



Department of Taxation and Finance

Distribution of Sales Tax Revenues to Localities

Report 2010-S-77



Thomas P. DiNapoli

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State of New York Office of the State Comptroller

Division of State Government Accountability

December 1, 2011

Mr. Thomas H. Mattox
Commissioner
Department of Taxation and Finance
W. A. Harriman Campus
Building 9
Albany, NY 12227

Dear Commissioner Mattox:

The Office of the State Comptroller is committed to helping State agencies, public authorities and local government agencies manage government resources efficiently and effectively and, by so doing, providing accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of State agencies, public authorities and local government agencies, as well as their compliance with relevant statutes and their observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations. Audits can also identify strategies for reducing costs and strengthening controls intended to safeguard assets.

Following is a report of our audit of the Department of Taxation and Finance entitled *Distribution of Sales Tax Revenues to Localities*. This audit was performed pursuant to the State Comptroller's authority under Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law.

This audit's results and recommendations are resources for you to use in effectively managing your operations and in meeting the expectations of taxpayers. If you have any questions about this report, please feel free to contact us.

Respectfully submitted,

*Office of the State Comptroller
Division of State Government Accountability*

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State of New York Office of the State Comptroller

EXECUTIVE SUMMARY

Audit Objective

Our objective was to determine whether the Department of Taxation and Finance (Tax Department) properly distributes the sales and use tax reported on personal income tax returns to the localities.

Audit Results - Summary

In New York State, most sales and use tax revenue is collected and remitted to the Tax Department by vendors and service providers who collect the tax at the point of sale. However, when the tax is not collected at the point of sale, individuals must pay the Tax Department directly using their personal income tax returns or by filing a separate sales tax return. The Tax Department is responsible for tracking sales tax revenues and certifying the amounts collected to the Comptroller, who then distributes a portion of the funds to over 120 participating localities. During 2010, the Tax Department certified \$23.6 billion in sales and use taxes for distribution, including \$35.4 million reported on personal income tax returns.

The Tax Department's e-MPIRE computer system is used to process personal income tax returns. Reports produced by the system track the amount of sales and use taxes reported on personal income tax returns and are used to determine how much should be distributed to each locality. Because the returns are electronically scanned into the system, the sales and use taxes reported on personal income tax returns are initially accepted at face value and the revenues are distributed accordingly. Taxpayer assessments are also created based on the sales and use taxes reported. If taxpayers make errors in completing these returns, the Tax Department must correct the erroneous distributions to localities by adjusting future payments. In addition, the erroneous taxpayer assessments must also be corrected.

We reviewed 90 personal income tax returns processed during the 13-month period ended December 31, 2010. The returns were selected from a population of returns where the taxpayers reported sales and use tax due, but the returns were subsequently adjusted because the taxpayers had made some type of error. We found the Tax Department's systems correctly processed these returns as submitted, but that taxpayers often made common errors when completing these returns that resulted in incorrect calculations of taxes due. Thirty-two of these returns had errors totaling \$371,656 related to the reporting of sales and use tax. These errors include cases where the taxpayers either carried down figures (such as their *Taxable*

Income) to the wrong line of the return, or reported other amounts (such as their *Total Income Tax Due*) on the *Sales and Use Tax* line. These errors resulted in the incorrect distribution of revenues to localities, as well as incorrect tax assessments sent to taxpayers. They also resulted in additional costs to the Tax Department, which had to adjust subsequent payments to localities and work with taxpayers to correct the improper assessments.

We advised Tax Department officials of certain improvements they could make to the tax return processing system to help detect some of these common taxpayer errors before the returns are processed. Officials agree that these improvements are needed, both to ensure appropriate amounts are distributed to localities and to avoid unnecessary costs associated with incorrect distributions.

Our report contains two recommendations for improving the Tax Department's effectiveness in detecting common taxpayer errors that result in the incorrect distribution of revenues to localities.

This report, dated December 1, 2011, is available on our web site at <http://www.osc.state.ny.us>. Add or update your mailing list address by contacting us at: (518) 474-3271 or
Office of the State Comptroller
Division of State Government Accountability
110 State Street, 11th Floor
Albany, NY 12236

Introduction

Background

The Tax Department collects tax revenue and provides associated services in support of New York State government operations. Sales and use tax is imposed on taxable items or services used in New York State. When the sales tax has not been paid at the point of sale, individuals must pay the tax directly to the Tax Department by reporting the amount owed on their personal income tax returns or other sales tax forms. In the fiscal year ended March 31, 2010, the Tax Department collected and accounted for almost \$60 billion in state taxes and \$40 billion in local taxes by administering 35 state and 7 local taxes including New York City and Yonkers income taxes. In 2010, the Tax Department certified \$35.4 million in sales and use tax revenue reported on personal income tax returns. New York State received \$16.6 million and the localities received \$18.8 million.

