ALAN G. HEVESI
COMPTROLLER

110 STATE STREET
ALBANY, NEW YORK 12236

STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

December 27, 2004

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

Re: Sales Tax Distribution Process
Report 2003-S-51

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 audited the sales tax distribution process administered by the Department of Taxation and Finance. Our audit covered the period January 1, 2003 through December 31, 2003.

A. Background

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 and four percent of the value of the purchased item or service, and was added to the statewide sales tax of 4.25 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, 2004, a total of $19.6 billion in sales tax revenue was collected by the Department. The Department distributed $9.9 billion to the localities and $9.7 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. At the time of our audit, about 299,000 vendors were required to make annual remittances, about 249,000 vendors were required to make quarterly remittances, and about 34,000 vendors were required to make monthly remittances. While vendors making monthly remittances accounted for only six percent of the vendors making sales tax remittances, they accounted for 85 percent of all sales tax revenue. Generally, sales tax remittances are sent to a Department contractor, and are to be deposited in an appropriate account upon receipt.

Vendors are also required to file a sales tax return. 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.

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. The sales tax returns are submitted to the Department's contractor, where they are checked for completeness and converted to electronic format. The information on the tax returns is then transmitted electronically to the Department, and is used in the sales tax distribution process.

Since most of the sales tax revenue comes from the vendors making monthly remittances, a significant amount of revenue is received each month. For example, in August of 2004, a total of $1.6 billion in sales tax revenue was received. To get the local portion of this revenue to the localities with as little delay as possible, the Department makes local distributions of sales tax revenue on the 4th and 12th of each month. In December and June, the Department also processes a third distribution.

The Department's distributions of sales tax revenue are usually based on estimates, because vendors' sales tax returns are not available until the end of each quarter. The returns indicate how much sales tax revenue each locality should receive, because they show how much tax revenue was collected in each locality by each vendor. In the absence of the returns, the Department estimates each locality's share of each vendor's collections on the basis of the vendor's prior year sales tax return for that quarter and any known changes in the vendor's operations that would affect sales tax distributions (such as the closing of a store in one locality or the opening of a store in another locality).

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.

The Department's distribution of sales tax revenue is thus characterized by a process of ongoing correction and adjustment. At the end of every quarter, corrections are made to account for inaccuracies in that quarter's estimated distributions, and adjustments are made to correct errors on prior period tax returns. Up-front adjustments may be made at any time. The process is very complex, because more than 250,000 tax returns must be processed every quarter and more than 100 localities must receive their share of the sales tax revenue. The process would be less complex if fewer corrections were required, and fewer corrections would be required if local distributions were made less frequently (e.g., quarterly rather than biweekly). However, the localities need the sales tax revenue to meet their daily operating costs. Thus, the Department must both distribute the revenue, and make corrections to the distributions, on an ongoing basis.

B. Audit Scope, Objective and Methodology

We audited 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. To accomplish our objective, we focused on the Department's processing of vendor sales tax returns, because the information on these returns provides the basis for the distribution of sales tax revenue. In particular, we reviewed a sample of 246 sales tax returns to determine whether the Department identified all the errors on the returns that would affect the distribution of sales tax revenue. The returns in our

sample were randomly selected from the March 2003 quarterly returns submitted by vendors required to make monthly remittances of sales tax revenue. We also interviewed Department officials, and reviewed Department records, policies, procedures, and rules and regulations.

We conducted our audit in accordance with Generally Accepted Government Auditing Standards. Such standards require that we plan and perform our audit to adequately assess Department operations included in our audit scope. Further, these standards require that we understand the Department's internal control structure and compliance with those laws, rules, and regulations that are relevant to the operations included in our audit scope. An audit includes examining, on test basis, evidence-supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under Generally Accepted Government Auditing Standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

Because of certain provisions in the New York State Tax Law, we are not permitted to publicly disclose the details of certain Department processes for administering New York State's tax laws. Therefore, the language in parts of this audit report is general rather than specific. We have discussed our detailed audit findings and related conclusions with appropriate Department officials.

C. Results of Audit

We found 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 recommend that certain additional error identification practices be adopted by the Department, and action be taken to expedite the issuance of assessments. We also recommend that controls be strengthened to limit the ability of Department staff to modify sales tax returns without supervisory approval.

Department officials generally agree with our recommendations. They point out that certain improvements will be addressed by the Department's new automated tax processing system (e-MPIRE) when it becomes operational in 2006. In the mean time, Department officials indicate they will look into interim solutions.

1. Distribution of Sales Tax Revenue

The Department distributes sales tax revenue on the basis of information in the vendors' sales tax returns. To determine whether the Department has established adequate processes for identifying errors in the returns that would affect the distribution of sales tax revenue, we reviewed a sample of 246 sales tax returns. The tax returns in our sample were randomly selected from the March 2003 quarterly returns submitted by vendors required to make monthly remittances of sales tax revenue. We focused on these vendors because they account for 85 percent of all sales tax revenue. We selected the March 2003 quarter because it was the most recent quarter for which prior period adjustments had generally been completed.

