

File No. 100247

Committee Item No. 8

Board Item No. //

COMMITTEE/BOARD OF SUPERVISORS

AGENDA PACKET CONTENTS LIST

Sub - Committee: Budget and Finance

Date: April 28, 2010

Board of Supervisors Meeting

Date: May 4, 2010

Cmte Board

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Completed by: Andrea S. Ausberry

Date Thursday, April 23, 2010

Completed by: Andrea S. Ausberry

Date Thursday, April 29, 2010

An asterisked item represents the cover sheet to a document that exceeds 25 pages. The complete document is in the file.

1 [Additional Penalty for Underreporting Tax by Twenty-Five Percent or More.]

2
3 **Ordinance amending Section 6.17-2 of the Business and Tax Regulations Code by**
4 **adding an additional "substantial underreporting" penalty equal to fifty percent of the**
5 **unreported tax for underreporting a tax liability by twenty-five percent or more.**

6 Note: Additions are single-underline italics Times New Roman;
7 deletions are ~~strikethrough italics Times New Roman~~.
8 Board amendment additions are double underlined.
9 Board amendment deletions are ~~strikethrough normal~~.

10 Be it ordained by the People of the City and County of San Francisco:

11 Section 1. The San Francisco Business and Tax Regulations Code is hereby amended
12 by amending Section 6.17-2, to read as follows:

13 SEC. 6.17-2. PENALTIES FOR UNDERREPORTING OF TAX.

14 (a) Penalties for taxpayer negligence. If the Tax Collector determines that all or part of
15 any tax required to be reported on any return was underreported and that such underreporting
16 was attributable to negligence or intentional disregard of rules and regulations, the Tax
17 Collector may impose a penalty upon the taxpayer in the amount of 5 percent of the amount of
18 the underreported tax, in addition to the tax or amount of tax, if the negligence or intentional
19 disregard of rules and regulations is for not more than one month, with an additional 5 percent
20 for each month or fraction of a month during which such negligence or intentional disregard of
21 rules and regulations continues, up to 20 percent in the aggregate.

22 (b) Penalties for intentional disregard of rules, fraud, or intent to evade tax. When it is
23 determined by the Tax Collector that all or part of any tax required to be reported on any
24 return was underreported and such underreporting was attributable to fraud or an intent to
25 evade the Business and Tax Regulations Code, the Tax Collector may impose a penalty upon

1 the taxpayer in the amount of 50 percent of the amount of the underreported tax. The
2 taxpayer or other person determined to be liable for penalties pursuant to this Section are
3 entitled to a notice of such determination to be issued in accordance with the provisions of
4 Section 6.11-1 et seq. and to the appeal rights set forth in Sections 6.13-1 et seq.

5 (c) Additional penalty for substantial underreporting.

6 (1) For purposes of this section, "substantial underreporting of tax" means the tax finally
7 determined by the Tax Collector under Articles 7, 9, 10, 10B, 11, or 12-A, of this Business and Tax
8 Regulations Code exceeds the amount of tax reported on a taxpayer's original or amended return for a
9 taxable period by 25 percent or more.

10 (2) If the Tax Collector determines that a taxpayer has made a substantial underreporting of
11 tax for any taxable period, the Tax Collector may impose an additional penalty in an amount equal to
12 50 percent of the tax attributable to the substantially underreported amount. The penalty for
13 substantial underreporting is in addition to any other penalty imposed under this Article 6.

14 (3) The additional penalty for substantial underreporting applies to all taxable periods ending
15 on or after the effective date of this Ordinance.

16 ~~(4) The City shall use no less than 50% of the penalties collected pursuant to this~~
17 ~~subsection (c) for technology costs in the Office of the Treasurer—Tax Collector related to~~
18 ~~collection of business taxes, fees and licenses.~~

19
20 APPROVED AS TO FORM:
21 DENNIS J. HERRERA, City Attorney

22 By:

23 
24 JEAN H. ALEXANDER
25 Deputy City Attorney

Item 8
File 10-0247

Department(s):
Treasurer/Tax Collector's Office

EXECUTIVE SUMMARY

Legislative Objective

- The proposed ordinance would amend Section 6.17-2 of the City's Business and Tax Regulations Code to (a) add an additional "substantial underreporting" penalty equal to 50 percent of the substantially unreported tax for those taxpayers who underreport tax liabilities owed to the City by 25 percent or more, and (b) direct that not less than 50 percent of the increased penalty revenues be used to fund technology improvements in the Office of the Treasurer-Tax Collector for the collection of business taxes, fees and licenses.

