



City of Arts & Innovation

Financial Performance and Budget Committee

TO: FINANCIAL PERFORMANCE AND BUDGET COMMITTEE **DATE:** AUGUST 12, 2022
FROM: FINANCE DEPARTMENT **WARDS:** ALL
SUBJECT: BUSINESS TAX DISCOVERY PROGRAM

ISSUE:

Receive an update and provide direction to staff regarding the City's Business Tax Discovery Program.

RECOMMENDATIONS:

That the Financial Performance and Budget Committee:

1. Receive an update on the current status of the City's Business Tax Discovery program and overall compliance rate;
2. Recommend to the City Council the approval and implementation of an option for a 3-month amnesty program for non-compliant accounts;
3. Recommend to the City Council to direct staff to implement standard procedures for all new discoveries following the amnesty program timeframe in compliance with the Riverside Municipal Code, including assessment of penalties and back taxes; and
4. Direct staff to return to the Financial Performance and Budget Committee in one year to provide an update on the outcome of the amnesty and discovery program and report resulting revenue enhancements.

LEGISLATIVE HISTORY:

Chapter 5.04 of the Riverside Municipal Code (RMC) sets forth the purpose and guidelines for assessing business tax and includes provisions for penalties on delinquent taxes (refer to Attachment 1 for applicable excerpts).

BACKGROUND:

The Business Tax division is responsible for ensuring that all entities conducting business with the City of Riverside obtain a business tax certificate. One of the methods by which the Business Tax Division ensures compliance with the RMC is by performing discovery, i.e., identification of entities subject to licensure/taxation that are not currently registered or are otherwise non-compliant. A Business Tax Investigator receives information from City departments and staff that a business may be operating within the City limits but requires an in-person contact for verification. The Investigator, through a series of letters and ultimately in-person contact, verifies the entity's compliance with the RMC and assists the business in applying for a business tax certificate.

In November 2020, the City contracted with Hinderliter De Llamas & Associates (HdL) to assist with various tax administrative services. As part of the Business Tax Compliance Services, HdL will assist the City with discovery services.

Per HdL, the industry standard and statute of limitations in the California Code of Civil Procedure Sec. 338(a) is to charge three years' back taxes plus penalties to all businesses identified as non-compliant plus the current year's tax. Although the RMC is silent on this subject, past City practice has been to charge three years' back taxes plus the current tax due, plus penalties as described in RMC Chapter 5.04.220.

On June 27, 2019, realizing the financial burden businesses were experiencing at the time, the City waived the prior three years' taxes and penalties for all new discoveries and advised that all new businesses identified will have an effective start date equal to the date of the discovery. In reviewing the City's current practice, and if continued, HdL expressed that they would need to perform an internal legal review to assess their potential legal risk before proceeding with compliance service on behalf of the City. Their concerns include:

- Violating equal protection
- Ethical concerns
- Opens the City, and potentially HdL, up to risk:
 - Compliant businesses may discover that other businesses are receiving a reprieve/waiver on paying past taxes (amnesty type issues/concerns).
 - Compliant businesses might request a refund for past taxes they paid.
 - Compliant businesses may choose not to pay their taxes moving forward, knowing that they will not have to pay back taxes.
 - Non-compliant businesses may continue to not pay their taxes knowing that they received a reprieve in the past and may receive amnesty again in the future.

HdL conducted a search for non-compliant businesses utilizing business registration data from the California Secretary of State and business tax filings with the Franchise Tax Board. HdL separated the data into two main discovery categories:

1. **General Businesses:** This category is comprised of various business types such as software companies, realtors, home businesses, retail, service, contractors, etc. HdL has obtained data from the Secretary of State reflecting approximately 19,000 Riverside businesses that have registered within the past year but have not registered their business with the City.

2. Property Rentals: HdL has identified a total of 14,508 property rentals via the City's property tax records and the County's data of single-family homes registered as "absentee". These properties are considered potential discovery accounts and are comprised of 12,638 residential and 1,870 commercial property rentals. They present an opportunity for the City to bring them into compliance.

- **Residential Rentals:** In June 2016, the City's Internal Audit Division presented to the Governmental Affairs Committee recommendations stemming from an audit of the City's Business Tax Division. The Finance Department worked in close collaboration with the Chambers of Commerce to develop a plan to enhance the City's Business Tax Administration Program. On August 2, 2017, the Finance Department presented the jointly developed action plan to the Governmental Affairs Committee, and it was recommended that the City Council review and approve recommended enhancements to the City's Business Tax Administration Program and a six-month Amnesty Program. One of the approved action items was to update the RMC to remove the requirement to register one residential rental unit by omitting the following from Section 5.04.010, "any person claiming to have only one (1) single-family residential rental unit shall declare such on a form provided by the Collector and shall obtain a tax-free certificate".

