

## MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE.

The meeting was called to order by Chairperson David Corbin at 11:05 a.m. on March 19, 2001, in Room 519-S of the Capitol.

All members were present except: Senators Praeger and Pugh

Committee staff present: April Holman, Legislative Research Department  
Don Hayward, Revisor of Statutes Office  
Shirley Higgins, Committee Secretary

Conferees appearing before the committee: Chris Clarke, Legislative Division of Post Audit  
Stephen S. Richards, Secretary, Department of Revenue

Others attending: See attached list.

Chairman Corbin called upon Chris Clarke, Legislative Division of Post Audit, for a briefing on a performance audit report entitled, "Retailer Sales Taxes: Assessing Whether the Amounts Distributed to Localities Have Been Computed Accurately," which was published on March 15, 2001, and which relates to **HB 2007**. A copy of the report was distributed to Committee members. Persons wishing a copy of the report may obtain one from the Legislative Division of Post Audit.

Ms. Clarke explained that the audit arose because local officials had voiced concern that they had not been receiving the correct amount of sales taxes since the Department of Revenue implemented its new computer system at the end of 1999. Another concern that led to the audit related to the reasons why \$19.5 million had to be transferred from the State General Fund and State Highway Fund into local tax funds in October of 2000. To address these two concerns, the audit addressed the following questions: (1) Has the Department of Revenue accurately distributed local sales tax revenues to local units of government? and (2) Why did \$19.5 million need to be transferred from the State General Fund and Highway Fund into local tax funds?

Before discussing audit questions further, Ms. Clarke briefly outlined the background of the state's sales tax collection system, noting that, currently, 75 counties and 169 cities impose an additional local sales tax. She explained that retailers across the state collect both state and local taxes. They are required to file a sales tax return periodically and remit the sales taxes they have collected to the Department of Revenue. Sales tax receipts are deposited by the Department into separate state and local accounts in the state treasury. The Department does not know what portion of the sales tax payment goes to the state and what portion goes to cities and counties until it processes the accompanying sales tax return. In order to ensure that monies are deposited quickly, the Department makes an initial estimated allocation of the taxes into three funds based on state law and a formula based on historical information. Basically, approximately 76 percent is deposited into state funds, and about 24 percent is deposited into local funds. Once the Department processes the sales tax return that accompanied the payments, it can determine the exact amount of sales tax that belongs to the state and the exact amount that goes to specific cities and counties. Using this information, the Department then adjusts the amounts deposited into the funds. Money from the local sales tax fund is distributed to cities and counties once a month. Ms. Clarke noted that, in October of 1999, the Department began using its new computer system to process sales tax returns. This was one of the final components of Project 2000.

As to question one addressed in the report, Ms. Clarke said the short answer is "yes" with regard to sales tax payments and returns that processed without error. However, several million dollars of payments that do not process automatically experience long delays, and some may never be distributed under the Department's current system unless the Department makes some changes. She went on to say that, in order to answer question one, Post Audit looked at the distributions made immediately following the implementation of the new system and then reviewed distributions for a more current period. She noted that the Department wanted to check the new system for a few months before relying on the information it generated about how local sales taxes should be distributed. Therefore, during the first three months under the new computer system, the Department made distributions to cities and counties based on estimates of the amounts owed to them. These estimates were based on the amount the city or county had

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received in the same time period the prior year plus or minus a growth factor. After making the estimated payments in November and December of 1999 and January of 2000, the Department used the new computer generated data to determine how much it actually should have paid to each locality during those three months. It then made corresponding adjustments in the distributions paid in April and July, but these adjustments did not go smoothly. First, the Department calculated that, statewide, it had underpaid localities about \$2 million for the three-month time period. A short time later, the Department discovered this calculation was wrong and that it had actually overpaid localities more than \$13 million for the same three-month time period. Without notifying the localities, the Department withheld approximately \$6.7 million from the April 2000 distribution. In July 2000, the Department notified the localities and withheld the other half (\$6.7 million) again. As a result, the localities were concerned that they had not been paid the correct amount. Ms. Clarke noted that Post Audit made a check of ten localities to ensure that, with all the adjustments, the ten had eventually been paid the correct amount for the three-month conversion period. It was found that one of the ten was not paid the correct amount and, in fact, the particular city received about \$31,000 too much. Department officials agreed with Post Audit's findings and attributed the error to converting information from the old system to the new system. Because the Legislative Post Audit Division found an error in this small sample, it recommends that the Department carefully review the adjustments made to each locality and report the results of its review to the Legislative Post Audit Committee by August 2001.

