estate salespersons as independent contractors for business tax purposes unless it can be established, on a case by case basis, that a true "employer/employee" relationship exists between the broker and salesperson.

Please call me if you have any questions.


RICHARD DOYLE
Sr. Deputy City Attorney

APPENDIX F

CITY OF SAN JOSE - MEMORANDUM

TO: JESSICA BATINICH,
Acting Chief of Treasury

FROM: JOAN R. GALLO,
City Attorney

SUBJECT: Application of Business Tax
To Insurance Brokers

DATE: October 9, 1992

APPROVED

DATE

BACKGROUND

You have asked whether business taxes can be imposed upon insurance company agents and brokers doing business within the City.

ANALYSIS

Article XIII, Section 28 (f) of the California Constitution exempts insurers from all state and local taxes or licenses except for the annual tax imposed upon insurers in that section. The California Supreme Court has held that this exemption from local taxes applies to agents of insurance corporations. The Court reasoned that because insurance corporations can act only through their agents, a tax upon the insurance agent constitutes a tax upon the insurance corporation in violation of the Constitutional exemption from local taxes.

However, subsequent cases and the California Insurance Code distinguish an insurance broker from an insurance agent. While an agent is authorized by an insurer to transact insurance for the insurer and to contractually bind the insurer, a broker only is authorized to transact insurance with, not on behalf of, an insurer and has no authority to bind an insurer. Therefore, California courts have reasoned that, unlike agents, insurance brokers are not exempt under the state Constitution from local taxes, and cities may impose business taxes on insurance brokers.

CONCLUSION

Although agents of insurance corporations are exempt from local taxes under the state Constitution, cities can impose local business taxes upon insurance brokers.

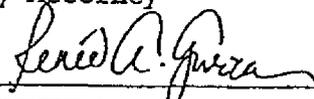
Please feel free to call this Office if you have any questions concerning this matter.

JOAN R. GALLO
City Attorney

RECEIVED

OCT 13 1992

FINANCIAL SERVICES

By: 

RENNE A. GURZA,
Associate Attorney

APPENDIX G

CITY OF SAN JOSE - MEMORANDUM

TO: Gerald A. Silva
City Auditor

FROM: Jessica Batinich
Deputy Director of
Finance, Treasury

SUBJECT: DELINQUENT BUSINESS LICENSE TAX
FOR THE BERRYESSA AND CAPITOL
FLEA MARKETS

DATE: February 15, 1994

APPROVED

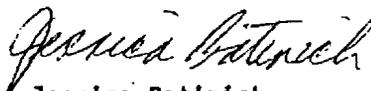
DATE

Thank you for your inquiry about the Finance Department's assessment of business tax on the two flea markets in December, 1993. This tax assessment was made to effect collection of the first tax installment due in FY 1993-94 under Ordinance No. 24211 which is in effect December 1, 1992 through November 30, 1994.

During the initial fiscal year of implementation, the tax assessed on the two public markets in San Jose was due in two equal installments on January 1, 1993 and June 1, 1993. During December 1992 and May 1993, the Finance Department sent each market a bill for the next upcoming installment due. Capitol Flea Market paid the first installment on time. However, Berryessa Flea Market paid that installment after the due date and was assessed a penalty of \$6625.00, which they paid on March 30, 1993. Both markets paid the second installment before the due date, after receipt of a bill from Finance.

During FY 1993-94, the tax was to be due in three installments on December 1, 1993, April 1, 1994 and June 1, 1994. Due to an error on the master business tax activity calendar, Finance staff did not send a bill to the two markets for the first FY93-94 business tax installment until December 10, 1993. Because of the change in due date timing this fiscal year, coupled with the activity calendar error, the department assessed the first tax installment on the markets with this billing notice and required the markets to pay within 7 days of the date the billing notice was issued or be subject to a late fee of 25% if the first tax installment was not paid on or before that date.