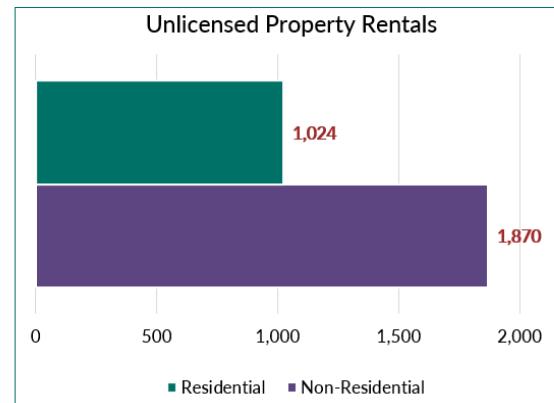
Taking into consideration the RMC update to remove the registration requirement for owners with only one (1) single-family residential rental, the number of identified non-compliant property rentals decreased from 12,638 to 1,024.

- **Commercial Rentals:** HdL has identified 1,870 non-compliant commercial rentals. The City's Business Tax Team and HdL will work together to ensure the owner entities are properly notified and provided an opportunity to come into compliance.



Business License Compliance Residential Verse Non-Residential

Property Rentals have always required a business license. Currently, there are 2,738 properties rentals licensed in stark contrast to the estimated 2,894 properties that have never obtained a license.



DISCUSSION:

Per HdL, the City's average annual business tax is estimated to be \$140.00. The City currently has 21,356 active, licensed businesses, including 4,284 delinquent accounts representing businesses that previously obtained a business license but are late on renewing their license for the current period; and approximately 21,894 discovery accounts that may be non-compliant. The City's current compliance rate is 45% which HdL categorizes as "below average" when compared to other cities the size of Riverside, which average a 65% - 72% compliance rate. The City and HdL continue to reach out to each delinquent account through collection efforts that include a series of letters, phone calls, and emails to bring each account current.



Business License Tax

Licensing Compliance in the City

The City has severe issues with licensing businesses. If we only consider current and delinquent licenses, the City's compliance rate would be 45%. HdL categorizes this delinquency rate as "below average."

However, the chart exposes how businesses who've yet to obtain a license can impact the overall compliance in the City.

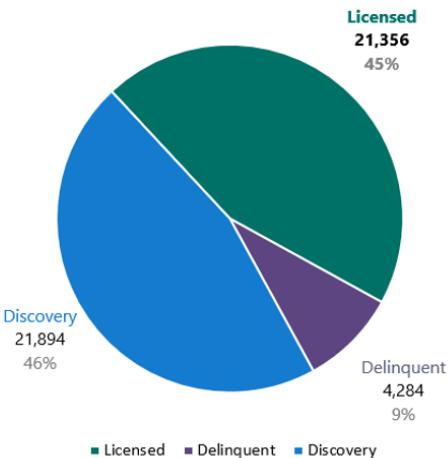
With potentially 21,894 unlicensed businesses, there is inequity in the enforcement of the business license tax and can equate to significant revenue loss.

License: Possess a business license for the current period.

Delinquent: Previously possess a business license but is late on renewing their license for the current period.

Discovery: Businesses that have yet to possess a business license with the City.

Count of Businesses by License Status



Staff is seeking direction from the Financial Performance and Budget Committee on how to move forward with the newly discovered accounts. It is important to note that HdL, per our current hybrid contract, receives a contingency fee of 35% of the revenues received for performing discovery services if the fees and penalties are charged as outlined in RMC Chapter 5.04. In the event that the City deviates from RMC Chapter 5.04, HdL has offered the following four contingency fee options available to the City and staff has outlined their respective pros and cons.

Option 1: Continue with the current practice of waiving past taxes and penalties. As mentioned above, HdL would need to conduct a thorough extended legal review if this option is selected.

HdL Contract Terms: HdL will collect only the current tax year and retain 100%.

Pros	Cons
Business-friendly to non-compliant customers	Non-compliant with RMC Chapter 5.04.
	City would receive \$0.00 revenue in year 1.
	Amnesty program can be seen as unfair / inequitable.

HdL Contract Terms: HdL will collect only the current tax year and retain 100%.	
Pros	Cons
	Compliant businesses might request a refund for past taxes paid.
	No need or incentive for businesses to remain compliant if past taxes are going to be waived.

Option 2: Collect 3 years past taxes and penalties.

