

State of Nevada
Department of Administration
Division of Internal Audits

Audit Report

**Office of the Secretary of State
Business Licenses**

Report No. 11-01
June 2011

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The Office should coordinate with State agencies and local governments to ensure businesses have Nevada Business Identification Numbers. The Office assigns a unique Nevada Business Identification Number to each business entity it has on file. Based on our findings, not all State agencies require businesses they regulate or contract with to provide evidence of a state business license. We randomly selected a sample of 260 businesses regulated by State agencies and found 13.46 percent were not in the Office's database. Not all local governments require businesses to provide their Nevada Business Identification Numbers either. If State agencies and local governments collect Nevada Business Identification Numbers, it would facilitate the Office's determining if the business is properly registered.

Objective 2: How Can the Office Verify Business License Exemptions?

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The Office should evaluate obtaining information needed to determine whether businesses meet license exemption requirements. Currently, the Office has about \$6.4 million in claimed exemptions, most of which are home based businesses. The

calculation is based on business license fees of \$100 a year. Statutorily, business license fees are scheduled to change from \$200 a year to \$100 beginning July 1, 2011.

The validity of home based business exemptions is difficult to verify. Based on a sample of 30 applications, businesses submit insufficient information to determine whether they are home based. Currently the statutory requirement for a business claiming the home based exemption limits their net earnings to no more than \$27,000 a year. The statute does not define net earnings, nor do businesses submit this information. The Office will also need to determine if it is legally appropriate to collect evidence for exemptions.

The Office should also evaluate the cost benefit of verifying compliance with exemptions. Systems will need to be developed to capture, retain, and review confidential information from businesses. Then Office staff will need to review this information to determine whether a business qualifies for an exemption.

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INTRODUCTION

As requested by the Secretary of State, and approved by the Executive Branch Audit Committee, we conducted an audit of how to capture revenue from non-compliant or unlicensed businesses¹ (unlicensed businesses) and reviewed exemptions for the Nevada business license.

Office's Role and Public Purpose

The Office of the Secretary of State (Office) is constitutionally created. It uses five divisions to carry out its roles. Examples of some of the divisions' duties include:

- Elections – reports and certifies the results of State primary and general elections.
- Notaries – appoints, trains, and if necessary, disciplines public notaries.
- Operations – manages internal functions such as accounting, budget and information technology.
- Securities – regulates Nevada's security industry, licenses individuals selling securities, registers security offerings, and enforces provisions of Nevada's securities laws.
- Commercial Recordings – accepts, files, maintains, and provides public access to business entity organizational documents; and issues business licenses.

A Nevada business license authorizes a business to provide goods and services. The initial and annual renewal business license fees are \$200 per year. However, license fees will decrease to \$100 per year beginning July 1, 2011 (NRS 76.100).

Statute (NRS 76.020) states a person shall not conduct business in Nevada unless they have a business license issued by the Office. A business generally is any person or entity that performs a service or engages in a trade for profit. Other businesses, for example, certain non-profit organizations, are also required to apply for business licenses from the Office. Depending on circumstances, some businesses may qualify for a business license fee exemption.

¹ The Office categorizes non-compliant businesses as those that deliberately avoid state business license requirements, whereas unlicensed businesses might unknowingly fail to apply for a state business license. For purposes of this report, noncompliant and unlicensed businesses are referred to collectively as unlicensed businesses.

Businesses must apply with the Office to receive a business license or an exemption. An applicant may apply on-line, in person, or by mail. The applicant supplies basic information such as business name, address, and the type of business. Business types include corporations, limited liability companies, and sole proprietorships. Unless exempt, the business pays a fee and the Office issues a business license. If the business declares an exemption, the Office issues an exemption certificate. The business' information is entered into the Office's database by the business applicant when filing online, or by Office staff when filing in person or by mail. Information on the business license is public record the Office posts on its website.

In Nevada, business licenses are issued at two levels: local governments and the State. Local governments are incorporated cities and non-incorporated areas of counties. Many local governments require local businesses to obtain a business license. The State also has a business license requirement. According to legislative testimony, only Nevada administers business licenses at the state level.