All vendors whose taxable sales exceed $300,000 a quarter are required to make monthly remittances of sales tax revenue, and if the vendors collect more than $500,000 a year in sales taxes, they are required to make their monthly remittances through electronic fund transfers. According to Department records, March 2003 quarterly returns were submitted by a total of 32,164 vendors making monthly remittances, of which 3,570 vendors were required to make electronic remittances and 28,594 vendors were not. Our sample consisted of 196 of the 3,570 electronic filers and 50 of the remaining 28,594 monthly filers. Working from Department records, we randomly selected 50 of the top 100 electronic filers with the highest reported tax for the quarter, and 146 of the remaining 3,470 electronic filers. We also randomly selected 50 of the 28,594 other monthly filers.

The Department routinely analyzes the sales tax returns submitted by vendors to identify possible errors. We reviewed the 246 sampled returns to determine whether the returns contained any revenue-related errors that were not identified by the Department's analyses. To make this determination, we referred to relevant Department rules and regulations, consulted knowledgeable Department staff, and reviewed certain associated data on the Department's sales tax database (the Department uses this data in its analyses to identify discrepancies and other possible errors in the information provided by the vendors). In addition, in some instances, we compared the returns to prior returns from the same vendors.

We found that 44 of the 246 tax returns contained revenue-related errors that had not been detected by the Department. The gross dollar value (i.e., underpayments plus overpayments) of these errors was about $3.5 million. Since the gross amount of sales tax reported on these 246 returns was about $550.5 million, the dollar value of the errors in the sample was less than one percent (.6 percent) of the total dollar value of the sample. We therefore conclude that the sales tax revenue distributed on the basis of the information in these 246 tax returns was not significantly affected by these relatively small errors. We also note that none of the 44 errors appeared to have a significant effect on any single locality.

We further conclude that, since the returns in our sample were randomly selected from the sales tax returns accounting for most of the sales tax revenue collected in New York State for the first quarter of 2003, it is highly likely that the total amount of sales tax revenue distributed by the Department for that quarter was distributed reasonably correctly. Moreover, if the sales tax distribution practices used by the Department in that quarter were representative of the practices generally used by the Department, and we found no reason to believe they were not, it is likely that local distributions of sales tax revenue, in general, are reasonably correct.

It should also be noted that the Department monitors the sales tax distribution process, on an overall basis, to determine whether distributions are consistent with information on the sales tax

returns and prior period adjustments to these returns are being made in a timely manner. To perform this monitoring, six months after the end of a quarter, the Department compares the distributions for the quarter (as adjusted through prior period adjustments and special up-front adjustments) to the fully processed tax returns for the quarter (the returns set aside for resolution, and still unresolved, are not included in the comparison); if at least 95 percent of the distributions can be matched to fully processed tax returns, the Department considers the distributions for that quarter to be reasonably accurate. According to Department officials, as of September 2003, 97 percent of the distributions for the March 2003 quarter could be matched to fully processed tax returns. Thus, according to the Department's benchmark, distributions for the March 2003 quarter were reasonably accurate. Generally, distributions cannot be matched to fully processed tax returns when the returns are still awaiting resolution or have yet to be submitted by the vendors.

While the errors in our sample were not large enough to significantly affect the accuracy of the sales tax distribution process, they are nonetheless errors that should be identified and corrected. Moreover, while many of the errors were small (i.e., less than $1,000), some of the errors exceeded $100,000. In addition, in one instance, the initial error was magnified, because the Department had to pay substantial interest to the vendor on account of the error.

Due to the sensitivity of the Department's processes for reviewing tax returns, our audit report cannot provide detailed descriptions of these undetected errors. However, we determined that, in general, the 44 erroneous tax returns contained two types of errors, and these two types of errors could be identified, and corrected, if the following two improvements were made in the Department's error identification practices:

- One type of error could be identified if Department staff were instructed to verify certain information on the tax returns that is not verified now. To promote cost-effectiveness in the review process, the Department could establish monetary thresholds for verification.

- The other type of error could be identified if certain information from vendors' prior sales tax returns were maintained on the sales tax database and automatically compared to the vendors' current returns. Since this type of error was sometimes repeated from quarter to quarter, provision could be made to automatically notify vendors when this type of error was detected.

Department officials agree that these types of improvements could be beneficial, and stated that such improvements are intended to be addressed in the design of the Department's new automated tax processing system (e-MPIRE), which is scheduled to become operational in 2006. Department officials stated that this new system will replace existing automated systems and processes with a single integrated system for all types of taxes. Department officials indicate that, when operational, this new system will provide numerous benefits and allow for improved flexibility, adaptability and customer service coupled with increased operational efficiency. We urge the Department to implement the improvements to the existing system to the extent they can be made cost effectively. In addition, large development projects such as e-MPIRE have a certain amount of risk for delay.

2. <u>Timeliness of Vendor Assessments</u>

In 19 of the 246 tax returns in our sample, the vendor was assessed a certain dollar amount by the Department for underpaying its sales tax liability or submitting its tax return late. We analyzed the timeliness of this assessment process and found that improvements are needed.