HdL Contract Terms: 35% contingency rate on full amount collected.	
Pros	Cons
Fully compliant with RMC Chapter 5.04.	Potential for complaints to City Council.
Industry standard with precedent and as documented in California Code of Civil Procedure Sec. 338(a).	Could be seen as not business friendly
Sets standard for business compliance.	Could be viewed as a money grab
Fair and equitable.	
City would immediately begin receiving revenue.	

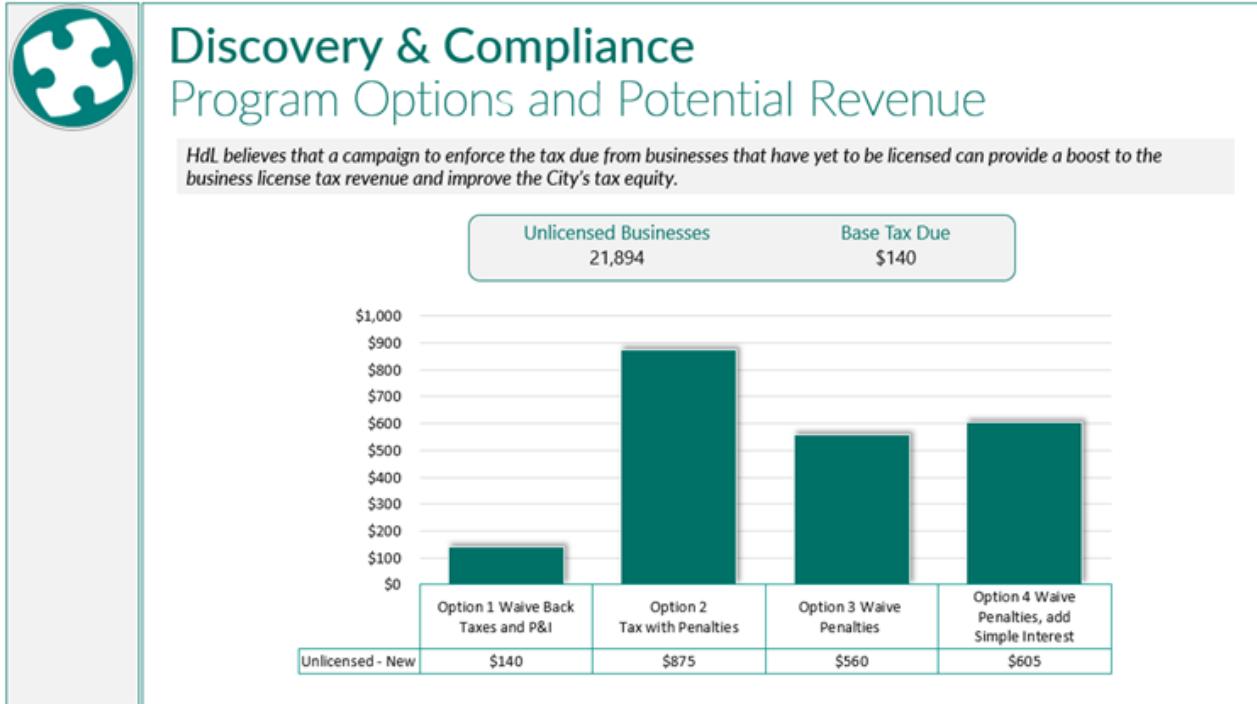
Option 3: Collect 3 years past taxes and waive penalties.

HdL Contract Terms: 35% contingency rate on full amount collected (HdL would waive their 17.5% charge that would normally be assessed on waived amounts).	
Pros	Cons
Partially consistent with industry standard (back taxes) with precedent and as documented in California Code of Civil Procedure Sec. 338(a).	<i>RMC Chapter 5.04.220 Delinquent taxes – Penalties</i> would not be adhered to.
Could be seen as business-friendly by waiving penalties.	Could be seen as unfair / inequitable.
Businesses would receive a waiver on past due penalties amounting to 75% of their business tax.	Compliant but delinquent businesses are charged a penalty versus non-compliant businesses that are not charged a penalty under this option.
City would immediately begin receiving revenue.	Potential for complaints to City Council

Option 4: Collect up to 3 years past taxes, waive penalties, and add 8% simple interest on the past due amount plus the current year tax (unless also past due) per *RMC Chapter 5.04.170 - Extension of time and waiver of penalty*.