Prior to October 2009, the Department of Taxation administered the State business license process. In October 2009, the Office took over the administration of state business licensing.

The Office uses about ten employees to process State business license applications and some businesses annual listing of officers. The estimated cost for fiscal year 2011 is about \$600,000, which is entirely general funds. We estimate business licenses will generate about \$51 million in fiscal year 2011².

Scope and Objectives

We began the audit in July 2010. Our audit addressed how the Office can identify unlicensed businesses and how it could verify business license exemptions. During the audit, we reviewed and discussed the Office's procedures with management and staff and sampled business license documentation. We interviewed Department of Taxation staff regarding regulatory processes when it administered business licenses. We also surveyed Nevada local governments to determine best practices and obtained listings of business licenses for sample comparison to the Office's records. We concluded field work and testing in March 2011.

² The revenue projection uses the \$200 license fee that is in effect through June 30, 2011.

Our audit focused on the following objectives:

- ✓ How can the Office identify unlicensed businesses?
- ✓ How can the Office verify business license exemptions?

The Division of Internal Audits expresses appreciation to the Secretary of State, management, and staff for their cooperation and assistance throughout the audit.

Contributors to this report included:

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Office of the Secretary of State Response and Implementation Plan

We provided draft copies of this report to the Secretary and Office officials for their review and comments. Their comments have been considered in the preparation of this report and are included in Appendix A. In its response, the Office accepted each of the recommendations we made. Appendix B includes a timetable to implement our recommendations.

NRS 353A.090 specifies that within six months after the Executive Branch Audit Committee releases the final audit report, the Chief of the Division of Internal Audits shall evaluate the steps the Office has taken to implement the recommendations and shall determine whether the steps are achieving the desired results. The Chief shall report the six-month follow-up results to the Committee and the Secretary of State.

The following report contains our findings, conclusions, and recommendations.

How Can the Office Identify Unlicensed Businesses?

The Office can identify unlicensed businesses by using business license data from local governments and coordinating the use of Nevada Business Identification Numbers. We estimate the State could collect up to \$1.9 million annually in additional business license fees.

The State's business licensing process is primarily self-reported. The Office currently receives about 321,000 applications a year from businesses seeking licenses. The Office does not have defined resources to identify unlicensed businesses on its own.

We contacted Nevada local governments³ and obtained electronic data listings of licensed businesses. We randomly sampled 182 businesses from their listings and compared them to the Office's database. Our sample revealed 22.5 percent of businesses in the local government listings were not in the Office's database. We reviewed these businesses with Office staff, who agreed they should be licensed.

Based on our findings, the Office could use local business license information in electronic format to identify unlicensed businesses. We estimate the Office could obtain up to \$1.9 million a year in license fees from identifying unlicensed businesses⁴. The calculation is based on business license fees of \$100 a year. Statutorily, business license fees are scheduled to change from \$200 a year to \$100 beginning July 1, 2011.

The Office could review records used by local governments to discover unlicensed businesses. For example, the Office could use some of the following sources to identify unlicensed businesses:

- Records – Assessors' and building permit data.
- Media – Yellow pages, newspapers, business listings, and websites.

The Office should determine the cost benefit and resources needed to use local government data or techniques to identify unlicensed businesses. While we were able to obtain business listings free, the data sometimes required some research into local government classifications in order to determine if the sampled business had a State license. In addition, the Office will need to consider how to pursue unlicensed businesses once identified.

³ The cities of Henderson, Las Vegas, North Las Vegas, Reno, and Sparks; and Clark and Washoe counties.

⁴ Revenue calculation: Sample result of 22.5 percent businesses unlicensed with the State applied to a population of 85,688 businesses licensed by the local governments sampled, using a \$100 license fee that goes into effect July 1, 2011.

Recommendation

1. Consider the cost benefit and resources needed to use local government data or techniques to identify unlicensed businesses.

