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STATE COMPTROLLER



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STATE OF NEW YORK  
**OFFICE OF THE STATE COMPTROLLER**

August 17, 1998

Mr. Michael H. Urbach  
Commissioner  
Department of Taxation and Finance  
W. A. Harriman State Office Campus  
Albany, NY 12227

Re: Compliance Efforts for the  
Withholding Tax Program  
Report 97-S-17

Dear Mr. Urbach:

Pursuant to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law, we have audited the practices and procedures used by the Audit Division of the Department of Taxation and Finance to detect and to address noncompliance with the Withholding Tax Law. Our performance audit covered the two-year period ended December 31, 1997.

**A. Background**

The Department of Taxation and Finance (Department) administers the State's tax laws and serves as its general tax collection agent. As such, the Department is responsible for collecting income tax withholding from employers and for ensuring compliance with the withholding laws. The Tax Law (Law) requires that employers transacting business in New York State withhold from employee wages an amount equal to the tax owed by the employee, file the appropriate tax returns and remit the amount of employee tax withheld. There are approximately 450,000 employers and 9.7 million employees in New York State. Withholding tax is the largest single revenue source for the State, exceeding \$20 billion annually.

The Department's Processing and Revenue Management Division (Division) has primary responsibility for the withholding tax program. The Division collects withholding taxes, maintains the employer accounts and ensures that employers on the system fulfill their routine filing and remitting responsibilities.

Employers may be subject to penalties and interest if the withheld tax is not remitted at the required time. Section 685 of the Law states that the penalty for employers who fail to file or fail to pay the tax as shown on the tax return can be up to 25 percent of the tax owed. Employer negligence can result in an additional penalty of five percent of the amount owed and willful failure by an employer can result in a penalty of 100 percent of the amount owed. The Department's Audit Division (Audit) has developed a variety of programs to identify noncompliant employers. Such programs produced approximately \$60 million in assessments in the two fiscal years ended March 31, 1997.

According to Department reports, withholding tax collections in 1990 were \$13.9 billion. By 1995, collections had risen 27 percent to \$17.7 billion. There were no large tax increases during this period. Therefore, the increase must be attributed to other factors. One factor is a 16 percent rise in the dollar value of annual payrolls in New York State over the period. Another factor may be the changes in reporting requirements that have transpired. For example, all employers have been required to file reconciliation returns quarterly instead of annually and employers of 250 or more have been required to file on magnetic media. These requirements have aided employers' ability to detect and to correct withholding tax errors and omissions and have given the Department improved access to information for detecting noncompliance.

In 1996, we began a series of audits and studies focusing on the withholding tax program. To date we have issued three final reports. The first report (96-S-9, issued February 4, 1997) covered our audit of withholding tax revenue collection processes. That audit concluded that, as a result of a new automated computer system, the Department had improved controls for ensuring collections were deposited timely, accurately and completely. Our second report (96-S-43, issued July 10, 1997) recommended certain enhancements for the maintenance of employer accounts, the creation of assessments, the resolution of protests and the processing of refunds related to the withholding tax program. Our third report (97-D-4, issued January 14, 1998) reflected our study conclusions that employers were generally satisfied with the withholding tax process.

## **B. Audit Scope, Objective and Methodology**

We audited the practices and procedures used by Audit to detect and to address noncompliance with withholding tax law requirements for the two-year period ended December 31, 1997. Our objective was to assess Audit's performance. To accomplish this objective, we interviewed Department officials, reviewed documents and reports pertaining to techniques used for identifying noncompliant employers and assessed available performance indicators.

We conducted our audit in accordance with generally accepted government audit standards. Such standards require that we plan and perform our audit to adequately assess those Department operations that are included within our audit scope. Further, these standards require that we understand the Department's internal control structure and its compliance with those laws, rules and regulations that are relevant to the operations which are included within our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying other such 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.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations that have been identified through a preliminary survey as having the greatest potential for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, little audit effort is devoted to reviewing operations that may be relatively efficient and effective. As a result, our audit reports are generally prepared on an "exception basis." However, on occasion, we identify a program which displays excellent progress toward achieving its goals. In such a case, we report the positive results achieved. This report highlights areas where the Department has displayed significant improvement and positive performance results.

### **C. Results of Audit**

We found that Audit has made significant progress in developing and using audit selection techniques to ensure greater withholding tax law compliance. Our audit indicates that enhanced audit selection techniques have resulted in more focused and productive withholding tax audits, and that withholding tax assessments have increased significantly. We believe the Department is poised to make further progress in ensuring withholding tax compliance and maximizing withholding tax revenue.

#### **1. Audit's Performance**

Our review shows that over the last several years Audit has improved its performance in certain important respects. For example, between 1989 and 1997, annual assessments from withholding tax audit cases rose from \$5.9 million to \$27.9 million. During this period, the number of cases selected every year for withholding tax audits rose from fewer than 400 in 1990 to an annual average of 1,270 cases for the period 1991 through 1997. The average dollar return per audit increased from \$15,365 in 1990 (\$5.9 million/384 cases) to \$31,795 and \$21,746 in 1996 and 1997, respectively. This represents a 41.6 percent improvement from 1990 to 1997.