Berryessa Flea Market paid this first installment within the time requested in the billing notice. However, Capitol Flea Market did not pay within the time required and was assessed a 25% penalty for late payment. The Capitol Flea Market subsequently paid the first tax installment on January 20, 1994 after repeated collection efforts; collection activities are continuing in pursuit of the assessed penalty. The business tax master activity calendar has also been corrected appropriately.



Jessica Batinich
Deputy Director of Finance, Treasury

cc: John V. Guthrie
Roger Pickler

(1290F)

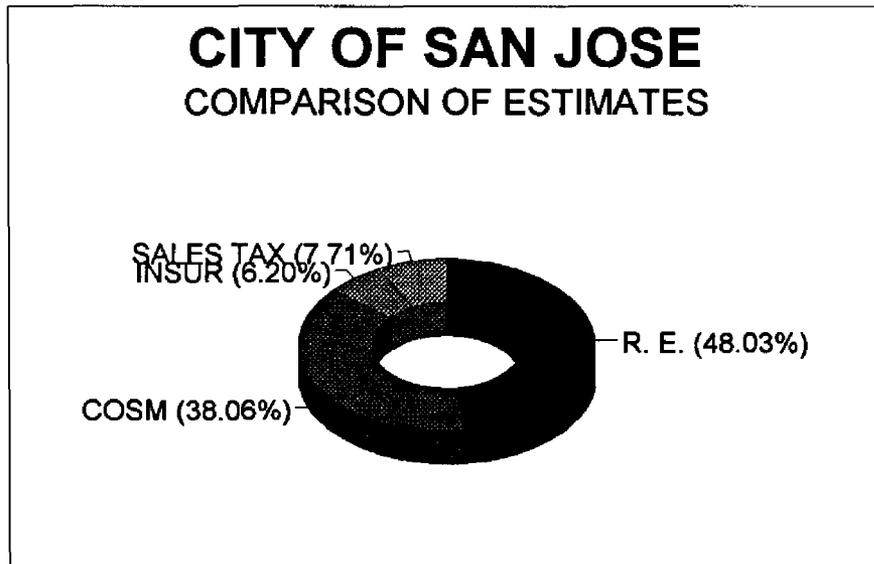
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RECEIVED**FEB 15 1994****CITY AUDITOR**

APPENDIX H

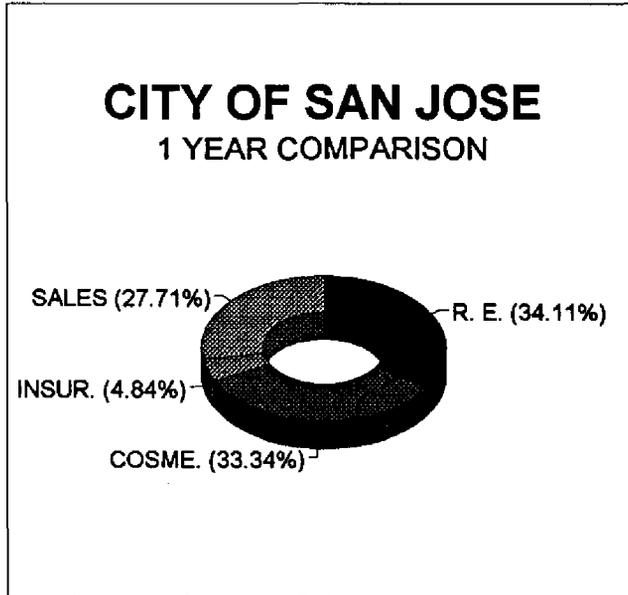
**CITY OF SAN JOSÉ
FINANCE - TREASURY
CURRENT YEAR, BACK YEARS, PENALTIES AND INTEREST**

	<u>ESTIMATE</u>
REAL ESTATE ESTIMATE	\$2,385,603
COSMETOLOGY ESTIMATE	\$1,890,607
INSURANCE ESTIMATE	\$307,780
SALES TAX ESTIMATE	\$383,046
TOTAL	\$4,967,036