Current Legal Mandates

- In accordance with Section 6.17-2(a) of the City's existing Business and Tax Regulations Code, if the Tax Collector determines that all or part of any business tax reported to the City on any tax return, was underreported due to negligence or intentional disregard of the City's rules and regulations, the Tax Collector may currently impose a five percent penalty on the taxpayer for the amount of the underreported tax to the City for each one month period that such negligence or intentional disregard continues, up to a maximum of a 20 percent penalty.
- In addition, in accordance with Section 6.17-2(b) of the City's Business and Tax Regulations Code, when the Tax Collector determines that all or part of any tax reported to the City on any tax return was underreported due to fraud or an intent to evade the City's Business and Tax Regulations Code, the Tax Collector may currently impose a 50 percent penalty of the amount of the underreported tax on the taxpayer.

Fiscal Impact

- An average of 15.6 percent of all Tax Collector audits conducted over the past three fiscal years resulted in substantial underreported business taxes. Based on the substantial underreported taxes in FY 2009-2010 and the penalties to be imposed under the proposed ordinance, Ms. Pauline Marx, Chief Assistant Treasurer estimates that \$365,371 of additional penalties would have been assessed for the first six months of FY 2009-2010 and additional annual penalties of \$662,000 would be realized in FY 2012-2013.

Policy Consideration

- The proposed ordinance would direct that no less than 50 percent of the additional penalty revenues collected, or approximately \$331,000 in FY 2012-2013, from imposing these additional 50 percent penalties on business taxpayers be expended for technology improvements in the Treasurer/Tax Collector's Office in order to improve the collection of business taxes, fees and licenses. The balance of 50 percent of such penalty revenues would accrue to the City's General Fund.

Recommendation

- Approval of the proposed ordinance is a policy decision for the Board of Supervisors.

BACKGROUND/MANDATE STATEMENT

Existing Legal Requirements

In accordance with Section 6.17-2(a) of the City's Business and Tax Regulations Code, when the Tax Collector determines that all or part of any business tax¹, reported to the City on any tax return was underreported, due to negligence or intentional disregard of the City's rules and regulations, the Tax Collector may impose a five percent penalty on the taxpayer for the amount of the underreported tax for each one-month period that such negligence or intentional disregard continues, up to a 20 percent total maximum taxpayer penalty.²

In addition, in accordance with Section 6.17-2(b) of the City's Business and Tax Regulations Code, when the Tax Collector determines that all or part of any tax, reported to the City on any tax return, was underreported, due to fraud or an intent to evade the City's Business and Tax Regulations Code³, the Tax Collector may impose a 50 percent penalty on the taxpayer for the amount of the underreported tax.

DETAILS OF PROPOSED LEGISLATION

Under the proposed ordinance, a new Section 6.17-2(c) would be added to the City's Business and Tax Regulations Code, to define "substantial underreporting of tax" to the City for Hotel Tax (Transient Occupancy Tax), Parking Tax, Utility Users Tax, Access Line Tax, Stadium Operator Admission Tax and Payroll Expense Tax as finally determined by the Tax Collector in accordance with Articles 7, 9, 10, 10B, 11 or 12-A of the City's Business and Tax Regulations Code. The definition of "substantial underreporting of tax" would be the amount which is underreported to the City that exceeds the amount of tax reported to the City on a taxpayer's original or amended return⁴ by 25 percent or more.

Under the proposed ordinance, if the Tax Collector determines that a taxpayer underreported any of their business taxes due to the City on their original or amended tax return by 25 percent or more, the Tax Collector may impose an additional 50 percent penalty on the substantially underreported tax amount which is owed to the City. According to Ms. Pauline Marx, the Chief Assistant Treasurer, the Tax Collector

¹ San Francisco business taxes include Hotel, Parking, Utility Users, Access Line, Stadium Operator Admission and Payroll Expense Taxes, all of which are self-reported by the taxpayer.

