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OFFICE OF THE STATE COMPTROLLER

October 4, 2006

Mr. Andrew S. Eristoff
Commissioner
Department of Taxation and Finance
State Office Campus - Building 9
Albany, New York 12227

Re: Report 2006-F-12

Dear Mr. Eristoff:

Pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution; and Article II, Section 8 of the State Finance Law, we have followed up on the actions taken by officials of the Department of Taxation and Finance to implement the recommendations contained in our audit report, *Sales Tax Distribution Process* (Report 2003-S-51).

Background, Scope and Objective

Counties, cities and certain school districts are authorized by Article 29 of the New York State Tax Law to impose a tax on the sale or purchase of certain items and services. If imposed, this local sales tax is added to the statewide sales tax imposed by New York State. In 2004, a local sales tax was imposed by all the counties, several cities and some school districts. This local sales tax generally ranged between three percent and five and one-half percent of the value of the purchased item or service, and was added to the statewide sales tax, currently at 4.00 percent.

Generally, the sales tax is paid to the vendor when a taxable purchase is made. The vendor is then required to forward the tax revenue to the New York State Department of Taxation and Finance (Department). The Department is responsible for distributing the local portions of the tax revenue to the appropriate localities. In the State fiscal year ended March 31, 2006, a total of $22.3 billion in sales tax revenue was collected by the Department. The Department distributed $11.6 billion to the localities and $10.7 billion to the State.

Vendors are required to remit their sales tax revenue either annually, quarterly or monthly, depending on the amount of tax revenue collected. The vendors collecting the greatest amount of revenue are required to remit monthly, while the vendors collecting the least amount are required to remit annually.

Vendors are also required to file a sales tax return. Those vendors making annual remittances are required to file annual sales tax returns, while vendors making quarterly and monthly remittances are required to file quarterly sales tax returns. This return contains information about the vendor's taxable sales for the period, such as the nature, amount and location of the sales. The location is important, because the local portion of the sales tax generally belongs to the locality in which the sale was made. However, in the sale of a motor vehicle or vessel, the purchaser's home address generally dictates which locality receives the local portion of the sales tax. Information about sales location thus provides the basis for the subsequent distribution of sales tax revenue to the localities.

Since most of the sales tax revenue comes from the vendors making monthly remittances, a significant amount of revenue is received each month. To get the local portion of the sales tax revenue to the localities with as little delay as possible, the Department makes local distributions, based on estimates, on the fourth and twelfth of each month. Additionally, in December and June, the Department also processes a third distribution.

When the information from the vendors' sales tax returns become available at the end of the quarter (or the end of the year, for smaller vendors), the Department uses the information to determine how much sales tax revenue each locality should receive for the quarter. Then, the final distribution for the quarter is made in such a way that, when this distribution is combined with the earlier estimated distributions, the total amount distributed to each locality in the quarter equals the amount that should have been distributed.

Thus, local distributions of sales tax revenue are ultimately based on the information provided by vendors in their sales tax returns. If this information is not accurate, the revenue may not be distributed correctly among the localities. Some localities may receive more sales tax revenue than they are due, and others may receive less. To identify possible errors in the information provided by vendors, the Department routinely analyzes this information as it is received. These analyses are both automated and manual. If any possible errors are identified during these analyses, the affected returns are set aside for further review and resolution. However, the sales tax revenue remitted by these vendors is not held up pending resolution of the possible errors. This revenue is distributed to the State and the affected localities without delay.

If the Department determines that a sales tax return is in fact erroneous, the local distributions affected by the erroneous return are corrected. Such corrections are usually made through prior period adjustments, which are batched and made at the end of each quarter. These prior period adjustments are a routine, ongoing part of the sales tax distribution process, because the Department typically identifies many errors during its analysis of vendor sales tax returns. Prior period adjustments are also made when filing errors and unreported sales are identified by Department audits of vendors.