HdL Contract Terms: 35% contingency rate on full amount collected (HdL would waive their 17.5% charge that would normally be assessed on waived amounts).	
Pros	Cons
Semi-business friendly by waiving penalties but charging 8% interest.	Could be seen as unfair / inequitable.
Businesses would receive a waiver on past due penalties amounting to 75% of their business tax.	Compliant but delinquent businesses are charged a penalty versus non-compliant businesses that are not charged a penalty under this option.
Compliant with RMC Chapter 5.04; while waiving penalties set forth in <i>Chapter 5.04.220 Delinquent taxes</i> , the exception provided by <i>Chapter 5.04.170 - Extension of time and waiver of penalty</i> would be invoked.	Potential for complaints to City Council.
City would immediately begin receiving revenue	

Potential revenue impact per Option:



The City seeks to bring non-compliant entities into compliance with RMC Chapter 5.04. HdL believes it is best to take a targeted approach to the discovery accounts by beginning with the property rental category first and then the general business category. HdL has conducted discovery programs with other cities and based off past results, recommends a three-month amnesty program for each category to run consecutively. Historically with similar amnesty programs, HdL has achieved an overall compliance rate of 75-80% versus a 60-65% without an amnesty program being offered. It is also important to set a time component as statistically, both the first and second months of an amnesty program typically produce a 15% response rate while the third and final month's response rate spikes to approximately 42%. There is usually a residual 10% increase (for late filers) that occurs during the fourth month.

The City recognizes that the business community is an important and valuable element in the City. The City also recognizes that guidelines and procedures set forth in the RMC and the adherence to and equitable application of those guidelines is essential to enhancing equity and building trust among its business community. Although all of the previously described options are viable, staff recommends Option 3. Option 3 will give business owners an opportunity to pay their back taxes while creating a foundation of compliance moving forward. After the initial amnesty program, staff recommends all new discoveries be equitably and fairly assessed at the statewide industry standard of charging three years back taxes plus the current year's tax, plus penalties as set forth in *RMC Chapter 5.04.220 Delinquent taxes – Penalties*.

STRATEGIC PLAN ALIGNMENT:

The topics included in the report support **Strategic Priority 5 – High Performing Government** and **Goal 5.4**: Achieve and maintain financial health by addressing gaps between revenues and expenditures and aligning resources with strategic priorities to yield the greatest impact.

This action aligns with each of the Cross-Cutting Threads as follows:

1. **Community Trust** – Community trust will be enhanced within the business community through consistent and equitable application of the City's business tax code and administration of the business tax discovery program, as well as adherence to the City's municipal code.
2. **Equity** – The proposed business tax discovery program seeks to ensure fairness of treatment, recognition of rights, and equitable application of the City's business tax code and administration of the business tax discovery program.
3. **Fiscal Responsibility** – RMC 5.04.020 states “This chapter is enacted solely to raise revenue for municipal purposes...” The City is committed to ensuring all businesses subject to the business tax requirements as set forth in the Riverside Municipal Code are compliant and to raise revenue for municipal purposes and the General Fund, which may in turn enable the City to expand services and fund critical needs.
4. **Innovation** – The City contracts with HdL which has access to sales and property tax data from various sources. Utilizing the most current resources, HdL will be able to implement the business tax discovery program with zero additional cost to the City utilizing the latest technologies and strategies to ensure compliance.
5. **Sustainability & Resiliency** – After the initial amnesty portion of the discovery program, there will be a continued effort to ensure compliance to the municipal code. Best practices will be reviewed and implemented to ensure the highest level of compliance to City laws and regulations.

FISCAL IMPACT:

This item was identified by staff as a Priority Based Budgeting Insight during the development of the FY 2022-2024 Biennial Budget as a potential source of new revenue that may help fund critical unfunded needs of the General Fund. If the business tax discovery program is implemented, staff will track the resulting Year 1 increase in business tax revenue and estimate potential ongoing new revenue as a result of the program. The revenue impact will be reported to the Financial

Performance and Budget Committee and the City Council for potential allocation to critical unfunded needs or other financial strategies designed to enhance the long-term fiscal health of the City.

The City contracted with HdL in November 2020 for a one-year term and the option of two additional one-year (annual) terms extended by mutual written consent of both parties. The City is currently in the first year of the two additional one-year terms. The City stands to receive new ongoing revenue from implementation of the discovery program due to the City's current non-compliance rate. HdL will receive a percentage of all revenue generated as a result of the service in the year of discovery, as previously described in the available options. Ongoing revenue will go to the City under HdL's flat contract rate for business tax administration services. Depending on the direction Council provides, there is a potential to increase City revenue by \$0 - \$9.5 million during the first year of implementation.



Discovery & Compliance

Program Options and Potential Revenue

Estimate Business Tax
Option 1

\$0.00

Estimate Business Tax
Option 2

\$9,578,625

Estimated Business Tax
Option 3

\$6,130,320

Estimated Business Tax
Option 4

\$6,352,500

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Approved as to form: Phaedra A. Norton, City Attorney

Attachments:

1. RMC Chapter 5.04: Taxes, Licenses and Regulations (excerpts)
2. Presentation