Coordinate Nevada Business Identification Numbers with State Agencies and Local Governments

The Office should coordinate with State agencies and local governments to ensure businesses have Nevada Business Identification Numbers. The Office assigns a unique Nevada Business Identification Number to each business entity when they apply for a business license or file organization papers⁵. Not all State agencies require businesses they regulate or contract with to provide evidence of a State business license. We randomly selected a sample of 260 businesses regulated by State agencies. Our sample revealed 13.46 percent of these businesses were not in the Office's database. Not all local governments require businesses to provide their Nevada Business Identification Numbers. If State agencies and local governments collect Nevada Business Identification Numbers, it would facilitate the Office's determining if the business is properly registered and provide better data matching.

Recommendation

2. Coordinate with State agencies and local governments to ensure they collect Nevada Business Identification Numbers as part of their processes.

⁵ Some businesses, such as corporations, are required by statute to file their organizational papers with the Office of the Secretary of State.

How Can the Office Verify Business License Exemptions?

The Office should review business license exemptions. This could verify whether \$6.4 million in exemptions are allowable.

Some business types or entities are statutorily exempt from paying a business license fee. These are:

- Governments,
- Non-profit organizations qualifying as tax exempt pursuant to Internal Revenue Service regulations,
- Natural persons⁶ whose sole business is renting four or fewer dwellings to others,
- Businesses whose primary purpose is to create or produce motion pictures,
- Persons operating a business from their home and whose net earnings from that business are not more than \$27,000 a year.⁷ (Home based business exemptions)
- An insurance company licensed pursuant to NRS 680B.020.

Business Exemptions

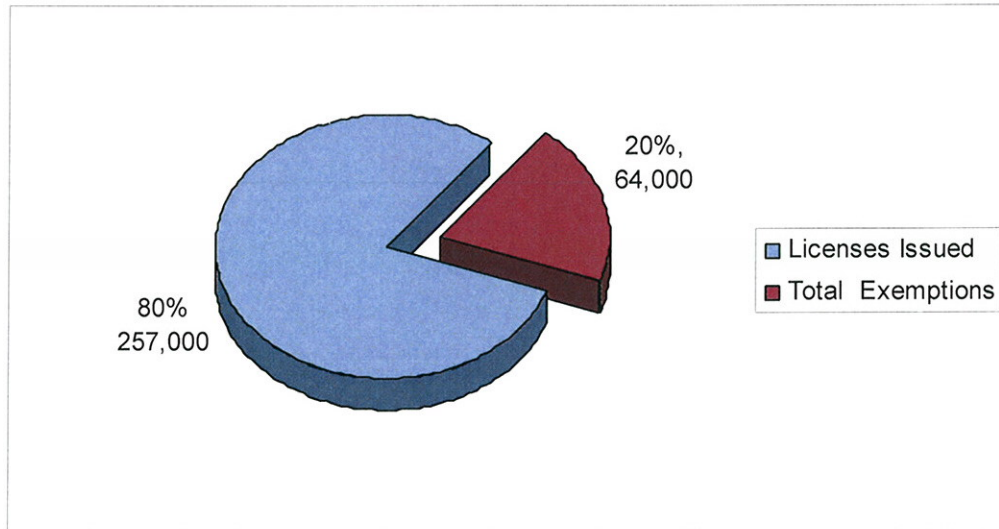
A large number of businesses claim State business license exemptions. The Office reports about 20 percent of the 321,000 businesses that filed in calendar year 2010 claimed a business license exemption as shown in Exhibit I.

⁶ By law, a "natural person" is a human being as distinguished from a "person" who can be either a natural person or an artificial person such as a corporation.

⁷ Adjusted annually, it is a calculation of 2/3 of the average annual wage. Currently the maximum allowed net earnings for a home based exemption is \$27,000.

Exhibit I

Business Licenses Issued and Total Exemptions



Source: Office of the Secretary of State for calendar year 2010.