To gauge whether the Department is paying the correct amount of sales taxes now, Post Audit selected a statistically valid random sample of 249 sales tax payments received by the Department in October 2000. The Post Audit Division traced payments through the Department's system, calculated the amounts due each locality, and compared its calculation with the actual amounts distributed. Of the payments that processed smoothly and included all the required information, about 88 percent were accurately distributed. However, 27 sales tax payments (11 percent of the sample) were not distributed at all. Most of these were payments that came into the system, but no return was received by the Department. Without the return, the Department does not know how to distribute the money. Most of the payments in the sample related to telefile. Further investigation revealed that more than \$3.2 million owed to cities and counties have not been distributed because the Department does not routinely research and act on payments that come into the system without a return. As of February 2001, there were approximately \$13.7 million in undistributed sales tax payments, comprising nearly 7,900 payments. Assuming that about 24 percent is the local share, about \$3.2 million is not being distributed to cities and counties. Since starting the new system almost one and one-half years ago, the Department has made only two efforts to identify and resolve these payments. Post Audit feels that the Department could and should attempt to routinely resolve these payments and that the Department has the necessary information to do so. Ms. Clarke noted that Post Audit contacted revenue officials in other states to get an idea of how they deal with such payments. Basically, other state officials said they distribute the money based on an estimate, even if the return has not been received. If the return shows up later, they make an adjustment. The officials said they wanted to avoid a backlog of undistributed monies and felt an estimated distribution was better than no distribution at all. Therefore, Post Audit recommends that the Department immediately establish a systematic process for dealing with sales tax payments that come in without a return and distribute the money as quickly as possible. The Department should follow up with the tax payment to get a return. For those that cannot be resolved after some time, the Department should establish a procedure to estimate how much is due to the locals and make a distribution based upon that estimate.

Ms. Clarke reported that investigation of the Department's computer system revealed, as a whole, that the system has most of the appropriate built in cross checks to insure that all sales tax payments that are processed are paid out. However, the system is missing a way to make sure that the correct dollar amount went to the correct locality. The Department would not know if the computer allocated a tax payment to a wrong city or county. The Post Audit Division recommends that the Department periodically check a sample of payments through the system and check the distribution as was done in the audit process.

With regard to question two of the audit, Ms. Clarke explained that, in short, the transfer of funds was needed primarily because a glitch in the Department's computer system caused too much money to be credited to state funds and too little to the local tax fund. Basically, in October 2000, the Department of Revenue informed state budget officials that \$19.5 million needed to be transferred from state funds to local funds and reported that the one-time

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transfer was needed to cover a shortfall in the local tax funds. The Department needed \$75 million, but had only \$51 million in the bank, which leaves a shortfall of \$24 million. However, the Department planned on recouping overpayments of about \$4.5 million from the counties, which brought them to the \$19.5 million figure. Post Audit confirmed that \$17.5 million of this transfer was directly related to how the new computer system handled utility sales tax payments. Basically, the computer did not recognize that some utility sales are exempt from state sales tax; therefore, the calculations the computer performed were incorrect. As a result, when a utility submitted a sales tax payment, more money was credited to the state fund than should have been, and less money was credited to the local fund. Ms. Clarke noted that this error was complex and called attention to an example Post Audit created shown in Appendix B of the Performance Audit Report. She pointed out that the error only related to how much money was deposited into the funds. The Department correctly paid the localities from those funds. She noted that the error began when the new system began in October 1999, and it went undetected for approximately eight months. When Department staff recognized the shortfall in June 2000, it quit making other routine adjustments to the fund balances while it tried to determine the cause of the problem. This caused additional shortages in the fund. The computer glitch affecting utility tax returns is scheduled to be corrected in April 2001. In the meantime, staff is aware of the problem and is making monthly manual adjustments.

Stephen S. Richards, Secretary of Revenue, responded to the Legislative Post Audit report on the Department of Revenue's distribution of local sales taxes. He stated that, overall, the Department's collection and distribution system is achieving its established goals, and the audit report bears this out. However, he has met with his staff to begin implementation of improvements to increase the accuracy of the Department's data and distribution of local revenues. He pointed out that the audit confirmed that, after adjustments were made in October 2000, state and local funds are in balance, and correct amounts were paid to the localities. He explained that, prior to his arrival with the Department, a new local government advisory council was formed with representatives of city and county finance officers. He continues to use the advisory council to improve communications with local governments. In addition, the Department has begun to identify methods to reasonably determine the proper jurisdiction and distribute receipts with no corresponding return. He agreed with the Post Audit recommendation that the Department develop procedures to estimate the portion due local jurisdictions for unidentified payments. He noted that the Department intends to formalize a process of routinely identifying payments received without returns and promptly seek resolution from the taxpayer. Mr. Richards also agreed that the Department should review the adjustments made during the system transition. The Department will review the distributions from the old system into the new system to resolve any remaining inconsistencies and will report the result to the Legislative Post Audit Committee in August 2001. In response to the recommendation that the Department needs a procedure to check the accuracy of distributions by jurisdiction, Mr. Richards believes a better approach is to expand the Department's on going review of the largest taxpayers' returns by developing system edits so that the system will help the Department review every return rather than doing a review on a sampling basis as this would allow early detection in errors in processing, and it would help identify taxpayer reporting errors. (Attachment 1)

The minutes of the March 14, 2001, meeting were approved.

The meeting was adjourned at 11:45 a.m.

The next meeting is scheduled for March 20, 2001.