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No. 2009/003

TO COUNTY ASSESSORS:

BUSINESS PROPERTY AUDITS – AUDIT SELECTION

Letter To Assessors 2008/059 provided notification of amended Revenue and Taxation Code section 469 (effective on January 1, 2009) which changes the requirement for what is commonly known as a *mandatory audit*, and announced the commencement of a project to review and revise, as appropriate, the Property Tax Rules pertaining to audits of locally assessed properties (AB 550, Ch. 297, Stats. of 2008). This letter provides guidance on the revised audit selection process.

Prior to January 1, 2009, Revenue and Taxation Code section 469 required county assessors to audit, at least once every four years, the books and records of any taxpayer engaged in a profession, trade, or business, if the taxpayer has assessable trade fixtures and business tangible personal property valued at $400,000 or more. These statutorily required audits are commonly referred to as *mandatory audits*. Additionally, a county assessor may audit the books and records of taxpayers with holdings below $400,000 in value under the authority of Revenue and Taxation Code section 470. These audits are referred to as *nonmandatory audits*. Generally, county assessors perform both mandatory and nonmandatory audits to ensure that their audit program includes a representative sample of all sizes and types of property taxpayers with personal property holdings subject to the property tax.

Effective January 1, 2009, county assessors are no longer required to audit all taxpayers with trade fixture and business tangible personal property holdings of $400,000 or more at least once every four years. Instead, the county assessor is required to annually audit a *significant number of audits* as specified in section 469, subdivision (a)(1):

> For purposes of this section, "significant number of audits" means at least 75 percent of the fiscal year average of the total number of audits the assessor was required to have conducted during the 2002–03 fiscal year to the 2005–06 fiscal year, inclusive, on those taxpayers in the county that had a full value of four hundred thousand dollars ($400,000) or more of locally assessable trade fixtures and business tangible personal property.

Under the prior law, in a county that had, for example, 800 taxpayers with trade fixtures and business tangible personal property holdings of $400,000 or more over the four-year period from the 2002-03 fiscal year to the 2005-06 fiscal year, the county assessor would have been required to conduct 200 audits per year to ensure that each taxpayer was audited. Effective January 1, 2009, section 469 sets the minimum number of audits required to be conducted at 75 percent of that amount, or in our example, 150 audits per year. Section 469, subdivision (a)(1), provides the methodology for determining the total number of audits that must be conducted by a county; and subdivisions (b)(1) and (b)(2) identify the types of taxpayers that comprise the *significant number of audits*. Section 469, subdivision (b), provides in part:

> (1) Fifty percent of the audits required by subdivision (a) shall be performed on taxpayers selected from a pool of those taxpayers that have the largest assessments of locally assessable trade fixtures and business tangible personal property in the county…
>
> (2) The remaining 50 percent of the required audits, as determined by paragraph (1) of subdivision (a), shall be selected in a manner that is fair and equitable to all taxpayers and may be based on evidence of underreporting as determined by the assessor.

Using our example above, the *significant number of audits* would include the following:

- 75 audits, one half of the 150 annually required audits, would be required to be conducted of the largest taxpayers in the county; and
- 75 audits would be selected by the county assessor from among any taxpayer in the county.

The taxpayers to be included in the pool of those that have the largest assessments in the county (including taxpayers with vessels or aircraft that are used in a business) are detailed in section 469(b)(1) which provides:

> (A) This pool of taxpayers shall be determined as follows:
>
> (i) The assessor shall rank all of the taxpayers in the county in descending order by the total locally assessed value of both trade fixtures and business tangible personal property.
>
> (ii) The assessor shall select a qualified number of those taxpayers with the largest assessments for inclusion in the pool. The qualified number shall be that number equal to 50 percent of the audits required by subdivision (a) multiplied by four.
>
> (B) Taxpayers in the pool shall be audited at least once within each four-year period following the latest fiscal year covered by a preceding audit and the audit may combine multiple fiscal years. The assessor is relieved of the requirement to audit the taxpayer at least once every four years if the assessor determines that the taxpayer’s assessments are no longer large enough for inclusion in the pool.