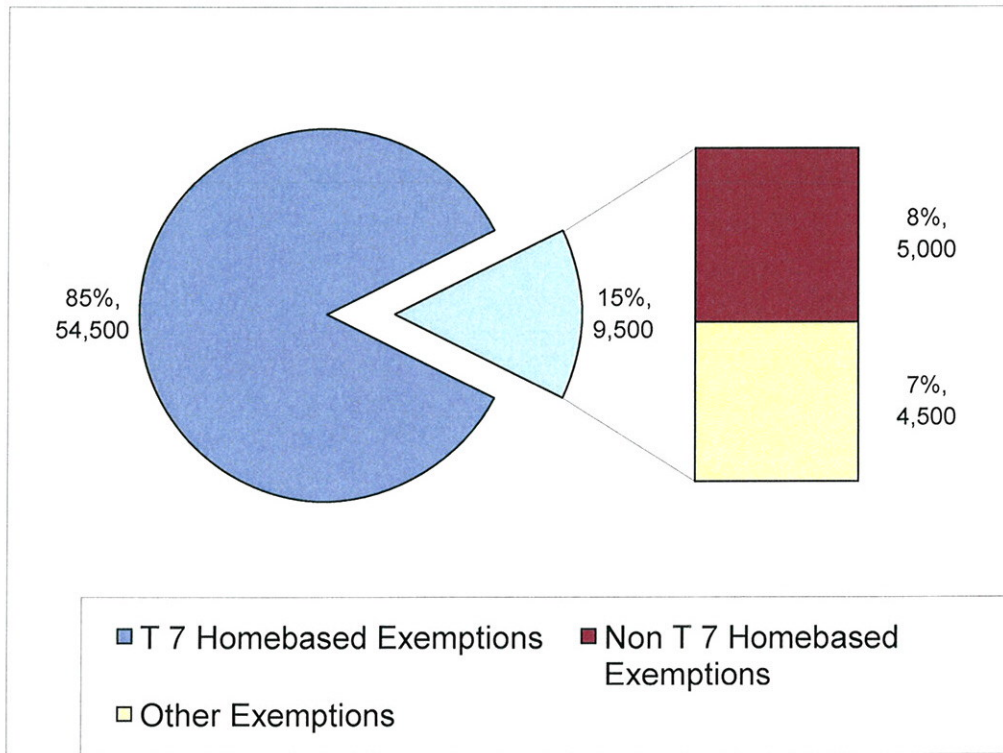
Other Nevada governmental jurisdictions do not have as high a percentage of businesses using exemptions. About 20 percent of registered businesses claim exemptions from State business licensing. We surveyed 13 Nevada city and county governments.⁸ Generally, they only allow non-profits to claim exemptions. This results in about 1 percent of their businesses claiming a business license exemption in these jurisdictions.

Most businesses claiming State business license exemptions are defined as Title 7 businesses. These businesses are created under Title 7 of the Nevada Revised Statutes which includes corporations and limited liability companies. About 54,500 businesses claiming the home based exemption are Title 7 businesses. This amounts to over \$5.4 million in potential business license fees. The calculation is based on business license fees of \$100 a year. Statutorily, business license fees are scheduled to change from \$200 a year to \$100 beginning July 1, 2011. The proportions of various exemption types claimed to licenses issued and total exemptions appear in Exhibit II.

⁸ Boulder City, Carson City, Elko, Ely, Henderson, Las Vegas, Mesquite, North Las Vegas, Reno, Sparks; and Churchill, Clark, and Washoe counties.

Exhibit II

Proportion of Business Claiming Business License Exemptions



Source: Office of the Secretary of State for calendar year 2010.

There appears to be ambiguity in the statute (NRS 76.020(2)c) for what is an exempt home based business. The current statute refers to "persons" operating their business from their home are eligible for the exemption. The Office is seeking to amend the home based business exemption statute. The proposed legislation would limit the home based business exemption to "natural persons" using their personal residences for their business.⁹ It would clarify that Title 7 businesses are not eligible for this exemption. Legislative testimony from those opposing the proposed legislation claim the proposed change could harm smaller businesses by requiring them to pay for a business license.

The Department of Taxation administered State business licenses until October 2009. When the Department of Taxation administered State business licenses, it created regulations limiting home based business exemptions to "natural persons" using their personal residences.