An assessment can be issued to a vendor as soon as the vendor's tax return has been fully processed by the Department. At this point, the error identification process is complete, and the tax return is electronically posted to the master file database. However, for the 19 assessments in our sample, an average of 100 days elapsed between the date the tax return was posted to the master file database and the date the vendor was issued the assessment. For example, one return was posted to the master file database on May 2, 2003, but the vendor was not assessed until September 11, 2003 (113 days); another return was posted to the master file database on July 7, 2003, but the vendor was not assessed until January 29, 2004 (193 days); and a third return was posted to the master file database on June 22, 2003, but the vendor was not assessed until April 15, 2004 (319 days). In comparison, it took the Department only 12, 24 and 38 days, respectively, to resolve the possible errors that had been identified on these three tax returns.

Local distributions of sales tax revenue may be affected when vendor assessments are delayed. We recommend that actions be taken to expedite the issuance of assessments once tax returns are fully processed. Department officials stated that the assessment process for electronic filers was automated in the Spring of 2004 and other improvements were made to bring assessments up-to-date for other filers.

3. Control Over Staff Modifications to Sales Tax Returns

During the error identification and error resolution processes, sales tax returns are reviewed by Department staff. During these reviews, the staff can edit the information in the sales tax return data fields. To provide assurance such edits are correct and appropriate, the edits should be subject to supervisory review and approval. While it may not be practical for all staff edits to be reviewed by supervisors, risks should be assessed to determine the extent of supervisory review necessary. However, we found that staff edits to sales tax returns are not subject to supervisory review and approval. As a result, incorrect or inappropriate edits are less likely to be detected and corrected. We recommend that the Department establish a supervisory review process commensurate with the risks involved in the review of sales tax returns. Department officials responded that they have instituted a quality assurance program to ensure timely and appropriate case resolution.

Recommendations

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.*

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.*

3. *Expedite the issuance of sales tax assessments.*

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

We provided Department officials with copies of this report in draft for their review and formal comment. Their comments were considered in preparing this report. Department officials agreed with our recommendations. For recommendations number 1 and number 2, Department officials expect to fully address these matters with the implementation of the e-MPIRE system. Pending the implementation of the new system, they will explore interim solutions for the current system. Regarding recommendation number 3, Department officials state the assessment process was automated for the 2004 year. They indicated that a quality assurance program has been instituted that should address recommendation number 4. A complete copy of the Department's response is included as Appendix A.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Taxation and Finance shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons why.

Major contributors to this report were Brian Mason, Arthur F. Smith, Andrew Fischler, Jeffery Dormond, John Karwacki, Theresa Lawrence, Wendy Matson and Dana Newhouse.

We wish to thank Department management and staff for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

Steven E. Sossei
Audit Director

cc: Robert Barnes, Division of the Budget
Andrew Maguire, Department of Taxation and Finance

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
W.A. HARRIMAN CAMPUS
ALBANY, NY 12227

Barbara G. Billet
Executive Deputy Commissioner

November 18, 2004

Mr. Steven Sossei
Audit Director
Office of the State Comptroller
110 State Street, 11th Floor
Albany, New York 12236

Dear Mr. Sossei:

Thank you for the opportunity to comment on the findings contained in the draft audit report entitled, "Sales Tax Distribution Process, (2003-S-51)." We appreciate the fact that the audit reported the Department's distribution of sales tax revenue is performed in a correct and expeditious manner.

The audit captures the critical nature of the distribution of some $19.6 billion in sales tax revenue to the localities and State based on the information supplied on the tax return by the taxpayer. It acknowledges the need for immediacy in Department operations in order to not only make sure the revenue is apportioned to the correct locality but, that any adjustments that may be required are appropriately performed.

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.

Response:

Currently, the Audit Division regularly verifies this information on a post processing basis for a very high percentage of these cases. We do, however, agree that there is merit to verifying this information earlier in the process.

The routine verification of certain return filing information is intended to be addressed within the Sales Tax component of the e-MPIRE (**e**-**M**anaged **P**rocesses for an **I**ntegrated **R**evenue **E**nterprise) system, regardless of the threshold amounts. However, this phase of e-MPIRE is not yet scheduled and will not occur before 2006.

However, we agree to look into the feasibility of incorporating additional verifications earlier in the process.

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.

Response:

As noted in our response to recommendation one, we will look to address these core issues through an interim solution pending a complete systematic solution in our e-MPIRE integrated tax system. In addition, we will evaluate the potential to automatically generate taxpayer notifications of discrepancies through the e-MPIRE process.

Recommendation 3:
Expedite the issuance of sales tax assessments.

Response:

The audit reports on operations for the year 2003. In May 2004, the assessment process was changed from a manual process to an automated process. Since that point all assessments have been issued timely for any return that is not fully paid or is filed late. Delinquencies are also issued on a routine and timely basis for vendors who fail to file.

Recommendation 4:
Establish a risk-based supervisory review process for staff edits to sales tax returns.

Response:

Within the past year, the Taxpayer Services and Revenue Division has instituted a quality assurance (QA) program to ensure both timely and appropriate case resolution. In addition, the Division will be increasing the number of high dollar accounts we review as part of the QA process.

Sincerely,

Barbara G. Billet

Barbara G. Billet
Executive Deputy Commissioner