Within the Tax Department, the Accounting Bureau's Sales Tax Unit is responsible for certifying to the Office of the State Comptroller the distribution of sales and use tax including monies collected on personal income tax returns. Individuals report sales or use tax on their personal income tax returns when:

- Purchasing an item or service subject to tax that is delivered to them in New York State without payment of New York State and local tax to the seller, or;
- Purchasing an item or service outside New York State that is subject to tax in New York State (and they were a resident of New York State at the time of purchase) and subsequent use in New York State.

Individuals must use forms ST-140 or ST-141 to calculate sales and use taxes owed when:

- The taxpayer prefers to calculate the exact amount of sales and use tax due;
- Sales and use tax is due on an item or service costing \$1,000 or more, or;
- Sales and use tax is due for purchases related to a business not registered for sales tax purposes, rental real estate, or royalty activities.

The amounts calculated on these forms can be reported on an individual's personal income tax return. However, if an individual is not filing a personal income tax return or has already filed a return, the ST-140 or ST-141 must be used to report the sales and use taxes owed. Form ST-140 is used to report annual sales, where form ST-141 is used for periodic reporting.

The Tax Department's e-MPIRE computer system processes personal income returns. Returns are electronically scanned and the system captures amounts reported on each line, including the *Sales and Use Tax* line. Each month, the Accounting Bureau receives reports summarizing the amounts reported on personal income tax returns for sales and use tax. The Accounting Bureau uses these reports to calculate the State and local shares of the sales tax revenues from these personal income tax returns. It then certifies to the Office of the State Comptroller the amounts to be distributed to the localities.

Audit Scope and Methodology

Our objective was to determine whether the Tax Department properly distributes the use tax reported on personal income tax returns to the localities. Our audit period included the 13 months ended December 31, 2010.

To accomplish our objective, we first interviewed Tax Department officials, reviewed applicable sections of Federal and State laws and regulations, and examined the Tax Department's relevant policies and procedures. We then selected a judgmental sample of 90 personal income tax returns to determine if improvements could be made in the way returns are processed to ensure sales and use tax revenues are correctly distributed to localities.

We conducted our performance audit in accordance with generally accepted government auditing standards. Those standards require we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

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. 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 functions do not affect our ability to conduct independent audits of program performance.

Authority

The audit was performed 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.

Reporting Requirements

We provided Tax Department officials with a draft copy of this report for their review and comment. Their comments were considered in preparing this audit report.

Within 90 days of the 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 therefor.

Contributors to the Report

Major contributors to this report include John Buyce, Walter Irving, Dennis Buckley, Scott Heid, Thierry Demoly and Kelly Evers Engel.

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Audit Findings and Recommendations

Improvements are Needed to the Tax Department's e-MPIRE System

When taxpayers submit personal income tax returns to the Tax Department, they are primarily responsible for ensuring the information is correct. In turn, the Department also has a responsibility to build certain screening procedures (edits) into the system to identify common errors and prevent the automatic processing of returns that include them.

Our review showed the e-MPIRE system does have an edit to capture certain taxpayer errors on the *Sales and Use Tax* line of the tax returns. This edit checks to see if the taxpayer has erroneously reported an amount on this line that is equal to certain amounts already entered on other lines of the tax return. We also noted that the Tax Department implemented another procedure in January 2011 to prevent large errors from occurring. This edit flags any personal income tax return reporting \$5,000 or more in sales and use tax due. These returns are reviewed by staff before they are processed to determine if errors exist. The Tax Department implemented this procedure in response to a \$10 million sales and use tax reporting error on a personal income tax return that was not detected until after funds were distributed to the localities.

We reviewed 90 personal income tax returns processed during the 13-month period ended December 31, 2010. The returns were selected from a population of returns where the taxpayers reported sales and use tax due, but the returns were subsequently adjusted because the taxpayers had made some type of error. We found 32 of these returns had errors related to the reporting of sales and use tax. In each of these cases, the taxpayers' return initially indicated more sales tax was owed than was actually due. As a result, funds were distributed to localities that had to be recovered from future distributions after the errors were corrected.