Currently, the Office does not have regulations related to this statute. If statute is not amended, the Office may adopt regulations or obtain an Attorney General's

⁹ 2011 Legislative Session, Assembly Bill 78.

opinion to clarify the intent of home based exemptions. Existing statutes allow the Secretary to adopt regulations (NRS 76.140).

Validating Business License Exemptions

The Office should evaluate obtaining information needed to determine whether businesses meet exemption requirements. It should also evaluate the cost benefit of verifying compliance with exemptions. Currently, the Office has about \$6.4 million in claimed exemptions. If statute is amended, about \$5.4 million in home based business exemptions would be eliminated for Title 7 businesses, leaving nearly \$1 million in claimed exemptions.

The Office obtains information regarding businesses through business license applications. The information is generally limited to:

- Responsible person's name and signature,
- Business name and, if applicable, other businesses associated with the business (for example, related businesses),
- Physical address and mailing address, if different,
- Business phone number and email address,
- If applicable, officers' names,
- If applying for an exemption, identifies which exemption applies, and
- Responsible party signs under penalty of perjury.

Businesses are not providing information to allow the Office to determine whether they qualify for an exemption. We sampled 30 home based business applications exemption filings; we could not verify whether any of the businesses qualified for a home based exemption. The problems included businesses that listed their address as:

- The same address as their resident agent,¹⁰
- A post office box,
- In a commercial area, and
- Out of state.

The statute for home based business exemptions is difficult to verify. The exemption requires the business to operate from a home. The Office would need to verify the business is primarily operated out of a home. The exemption also limits net earnings from the business to no more than 2/3 of the average wage. This figure changes annually, and is currently \$27,000 a year. The statute lacks a definition for what constitutes net earnings. The Office would need to define, determine, and verify net earnings.

¹⁰A person authorized to accept service of process for another person, especially Title 7 businesses.

In order to verify exemptions, the Office will need to determine if it is legally appropriate to collect evidence for exemptions. The Office currently receives only public information for business licenses. To prove businesses qualify for home based exemptions, the Office will need to obtain evidence such as business federal tax returns to enable it to analyze whether the business's net earnings meet the exemption. This is not public information.

The Office will also need to determine if collecting, retaining, and reviewing confidential information is cost beneficial. Systems will need to be developed to capture this information from businesses. Then Office staff will need to review this information to determine whether a business qualifies for an exemption.

Recommendations

3. Evaluate obtaining information needed to determine whether businesses meet exemption requirements.
4. Evaluate the cost benefit of verifying compliance with exemptions.

Appendix A

Office of the Secretary of State Response and Implementation Plan



OFFICE OF THE SECRETARY OF STATE

ROSS MILLER
Secretary of State

April 26, 2011

Mr. William Chisel, CPA
Chief
Division of Internal Audits
Department of Administration
3427 Goni Road, Suite 103
Carson City, NV 89706

Dear Mr. Chisel:

Thank you to you and your team, especially Mike Colburn and Paul Chalekian, for the analysis of two issues concerning compliance with the State's annual Business License requirements. The findings in this report confirms the need to strengthen compliance mechanisms for ensuring that all businesses required to obtain a business license or claiming an exemption, are in fact compliant.

Based on a review of legislative history, it is clear that in 2003, and subsequently in 2009, when the Legislature enacted provisions governing the issuance of the annual State Business License (SBL), it was the Legislature's expectation that the state develop a database of businesses to ensure that any business meeting the definition of "conducting business" in the state is compliant, unless that business meets the qualifications of an exemption as specified in statute. The audit findings substantiate what this Office suspected with regard to the administration and issuance of the State Business License; namely, that the State needs to determine the costs necessary to develop procedures and mechanisms ensuring that those doing business in Nevada properly maintain a State Business License or, if claiming an exemption, that they meet the exemption criteria annually.

As such, I am prepared to implement the recommendations set forth in the Audit Report. In so doing we will develop a process that ensures compliance with the State's business license requirements and consequently captures revenue due the State for the privilege of conducting business pursuant to NRS Chapter 76. Implementing the recommendations will require better data sharing with state and local government agencies that interact

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with many of the same businesses as the Office of the Secretary of State and will clarify the rules governing qualification for and verification of business licenses exemptions.