A measure of Audit's effectiveness is a decline in the percentage of audits that result in no change in liability to the audited employer or individual. From fiscal year 1991 to fiscal year 1997, the number of "no-change" audits fell from 77 percent to 47 percent of the audits performed. The drop in the no-change rate indicates that resources are better focused on potentially productive audits.

These improvements in Audit's performance have been caused by several factors. One factor is that the number of staff available for field audits increased 18 percent from fiscal year 1991 to fiscal year 1997. Another factor has been the implementation of a withholding tax database and the concurrent establishment of more effective audit selection techniques. Audit officials explained that, effective January 1, 1992, the Department established a withholding tax database as a result of electronic media filing and combined withholding tax and wage reporting. The database now consists

of all quarterly filed returns from employers. The database provides Audit with the ability to access and analyze information that did not exist with paper returns. Consequently, Audit has been able to develop computer-assisted selection techniques to help target its limited resources to the most productive audits of noncompliant employers.

We reviewed information showing audit cases selected from the database during fiscal years 1996 and 1997. We found that cases selected from the database represented about three percent of the total audit cases and produced \$1.9 million of the total \$59.9 million of audit assessments for these two fiscal years. Department officials stated that audit selection with the database had been impeded by incomplete or old data, but that significant improvements were being achieved in more recent months as better data has been obtained. Our review of production statistics for the first four months of fiscal year 1997-98 showed that database audit selections accounted for 18 percent of the total audit cases and approximately \$1 million of the total of \$13.6 million assessed during this period. These results confirm increased productivity from audit selection techniques using the database. Department officials indicated that they viewed the withholding tax database as the primary vehicle for the future selection of audits. We believe that the Department will need to continue to allocate programming and clerical support resources to the database and the related case selection techniques to ensure performance improvements from withholding tax audits.

In addition, Audit is measuring its performance by accumulating data that is useful for monitoring the relative productivity of its various case selection techniques. For example, Audit generates ad hoc reports to show the number of audit cases, the number of audit days used, the total dollars assessed, and the total dollars collected for each of case selection methods. Review of this information allows management to direct resources to the more productive audit areas and, therefore, to further improve performance. Of seventeen selection techniques used over the last two full fiscal years, nine have either been dropped for reasons of low productivity or merged with similar, more productive methods.

## **2. Information from Other New York State Agencies**

By obtaining employer-related computer data from other New York State agencies, the Department may be able to significantly enhance its employer withholding tax program and related audit selection techniques. For example, our prior audit (report 90-S-46, issued November 14, 1990) noted that both the Department and the Department of Labor (Labor) collect information from employers. However, New York State law does not allow exchange of this information, even though such an exchange could benefit both agencies. Legislation had been proposed, for example, to establish a common employer reporting system for the Department and for Labor. Had this proposal become law, employers would have reported both withholding and unemployment insurance information, and made the associated payments to a single State agency. We encourage the Department's efforts to access information from other State agencies that would result in more effective and efficient withholding tax collection and compliance.

**Recommendations**

1. *Continue to support database and audit case selection initiatives with necessary Department resources.*
2. *Continue to monitor the relative effectiveness of withholding tax case selection methods and to make modifications as necessary.*
3. *Continue to pursue beneficial sharing of information with other New York State agencies.*

A draft copy of this report was provided to Department officials for their review and comment. Their comments have been considered in the preparation of this report and are included as Appendix A. Department officials agree with our recommendations and note that these measures have been and will continue to be promoted by the Audit Division.

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 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.

Major contributors to this report were Arthur F. Smith, Todd Seeberger, Maureen Costello, and Mark Radley.

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

Very truly yours,

Jerry Barber  
Audit Director

cc: Robert L. King



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

KEVIN F. MURRAY  
EXECUTIVE DEPUTY COMMISSIONER

August 10, 1998

Mr. Jerry Barber  
Audit Director  
Office of the State Comptroller  
A. E. Smith State Office Building  
13<sup>th</sup> Floor  
Albany, New York 12236

Dear Mr. Barber:

Thank you for the opportunity to respond to your draft report detailing findings and recommendations in your audit, "Compliance Efforts for the Withholding Tax Program," (97-S-17).

We are pleased with the report's conclusion that significant progress has been made in developing and using audit selection techniques to ensure greater compliance with the Withholding Tax Law.

We particularly appreciate the auditors' recognition that enhanced audit selection techniques have resulted in more focused and productive Withholding Tax audits, and that Withholding Tax assessments for audit activity have increased significantly.

We agree with the three formal recommendations, noting that these measures have been and will continue to be promoted by the Audit Division.

Sincerely,

A handwritten signature in cursive script that reads "Kevin F. Murray".

Kevin F. Murray  
Executive Deputy Commissioner