Thus, only taxpayers that have the largest assessments in the county, as defined, would continue to be subject to an audit once every four years. To determine the number of taxpayers that would continue to be audited on a cyclical basis, all of the taxpayers in the county should be ranked annually in descending order by assessed value of trade fixtures and business tangible personal property. Then, 50 percent of annual audits required for a particular county, multiplied by four, serves as the cut-off point for the set of taxpayers subject to a audit once every four years. Continuing with the example above, if a county previously had 800 taxpayers subject to a mandatory audit, the county would instead have a pool of 300 (150 x 50% x 4) taxpayers that they are required to audit on a four-year cycle. If any taxpayer ceases to be in the top 300 assessments, then the taxpayer would no longer be required to be audited.

The purpose of the legislative change is to (1) provide county assessors more flexibility to maximize their limited audit resources by reducing the total number of mandatory audits; and (2) improve reporting compliance by expanding the parameters of taxpayers subject to what is now known as a *significant number of audits*. Eliminating the arbitrary $400,000 mandatory audit threshold gives a county assessor flexibility to more efficiently use scarce resources.

The enclosed table includes two examples to further illustrate the revised audit selection process as provided in section 469, effective January 1, 2009. If you have questions, you may contact Mrs. Ladeena Ford at 916-445-0208 or a ladeena.ford@boe.ca.gov

Sincerely,

/s/ David J. Gau

David J. Gau
Deputy Director
Property and Special Taxes Department

DJG:lf
Enclosure

AUDIT SELECTION PROCESS

The following table includes two examples of how to determine the number of audits required under amended section 469. It is provided for illustration purposes only. Each county's actual *significant number of audits* must be determined using the guidelines provided in amended section 469.

Statutory Requirement Prior to January 1, 2009		**Example A**	**Example B**
Total number of mandatory audits during the 2002–03 fiscal year to the 2005-06 fiscal year		**800**	**61**
Number of audits required to be conducted each year	**Step 1**	**200** *(800 ÷ 4)*	**15.25** *(61 ÷ 4)*
Effective January 1, 2009			
Minimum number of audits required to be conducted each year, that is, *significant number of audits*. **Rounded**	**Step 2**	**150** *(75% x 200)*	**11.4375** *(75% x 15.25*) **11**
Breakdown of *Significant Number of Audit*			
Annually required audits to be conducted of the largest taxpayers in the county	**Step 3**	**75** *(50% x 150)*	**5.5** *(50% x 11)*
Annually required audits to be selected by the county assessor from among any taxpayer in the county	**Step 4**	**75** *(50% x 150)*	**5.5** *(50% x 11)*
Taxpayers with Largest Assessments			
		Example A	**Example B**
Taxpayers required to be audited on a four-year cycle	**Step 5**	**300** *(150 x 50% x 4)*	**22** *(11 x 50% x 4)*

In Example A illustrated above, the county would have a pool of 300 (150 x 50% x 4) taxpayers that are required to be audited on a four-year cycle. In Example B, the county would have a pool of 22 (11 x 50% x 4) taxpayers that are required to audited on a four-year cycle. If any taxpayer ceases to be in the top assessments (300 and 22, respectively), then the taxpayer would no longer be required to be audited.

Example B identifies the significant number of audits as 11.4375 (Step 2). If Step 2 does not result with a whole number, the number should be rounded before calculating the pool of audits. When this number is split into the annually required audits to be conducted of the largest taxpayers in the county (Step 3) and the annually required audits to be selected by the county assessor from among any taxpayer in the county (Step 4), the number is 5.5 each. A determination must be made on how to split the odd number audit. For example, the county assessor may conduct five audits from the pool of the largest taxpayers in the county and six audits from among any taxpayer in the county in the first year. In this example, the only issue would be to meet the requirement of auditing 22 of the largest taxpayers in the county within a four-year cycle. In other words in the above example, during a four-year audit cycle, the county assessor would be required to audit:

- Five of the largest taxpayers in the county and six from among any taxpayer in the county each year for two years; and
- Six of the largest taxpayers in the county and five from among any taxpayer in the county each year for the remaining two years of the audit cycle.