CITY OF SAN JOSÉ FINANCE - TREASURY ESTIMATED ONE YEAR REVENUE

REAL ESTATE ESTIMATE	\$471,510
COSMETOLOGY ESTIMATE	\$460,800
INSURANCE ESTIMATE	\$66,840
SALES TAX ESTIMATE	\$383,046
TOTAL	\$1,382,196



CITY OF SAN JOSÉ
FINANCE - TREASURY
ESTIMATE BUSINESS TAX REAL ESTATE AGENTS

	<u>CURRENT</u> <u>YEAR</u>	<u>1993</u>	<u>1992</u>	<u>1991</u>	<u>TOTAL</u>
LEADS END OF YEAR (1)	3143	3143	2971	2774	
PERCENT CHNG (2)		5.48%	6.65%	8.44%	
TURNOVER	0	172	198	234	
LEADS END OF YEAR	3143	3143	2971	2774	
TURNOVER	0	172	198	234	
LEADS AT BEG OF YEAR	3143	2971	2774	2540	
LEADS AT BEG OF YEAR	3143	2971	2774	2540	
SINGLE YEAR - TAX DUE	\$150	\$150	\$150	\$150	
SINGLE YEAR REVENUE (3)	\$471,510	\$445,679	\$416,036	\$380,927	\$1,714,152
PENALTY @ 50%	\$235,755				\$235,755
TAX + PENALTY	\$707,265	\$445,679	\$416,036	\$380,927	\$1,949,907
INTEREST	0	\$80,222	\$149,773	\$205,701	\$435,696
SUB TOTAL	\$707,265	\$525,901	\$565,809	\$586,628	\$2,385,603
ESTIMATED TOTAL					\$2,385,603
ESTIMATE PER AUDITOR					\$2,837,388
ADJUSTMENT					(\$451,785)

(1) ASSUMING A TURNOVER AND A SOMEWHAT STATIC # OF BUSINESSES
THIS WOULD IMPLY THAT A % OF EXISTING BUSINESSES ARE NEW EACH YEAR.
THEREFORE 5.48% OF EXISTING LEADS WERE NOT IN BUSINESS IN 1993, 12.13% IN 1992
AND 20.57% IN 1991.

(2) STATISTICS PROVIDED BY STATE OF CALIFORNIA REAL ESTATE BOARD

(3) SINGLE YEAR REVENUE IS CALCULATED BASED ON ROUNDING FROM PERCENT OF
CHANGE

CITY OF SAN JOSÉ
FINANCE - TREASURY
NUMBER OF REGISTERED REAL ESTATE AGENTS
AND EMPLOYEES

<u># OF EXISTING BUSINESSES LICENSES</u>	<u># OF EMPLOYEES (1)</u>	<u>TOTAL EMPLOYEES (1)</u>			
258	1	258			
80	2	160			
53	3	159			
25	4	100			
15	5	75			
4	6	24			
5	7	35			
7	8	56			
2	9	18			
5	10	50			
2	11	22			
1	12	12			
3	15	45			
1	18	18			
1	20	20			
1	21	21			
1	24	24			
1	25	25	AUDIT ESTIMATE		7794
1	28	28	% EST. OUT OF TOWN	50.00%	
2	30	60	# EST. OUT OF TOWN		<u>-3897</u>
1	31	31	ADJUSTED AUDIT ESTIMATE		3897
1	33	33	EMPLOYEE COUNT		1570
1	36	36	% EST. INDP. CONTRACTORS	40.00%	
1	40	40	# EST. INDP. CONTRACTORS		<u>-628</u>
1	46	46	ADJUSTED EMPLOYEE COUNT		942
1	47	47	% EST. NON-LIC.	20.00%	
1	50	50	# EST. NON-LIC.		<u>-188</u>
1	<u>77</u>	<u>77</u>	ADJUSTED EMPLOYEE COUNT		754
476	619	1570	EST. POTENTIAL LEADS		<u>3143</u>