² According to Mr. George Putris, Tax Administrator in the Treasurer/Tax Collector's Office, the Tax Collector's Office determines negligence or intentional disregard based on the facts and circumstances of each case, subject to a hearing process for appeals.

³ According to Ms. Pauline Marx, Chief Assistant Treasurer, because the burden is on the Tax Collector's Office to prove a taxpayer's fraud or intent to evade the City's Business Tax and Regulations Code, under Section 6.17-2(b), this provision is difficult to enforce and is therefore often only used in lawsuits.

⁴ Ms. Marx advises that original returns are the taxpayer's forms that are initially submitted with tax payments to the Tax Collector's Office, typically after the quarter or year are over. Amended returns are updated information and tax payments that are submitted by the taxpayer at a later date, typically based on audits or additional information.

typically determines that a taxpayer underreported their taxes based on audits performed by the Tax Collector’s Office. The proposed 50 percent penalty would be (a) in addition to any other penalties imposed under Section 6.17-2 of the Administrative Code, and (b) applicable to all taxable periods on or after the effective date of the proposed ordinance⁵. In addition, the proposed ordinance would require the City to expend no less than 50 percent of the penalty revenues that are collected pursuant to this provision for technology improvements in the Office of the Treasurer/Tax Collector in order to improve the collection of business taxes, fees and licenses.

Mr. George Putris, Tax Administrator for the Treasurer/Tax Collector’s Office, advises that currently whether a taxpayer underreports a small amount or large amount of business taxes, the rate of penalties is the same. As noted above, Section 6.17-2(a) of the City’s Business and Tax Regulations Code provides that when the Tax Collector determines that all or part of any business tax reported on any return was underreported due to negligence or intentional disregard of the City’s rules and regulations, the Tax Collector may impose a five percent penalty on the taxpayer for the amount of the underreported tax to the City for each one month period, up to a maximum 20 percent penalty. Only if the City can prove fraud is the penalty increased to 50 percent on the amount of the underreported tax, in accordance with Section 6.17-2(b) of the Code. However, Mr. Putris advises that proving fraud is difficult and further, the burden of proof is on the City.

Under the proposed ordinance, the City would add another tier to the penalty structure such that taxpayers who underreport their business taxes in substantial amounts, as defined above, would incur penalties of 50 percent of the substantially underreported tax to the City, irrespective of whether such underreporting was due to fraud. According to Mr. Putris, the proposed ordinance is intended to create a stronger incentive for taxpayers to more accurately report their business taxes to the City.

FISCAL ANALYSIS

Example of Calculated Taxpayer Penalties

To calculate how the additional penalties would be assessed, the following example was provided by Mr. David Augustine, Policy and Programs Manager in the Treasurer/Tax Collector’s Office:

\$10,000	Amount of Parking Tax Initially Reported and Paid by Taxpayer
<u>- \$15,000</u>	Amount Determined in Tax Collector’s Subsequent Audit Actually Owed
\$5,000	Amount of Parking Tax Underreported and Underpaid by Taxpayer

⁵ The proposed ordinance is anticipated to be effective by June of 2010, such that the proposed penalties could be imposed in September of 2010 for quarterly tax payments, such as Hotel and Parking Taxes, and imposed for CY 2010 for annual tax payments, such as Payroll Expense Taxes due in March of 2011.

\$10,000 x 1.25 = \$12,500 to determine that underreported tax was greater than 25%.

\$15,000	Amount of Taxes Owed to the City
- \$12,500	Threshold for Assessing 50% Additional Penalties
\$ 2,500	Amount of Taxes Subject to 50% Tax Penalty
X .50	Penalty Rate of 50%
\$1,250	Amount of Additional Penalty Owed

In addition to the above-noted \$1,250 penalty owed on the \$2,500 of substantially underreported taxes, the same taxpayer would also be subject to the existing five percent per month penalty, up to a maximum of 20 percent penalty, owed on the \$2,500 balance of the tax shortfall, or a maximum additional penalty of \$500 (\$2,500 x .20). Therefore, under the proposed ordinance, based on this example, this business taxpayer would be subject to maximum penalties totaling up to \$1,750 (\$1,250 + \$500). In comparison, under the existing Administrative Code provisions, this same taxpayer would be subject to a maximum penalty of \$1,000 (\$5,000 underreported tax x .20 maximum penalty rate). As displayed in this example, the proposed ordinance would result in \$750 (\$1,750 less \$750) of additional penalty revenue for the City, an increase of 75 percent.