For 21 of these returns, errors occurred because the taxpayer either carried down other amounts (such as their *Taxable Income*) to the *Sales and Use Tax* line (Carry Down errors) or reported their *Total Income Tax Due* on the *Sales and Use Tax* line (Combined Taxes errors). The other 11 errors occurred either because taxpayers filed more than one return containing inconsistent data, or because they made various calculation errors at some point on their return. A breakdown of the 32 errors by type is shown in the following table:

Type of Error	Number	Sales & Use Tax Impact
Carry Down	11	\$ 186,325
Combined Taxes	10	97,895
Multiple Inconsistent Returns Filed	7	22,165
Other Miscellaneous Calculation Errors	4	65,271
Total	32	\$ 371,656

Our review showed the e-MPIRE system does not have edits to detect at least two easily identifiable taxpayer errors which comprised many of the reporting problems we noted. For example, there is no edit to identify when a taxpayer improperly enters their *Taxable Income* on the *Sales and Use Tax* line. For 7 of the 11 carry down errors we identified, the taxpayer's *Taxable Income* and the amount reported on the *Sales and Use Tax* line were the same.

In addition, although the e-MPIRE system contains an edit designed to identify combined tax errors where a taxpayer has incorrectly reported their *Total Tax Due on the Sales and Use Tax* line of the return, sometimes it does not work if the taxpayer has prepared their return using cents instead of just whole dollars. In these cases, the amount reported by the taxpayer may not equal the whole dollar amount calculated by the e-MPIRE system due to small rounding differences. Our sample included three returns where the *Sales and Use Tax* amount was slightly different from the *Total Tax Due* amount calculated by the e-MPIRE system because the system did not capture cents. An edit with broader criteria could account for these system nuances and identify these returns as having taxpayer errors.

The more that the Tax Department can do to identify and prevent these common errors before they are processed, the more it can ensure its limited resources are used most effectively. When returns with incorrect amounts are processed, funds not only get distributed to localities and require subsequent adjustment; but more resources are wasted correcting other resulting problems. For example, we found it took an average of over 90 working days to adjust the returns with taxpayer errors that we sampled. These returns also resulted in the Tax Department sending 25 unnecessary bills to taxpayers, which then resulted in 24 informal taxpayer protests. The Tax Department then had to devote more

resources to respond to these protests through written correspondence, and even more taxpayer contacts were then necessary to actually clear the protests. More importantly, the tax bills likely created a level of stress for the taxpayers that could have been avoided had the Tax Department identified errors before the returns were processed.

We also performed the following other tests to ensure that sales and use taxes were being properly recorded, calculated and distributed by the Tax Department once the returns were processed. These tests did not identify any problems or deficiencies.

- We selected a sample of 75 personal income tax returns with reported sales and use tax amounts and compared the amounts reported by the e-MPIRE system to the actual tax returns. For all 75 returns, the amounts matched.
- For the six-month period January 1, 2010 through June 30, 2010, we verified that the amounts identified by the tax return processing systems were accurately passed through and reported on the accounting department's corresponding certifications for distribution.
- For the same six-month period, we also tested the Tax Department's distribution calculations by independently calculating each locality's distribution amount using the appropriate distribution percentage and the use tax revenues reported on personal income tax returns for each month. We compared our calculations to the corresponding month's distribution certification and found our calculations were the same as those reported by the Tax Department.

- Recommendations**
1. Modify the system edits for personal income tax returns to identify cases when the amount shown on the *Sales and Use Tax* line is the same as other amounts already entered on the return, such as the taxpayer's *Taxable Income*.
 2. Modify the system edits for personal income tax returns that ensure that comparisons, such as the one between the *Sales and Use Tax* line and the taxpayer's *Total Tax Due*, will capture amounts that may be impacted by small rounding differences.

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Agency Comments



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

THOMAS H. MATTOX
COMMISSIONER

November 7, 2011

Mr. John Buyce
Audit Director
Office of the State Comptroller
Division of State Government Accountability
110 State Street, 11th Floor
Albany, New York 12236-0001

Dear Mr. Buyce:

Thank you for the opportunity to comment on your draft audit report, "Distribution of Sales Tax Revenues to Localities, (2010-S-77)." As your report pointed out, the Department needs to make improvements to the tax return processing system to help detect common taxpayer errors before the returns are processed.

Following is our specific response to the recommendations:

Recommendation 1:

Modify the system edits for personal income tax returns to identify cases when the amount shown on the *Sales and Use Tax* line is the same as other amounts already entered on the return, such as the taxpayer's *Taxable Income*.

DTF Response:

The Department will implement this system edit for 2011 Personal Income Tax (PIT).

Recommendation 2:

Modify the system edits for personal income tax returns that ensure that comparisons, such as the one between the *Sales and Use Tax* line and the taxpayer's *Total Tax Due*, will capture amounts that may be impacted by small rounding differences.

DTF Response:

The Department will implement system edit for the 2012 processing year.

Again, thank you for the opportunity to comment and we value your suggestions on ways to improve our operations.

Sincerely,

A handwritten signature in black ink, appearing to read 'THM', written over a light blue circular stamp.

Thomas H. Mattox
Commissioner

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