(1) EMPLOYEE COUNTS ARE BASED ON FULL TIME EQUIVALENTS (FTE)
AND THE ACTUAL EMPLOYEE COUNTS COULD REFLECT A LARGER NUMBER

NOTE: GROSS REAL ESTATE BUSINESSES ON DATA BASE = 704; THE ABOVE TOTAL OF 476
EXCLUDES REAL ESTATE APPRAISERS, MORTGAGE BROKERS, PROPERTY MANAGEMENT FIRMS

CITY OF SAN JOSÉ
FINANCE - TREASURY
ESTIMATE BUSINESS TAX COSMETOLOGISTS

	CURRENT YEAR	1993	1992	1991	TOTAL
LEADS END OF YEAR (1)	3072	3072	2458	1966	
PERCENT CHNG (2)		20.00%	20.00%	20.00%	
TURNOVER	0	614	492	393	
LEADS END OF YEAR	3072	3072	2458	1966	
TURNOVER	0	614	492	393	
LEADS AT BEG OF YEAR	3072	2458	1966	1573	
LEADS AT BEG OF YEAR	3072	2458	1966	1573	
SINGLE YEAR - TAX DUE	\$150	\$150	\$150	\$150	
SINGLE YEAR REVENUE (3)	\$460,800	\$368,640	\$294,912	\$235,930	\$1,360,282
PENALTY @ 50%	\$230,400				\$230,400
TAX + PENALTY	\$691,200	\$368,640	\$294,912	\$235,930	\$1,590,682
INTEREST	0	\$66,355	\$106,168	\$127,402	\$299,926
SUB TOTAL	\$691,200	\$434,995	\$401,080	\$363,332	\$1,890,607
ESTIMATED TOTAL					\$1,890,607
ESTIMATE PER AUDITOR					\$3,305,328
ADJUSTMENT					(\$1,414,721)

(1) ASSUMING A TURNOVER AND A SOMEWHAT STATIC # OF BUSINESSES
THIS WOULD IMPLY THAT A % OF EXISTING BUSINESSES ARE NEW EACH YEAR.
THEREFORE 20% OF EXISTING LEADS WERE NOT IN BUSINESS IN 1993, 40% IN 1992
AND 60% IN 1991.

(2) STATISTICS PROVIDED BY STATE BOARD OF COSMETOLOGY

(3) SINGLE YEAR REVENUE IS CALCULATED BASED ON ROUNDING FROM PERCENT OF
CHANGE

**CITY OF SAN JOSÉ
FINANCE - TREASURY
NUMBER OF REGISTERED COSMETOLOGISTS
AND EMPLOYEES**

# OF EXISTING BUSINESSES LICENSES	# OF <u>EMPLOYEES (1)</u>	TOTAL <u>EMPLOYEES (1)</u>			
528	1	528			
170	2	340			
65	3	195			
38	4	152			
15	5	75			
20	6	120			
10	7	70			
11	8	88			
3	10	30			
1	11	11			
1	13	13			
2	14	28			
1	18	18			
1	25	25			
1	39	39			
1	42	42			
1	61	61			
<u>869</u>	<u>269</u>	<u>1835</u>			
			AUDIT ESTIMATE		4540
			EMPLOYEE COUNT		1835
			% EST. NON-LIC..	20.00%	
			# EST. NON-LIC.		<u>-367</u>
			ADJUSTED EMPL COUNT		1468
			EST. POTENTIAL LEADS		<u>-1468</u>
					3072

(1) EMPLOYEE COUNTS ARE BASED ON FULL TIME EQUIVELENTS (FTE)
AND THE ACTUAL EMPLOYEE COUNTS COULD REFLECT A LARGER NUMBER