Audits Conducted and Penalties Assessed

Table 1 below summarizes for the last three fiscal years, the (a) number of audits conducted annually by the Tax Collector’s Office, (b) number and percent of these annual audits that resulted in underreported taxes, (c) the number and percent of such audits that resulted in substantial underreported taxes as defined in the proposed ordinance, and (d) the amount of penalty revenues assessed on the underreported taxes based on the existing Administrative Code provisions.

Table 1: Audits Conducted, Underreported Business Taxes Identified and Penalties Assessed in FY 2007-2008, FY 2008-2009 and FY 2009-2010

	FY 2007-08	FY 2008-09	FY 2009-2010*
Total Number of Audits Conducted	943	922	750
Number (and Percent) of Audits with Underreported Business Taxes	362 (38.4%)	347 (37.6%)	294 (39.2%)
Number (and Percent) of Audits With Substantial Underreported Business Taxes	147 (15.6%)	151 (16.4%)	112 (14.9%)
Penalties Assessed Based on Underreported Business Taxes	\$1,320,612	\$1,222,031	\$814,477

*Projected numbers for FY 2009-2010 based on actuals through December 31, 2009.

Source: Tax Collector’s Office

As shown in Table 1 above, between 14.9 percent and 16.4 percent, or an average of 15.6 percent of all the Tax Collector audits conducted over the past three fiscal years, resulted in substantial underreported business taxes. Currently, all business tax penalty revenues accrue to the City’s General Fund.

Ms. Marx advises that the Tax Collector's Office recovers approximately 72 percent of the underreported business taxes and penalties within 60 days. After 60 days, the delinquent accounts are referred to the Tax Collector's Bureau of Delinquent Revenue (BDR) for collection. BDR has numerous tools available for collecting delinquent tax revenues, including debtor contact through correspondence and telephone, credit agency reporting, liens, summary judgments and the ability to set up payment plans.

Estimated Increase in Penalty Fee Revenues

If the proposed ordinance is approved by the Board of Supervisors, taxpayer penalties would increase from the current maximum of 20 percent to 50 percent, for those taxpayers who underreport their business taxes by 25 percent or more. Based on the substantial underreported tax payments identified in the audits shown in Table 1 for FY 2009-2010, Ms. Marx estimates that, if the proposed ordinance were in effect, the City could have assessed additional penalties of approximately \$365,371 based on the actual audit findings from the first six months of this fiscal year.

Under the proposed ordinance, if approximately 15.6 percent of future Tax Collector audits result in substantially underreported business taxes to the City as defined in the proposed ordinance, Ms. Marx estimates that the Tax Collector would assess additional annual penalties of approximately \$331,000 in FY 2011-2012, increasing to approximately \$662,000 in FY 2012-2013 and potentially \$993,000 in FY 2013-2014.

Ms. Marx notes that penalty revenues in further out years are difficult to estimate, as the intent of the proposed ordinance is to encourage business taxpayers to more accurately report and pay their business taxes that are owed to the City. Therefore, the Tax Collector's Office hopes that in future years, penalty revenues may decrease, but the reported taxpayers' businesses taxes, and therefore the City's business tax revenues, would ultimately increase.

POLICY CONSIDERATIONS

Relatively Few Taxpayers Would Be Impacted By the Proposed Ordinance

The proposed ordinance would not apply to the majority of businesses in the City. According to the Tax Collector's Office, there are an estimated 80,000 businesses in San Francisco, of which approximately 74,000 businesses, or 93 percent, are not subject to paying any business taxes⁶ to the City. Of the remaining 6,000 businesses that are subject to any business taxes, the majority of businesses comply with the City's existing tax regulations and pay their applicable taxes owed to the City.