Errors on sales tax returns are also corrected through special up-front adjustments. These up-front adjustments are made when a Department analysis determines that a locality has received significantly less revenue than it was due because of an error on a vendor's tax return (e.g., a vendor's taxable sales may have been attributed to the wrong locality, because sales data was entered in the wrong place on the tax return). Generally, up-front adjustments are used to correct errors made by large vendors remitting significant amounts of tax revenue. Because of the

significance of the tax revenue from these vendors, their tax returns receive special attention from the Department, and if significant errors are identified in these returns, immediate up-front adjustments are used to correct the errors, rather than prior period adjustments, to expedite the correction process. In addition, if local officials believe they have received less sales tax revenue than they were owed, they may ask Department officials to determine whether any errors were made.

Our initial audit report, which was issued on December 27, 2004, examined the sales tax distribution process administered by the Department for the period January 1, 2003 through December 31, 2003. The objective of our performance audit was to determine whether local distributions of sales tax revenue are reasonably correct. Our report identified that local distributions of sales tax revenue are reasonably correct. However, certain improvements can be made in the Department's processing of sales tax returns, as errors affecting the local distributions are not always detected by the Department. We also found that assessments were not always issued promptly to vendors for underpayment of taxes or late filing of tax returns. We recommended that certain additional error identification practices be adopted by the Department, and action be taken to expedite the issuance of assessments. We also recommended that controls be strengthened to limit the ability of Department staff to modify sales tax returns without supervisory approval. The objective of our follow-up, which was conducted in accordance with generally accepted government auditing standards, was to assess the extent of implementation as of September 12, 2006, of the four recommendations included in our initial report.

Summary Conclusions and Status of Audit Recommendations

We found that Department of Taxation and Finance officials have made some progress in correcting the problems we identified. However, additional improvements are needed. Of the four audit recommendations, two recommendations have been implemented and two recommendations have been partially implemented.

Follow-up Observations

Recommendation 1

Establish monetary thresholds for the verification of certain information on sales tax returns [the nature of this information has been discussed in detail with Department officials], and routinely verify the information meeting these thresholds during the Department's processing of sales tax returns.

Status - Partially Implemented

Agency Action - The Department is in the process of developing a complete redesign of the tax processing computer system. The project is called e-MPIRE. The e-MPIRE system is being implemented in four phases with an expected completion date in 2008. The fourth phase will include the sales tax portion, which will address this recommendation.

Recommendation 2

Maintain certain information [the nature of this information has been discussed in detail with Department officials] from vendors' prior quarterly returns on the sales tax database, and automatically compare this information to vendors' current returns during the Department's processing of sales tax returns. Automatically notify vendors when errors are detected through this comparison.

Status - Partially Implemented

Agency Action - As with recommendation 1, the Department is in the process of developing the e-MPIRE system. The sales tax component, that will implement this recommendation, is included in the fourth phase, scheduled to be completed in 2008.

Recommendation 3

Expedite the issuance of sales tax assessments.

Status - Implemented

Agency Action - The Department implemented a computer application to automate the issuance of assessments based on adjustments of sales tax returns in July 2004. The Department uses this along with frequent system updates, nightly instead of twice a week to expedite sales tax assessments.

Recommendation 4

Establish a risk-based supervisory review process for staff edits to sales tax returns.

Status - Implemented

Agency Action - The Department established a Quality Review database and procedures to help supervisors assess risk and help identify staff edits for review. The Quality Review database procedures require supervisors review cases, on a rotating basis, for each of the case resolvers in their area. There are requirements established for which cases are to be reviewed. Any case resolved incorrectly is returned to the resolver who worked on it for explanation or correction. Case resolvers are also given feedback when they are working up to standard.

Major contributors to this report were Donald Paupini and Donald Collins.

We would appreciate your response to this report within 30 days, indicating any actions planned to address the unresolved issues discussed in this report. We also thank the management and staff of the Department for the courtesies and cooperation extended to our auditors during this process.

Very truly yours,

Kenneth I. Shulman
Audit Manager

cc: Lisa Ng, Division of the Budget
Andrew Maguire, Department of Taxation and Finance