**CITY OF SAN JOSE
FINANCE - TREASURY
ESTIMATE BUSINESS TAX INSURANCE**

	CURRENT YEAR	1993	1992	1991	TOTAL
LEADS END OF YEAR (1)	446	446	390	341	
PERCENT CHNG (2)		12.51%	12.51%	12.51%	
TURNOVER	0	56	49	43	
LEADS END OF YEAR	446	446	390	341	
TURNOVER	0	56	49	43	
LEADS AT BEG OF YEAR	446	390	341	298	
LEADS AT BEG OF YEAR	446	390	341	298	
SINGLE YEAR - TAX DUE	\$150	\$150	\$150	\$150	
SINGLE YEAR REVENUE (3)	\$66,840	\$58,478	\$51,163	\$44,762	\$221,243
PENALTY @ 50%	\$33,420				\$33,420
TAX + PENALTY	\$100,260	\$58,478	\$51,163	\$44,762	\$254,663
INTEREST		\$10,526	\$18,419	\$24,172	\$53,116
SUB TOTAL	\$100,260	\$69,004	\$69,581	\$68,934	\$307,780
ESTIMATED TOTAL					\$307,780
ESTIMATE PER AUDITOR					\$788,859
ADJUSTMENT					(\$481,079)

(1) ASSUMING A TURNOVER AND A SOMEWHAT STATIC # OF BUSINESSES THIS WOULD IMPLY THAT A % OF EXISTING BUSINESSES ARE NEW EACH YEAR. THEREFORE 12.51% OF EXISTING LEADS WERE NOT IN BUSINESS IN 1993,25.02% IN 1992 AND 37.53% IN 1991.

(2) STATISTICS PROVIDED BY STATE INSURANCE DEPT.

(3) SINGLE YEAR REVENUE IS CALCULATED BASED ON ROUNDING FROM PERCENT OF CHANGE

CITY OF SAN JOSÉ
FINANCE - TREASURY
NUMBER OF REGISTERED INSURANCE AGENTS
AND EMPLOYEES

<u># OF EXISTING BUSINESSES LICENSES</u>	<u># OF EMPLOYEES (1)</u>	<u>TOTAL EMPLOYEES (1)</u>			
39	1	39			
23	2	46			
15	3	45			
9	4	36			
6	5	30			
7	6	42			
5	7	35			
5	8	40			
2	9	18	AUDIT ESTIMATE	1084	1084
4	10	40	EMPLOYEE COUNT	798	
2	11	22	%EST. NON-LIC.	20.00%	
1	12	12	# EST. NON-LIC.	<u>160</u>	
1	13	13	ADJUSTED EMPLOYEE COUNT	638	-638
1	15	15	EST. POTENTIAL LEADS		446
2	17	34			
1	22	22			
1	51	51			
2	52	104			
1	74	74			
1	80	80			
128	402	798			

(1) EMPLOYEE COUNTS ARE BASED ON FULL TIME EQUIVELENTS (FTE)
 AND THE ACTUAL EMPLOYEE COUNTS COULD REFLECT A LARGER NUMBER

APPENDIX I

CITY OF SAN JOSE - MEMORANDUM

TO: Gerald A. Silva
City Auditor

FROM: John V. Guthrie
Director of Finance

SUBJECT: BUSINESS TAX
ACCOMPLISHMENTS

DATE: May 11, 1994

APPROVED:

DATE:

This memorandum responds to your request to present additional program accomplishments related to the collection of Business Tax in the City of San Jose. Among other things, during FY 92-93 and FY 93-94 the Finance Department has:

- ◆ Permanently assigned two Investigator-Collectors to the Business Tax Counter. This assignment has increased the accuracy and consistency in data entry and customer service has improved. Comments from the public have been positive, such as "I have a feeling that I'd like to do business in San Jose." Customers are waiting in line less because the Investigator-Collectors have developed a routine and work as a team. The assigned counter Investigator-Collectors also research all returned mail and returned checks items, coordinate mass mailings to individual business categories and identify leads for field collection follow-up. This reassignment of counter and in-office collection activity has freed the 7 other Investigator-Collectors to spend more time pursuing delinquency collection, lead identification and lead collection in the field.
- ◆ Began cross training Business Tax Investigators in Sewer Service and Use. This training is helping them to identify possible business tax leads, particularly in the commercial and industrial landlord categories.
- ◆ Began cross training Business Tax Investigator-Collectors in Accounts Receivable collections. This cross training effort is helping them develop better negotiation skills, skip-tracing, asset identification, small claims experience, telephone collection skills and team building skills.
- ◆ Improved education and outreach efforts undertaken to expose as many of the business communities as possible to the business tax requirements in the City of San Jose. The department actively participates in all City Hall in the Neighborhoods, and has provided speakers at the various chambers of commerce.
- ◆ Resolved a multi-year backlog of over 1600 pending "lead" accounts, resulting in collection of approximately \$360,000.