⁶ Although the majority of businesses are not subject to paying business taxes, all businesses are required to register and pay an annual Business Registration Fee of \$25 to \$500.

In addition, the proposed ordinance would only apply to those taxpayers who substantially underreport their taxes, such that the proposed 50 percent penalty would only apply to those taxes that are substantially underreported.

Increased Penalty Revenues Directed for Technology Improvements

The proposed ordinance would direct that no less than 50 percent of the additional penalty revenues collected from imposing the additional 50 percent penalties on business taxpayers would be expended for technology improvements in the Office of the Treasurer/Tax Collector, in order to improve the collection of business taxes, fees and licenses. As noted above, the additional penalty revenues are projected to generate \$331,000 in FY 2010-2011, \$662,000 in FY 2011-2012 and up to approximately \$993,000 in FY 2013-2014, such that \$165,500 in FY 2010-2011, \$331,000 in FY 2011-2012 and up to approximately \$496,500 in FY 2013-2014 would be appropriated for technology improvements in the Office of the Treasurer-Tax Collector for the collection of business taxes, fees and licenses.

Ms. Marx advises that the Treasurer/Tax Collector's Office needs to replace aging technology systems used for the collection and audit of business taxes. The current Business Tax System, which was created in 1988, currently manages the City's Business Registration, Payroll Taxes, Hotel Taxes, Parking Taxes, Access Line Taxes, Tourism Improvement District Assessments and the Cigarette Litter Abatement Fees. According to Ms. Marx, the City's Business Tax System accounts for over \$810,000,000 of tax revenues plus an additional \$70,000,000 of other fees and revenues for the City. However, the existing Business Tax System cannot (a) quickly add new taxes or fees, (b) consolidate types of taxes, (c) accept online tax information or deposits, or (d) manage workflow in the Tax Collector's Office.

According to Ms. Marx, in addition to upgrading the City's Business Tax System, the Tax Collector's Office needs to upgrade the Treasurer/Tax Collector's on-line filing system to enable businesses to pay their annual Business Registration Fee and Payroll Expense Tax each year. The new online system combines the Registration Renewal Form and the Payroll Expense Tax Statement into one on-line automated filing process to provide a clear and more user-friendly means for businesses to complete their forms with guided entries, automated calculations, and fewer questions to answer. This new "smart form" also utilizes modern technologies that enable the forms to be processed more quickly, securely and efficiently by the Treasurer/Tax Collector's Office. Ms. Marx advises that additional funding from the proposed penalty revenues would allow the Treasurer/Tax Collector's Office to expand this online system in the future to allow more businesses to more easily file and pay taxes due the City.

Ms. Marx advises that these new system upgrades are anticipated to cost approximately \$2,500,000, with ongoing additional maintenance expenses of approximately \$80,000 to \$100,000 annually.

Currently, all business tax penalty revenues accrue to the City's General Fund⁷. In addition, all costs for upgrading the Treasurer/Tax Collector's Office are typically funded with City General Fund revenues, subject to appropriation approval by the Board of Supervisors. Under the proposed ordinance, penalty revenues used for Tax Collector's Office technology improvements would continue to be subject to appropriation approval by the Board of Supervisors.

Consideration should be given as to whether it is appropriate that not less than 50 percent of the proposed additional penalties for all future years must be expended for technology improvements for the Treasurer/Tax Collector's Office, or that such penalty revenues should continue to accrue to the City's General Fund.

RECOMMENDATIONS

Approval of the proposed ordinance, which would (a) add an additional "substantial underreporting" penalty equal to 50 percent of the unreported business tax for those business taxpayers who underreport tax liabilities to the City by 25 percent or more, and (b) direct that not less than 50 percent of the increased penalty revenues be expended for technology improvements in the Office of the Treasurer-Tax Collector to improve the collection of business taxes, fees and licenses, is a policy decision for the Board of Supervisors.

⁷ Although all business tax penalty revenues accrue to the City's General Fund, Hotel Taxes are apportioned according to formula and most of the Parking Taxes are ultimately transferred to the Municipal Transportation Agency (MTA).