Prior to October 2009, businesses exempt from the State Business License were not required to affirmatively file an exemption. When the Secretary of State's office assumed the administration of the SBL, it was determined that any business claiming an exemption must file an application claiming a specific exemption and sign under penalty of perjury. The business and the exemption claimed is a part of the public record and made publicly available on the Secretary of State's free business entity search. Through this public listing false or improper exemption filings have been identified and reported.

Currently, the office has legislation pending that would clarify that only a sole proprietor or partnership would qualify for the home-based business exemption. AB 78 would codify in statute the intent of the 2003 legislation creating the annual State Business License and the definition adopted by the Tax Commission through regulation in 2004, and would clarify that the home-based business exemption applies only to a natural person operating a business from his or her personal residence and whose net earnings are $66 \frac{2}{3}$ of the average Nevada annual wage pursuant to NRS Chapter 612. The average Nevada annual wage generally fluctuates each year. At the time of this report, the average annual wage for 2010 is \$27,000.00.

Opponents of AB 78 claim this measure will harm Nevada's business friendly reputation, causing companies to domicile in other jurisdictions. They fail to mention is that they did not object to this provision when the Tax Commission adopted the definition by regulation in 2004. Further they knew, in 2003 when the legislature changed the SBL requirements and created this exemption that it was meant to apply to a natural person. More specifically, based on a review of legislative history, the legislature intended the home-based exemption be limited to a direct seller, a person who as an independent contractor such as the Avon, Mary Kay cosmetics, Pampered Chef or Creative Memories salesperson runs a business from his or her home and whose income from this business does not exceed the amount defined in statute. It is clear from your analysis that the exemption needs to be supported by information provided to the State so the exemption qualification can be validated. Once the type of supporting documentation is determined, an analysis of the cost to the State to put a verification procedure in place can be completed.

Further, recalling Internal Audit's analysis on the cost benefit potential of the Nevada Business Portal conducted several years ago, the recommendations in this report regarding data/information sharing between governmental entities and establishing greater utilization of the Nevada Business Identification Number issued by this Office,

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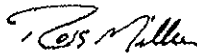
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correspond significantly with the findings in that original cost benefit analysis. As we launch Phase 2 of the Nevada Business Portal, which focuses on integrating some local government licensing functions, including data-sharing, we will make great strides in collecting better information about unlicensed businesses and will be able to bring these businesses into compliance.

Thank you again for the effort you put forth. I look forward to the presentation to the Executive Branch Audit Committee at its next meeting.

Respectfully,



ROSS MILLER
Secretary of State

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Appendix B

Timetable for Implementing Audit Recommendations

In consultation with the Office, the Division of Internal Audits categorized the four recommendations contained within this report into two separate implementation time frames (i.e., *Category 1* – less than six months; *Category 2* – more than six months). The Office should begin taking steps to implement all recommendations as soon as possible. The Office's target completion dates are incorporated from Appendix A.

Category 1: Recommendation with an anticipated implementation period of less than six months.

<u>Recommendation</u>	<u>Time Frame</u>
3. Evaluate obtaining information needed to determine whether businesses meet exemption requirements. (page 10)	Oct 2011

Category 2: Recommendations with an anticipated implementation period exceeding six months.

<u>Recommendations</u>	<u>Time Frame</u>
1. Consider the cost benefit and resources needed to use local government data or techniques to find unlicensed businesses. (page 5)	Dec 2011
2. Coordinate with State agencies and local governments to ensure they collect Nevada Business Identification Numbers as a part of their processes. (page 5)	Apr 2012
4. Evaluate the cost benefit of verifying compliance with exemptions. (page 10)	Dec 2011

The Division of Internal Audits shall evaluate the action taken by the Office of the Secretary of State concerning report recommendations within six months from the issuance of this report. The Division of Internal Audits must report the results of its evaluation to the Committee and the Office.