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Business Tax Accomplishments

May 11, 1994

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- ◆ Resolved a multi-year backlog of uncollected delinquent accounts and implemented procedures to prevent a recurrence.
- ◆ In coordination with ISD, The Treasury Division developed computer matches of commercial and residential property owners using County Assessor records with the Business Tax data base to identify business tax leads.
- ◆ Business Tax Investigator-Collectors audited all branch accounts in their districts to insure their accuracy and accounts were adjusted (rebilled or closed) based on the updated information provided by the owners and from Investigator-Collectors' research as to the current number of employees and square footage of the property.
- ◆ Treasury Division audited all residential, commercial and industrial landlord business tax accounts to verify the accuracy of current and future billings.
- ◆ Mailed notices to all exempt accounts expiring in September and December 1993 and in March 1994 to verify the exemptions were still valid. Notices will be mailed in July 1994 to exempt account that expire in June 1994.
- ◆ Revised procedures for application for handbill permit. As a result, the separate application for handbill permits was eliminated. This procedure saves both time and expense for the City when processing handbill permits.
- ◆ Revised and updated the business tax procedures manual from cover to cover and distributed to all Investigator-Collectors and other personnel in the Treasury Division.
- ◆ Initiated research and collection efforts to improve compliance with business tax requirements by distributors of home-party based products such as Herbal Life, Amway and Avon, etc.
- ◆ Implemented monthly reporting format for Investigator-Collectors to monitor collection activity, performance and workload.
- ◆ Refined weekly collector staff meetings to review codes, collection techniques and provide regular training in specific areas needing improvement.
- ◆ Began participation in State of California offset program to effect collection of unpaid business tax accounts for which we have received judgments. This program deducts such judgment amounts from any tax refund or lottery winnings due to a customer and pays the judgment amount directly to the submitting local agency.

Business Tax Accomplishments

May 11, 1994

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- ◆ Assigned Investigator-Collectors to participate in City training classes to develop and/or improve skills in Teambuilding, Negotiations, Effective Meetings, Forecasting, Communications, Computer Skills and TQM. After each class they attend, they share key information with the group.
- ◆ Implemented procedures to review all City billing databases for other delinquent accounts owed to the City by the same customer, and file small claims action simultaneously for all money owed by the customer.
- ◆ Investigator-Collectors have formed Focus Groups to investigate such issues as:
 - Sales Tax Focus Group; to identify methods of improving collection of sales tax by 1) Education; 2) Insuring new businesses are issued sales permits designating the City of San Jose; 3) Insuring sales tax at special events (eg. Tapestry and Talent) is coded to be paid to the City of San Jose and 4) Changing purchasing procedures to allow the City to self-accrue sales tax in certain situations. This effort will insure the City collects its full 1% in sales tax. Instead of the tax going into a pool where the City will collect only a fraction of the 1%. In addition, this effort will reduce further risk to the City if the vendor fails to pay the tax to the State.
 - Automated Collection Systems; Finance staff is evaluating the economic and practical feasibility of obtaining an automated collection system.
 - Reclassification of the Investigator-Collector series; Finance staff is reviewing a reclassification of the Investigator-Collector series to Revenue Collections Officer or Revenue Collections Specialist. They are also reviewing pay issues; the department is at risk of losing good, qualified help to other departments, whose jobs are classified at higher rates of pay for similar work.


John V. Guthrie
Director of Finance