DEPARTMENT OF REVENUE
FINANCIAL AUDIT
FOR THE YEAR ENDED JUNE 30, 1989

MARCH 1990

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

90-20

Veterans Service Building, Saint Paul, Minnesota 55155 • 612/296-4708

DEPARTMENT OF REVENUE

FINANCIAL AUDIT
FOR THE YEAR ENDED JUNE 30, 1989

Public Release Date: March 30, 1990 No. 90-20

OBJECTIVES:

- EVALUATE INTERNAL CONTROL STRUCTURE: Tax assessments and collections, cash receipts, purchasing of supplies and materials, cash disbursements, and fixed assets.
- TEST COMPLIANCE WITH CERTAIN FINANCE-RELATED LEGAL PROVISIONS.

CONCLUSIONS:

We found one area where the internal control structure needed improvement:

- The Collection Division maintains inadequate control over property seized to satisfy taxpayer liabilities.

We found two areas where the department had not complied with finance-related legal provisions:

- Withholding overpayment tax orders were not processed on a timely basis.
- Interest was not being paid on telephone gross earnings tax refunds.

Contact the Financial Audit Division for additional information.
(612) 296-1730

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
VETERANS SERVICE BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator John E. Brandl, Chairman
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. John James, Commissioner
Department of Revenue

Audit Scope

We have completed a financial related audit of the Department of Revenue for the year ended June 30, 1989. Our audit was limited to only that portion of the State of Minnesota financial activities attributable to the transactions of the Department of Revenue as discussed in the Introduction. We have also made a study and evaluation of the internal control structure of the Department of Revenue in effect as of June 30, 1989.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial activities attributable to the transactions of the Department of Revenue are free of material misstatements.

As part of our study and evaluation of the internal control structure, we performed tests of the Department of Revenue's compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions.

Management Responsibilities

The management of the Department of Revenue is responsible for establishing and maintaining an internal control structure. This responsibility includes compliance with applicable laws, regulations, contracts, and grants. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- assets are safeguarded against loss from unauthorized use or disposition;
- transactions are executed in accordance with applicable legal and regulatory provisions, as well as management's authorization; and

- transactions are recorded properly on the statewide accounting system in accordance with Department of Finance policies and procedures.

Because of the inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Internal Control Structure

For purposes of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- tax assessments and collections,
- cash receipts,
- purchasing of supplies and materials,
- cash disbursements, and
- fixed asset inventory control.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed the control risk.

Conclusions

In our opinion, the internal control structure of the Department of Revenue in effect at June 30, 1989, taken as a whole, was sufficient to meet the objectives stated above insofar as those objectives pertain to the prevention or detection of errors or irregularities in amounts that would be material in relation to the financial activities attributable to transactions of the Department of Revenue.

However, we noted certain matters involving the internal control structure and its operation that we reported to the management of the Department of Revenue in finding 1, including other verbal findings discussed at the exit conference on February 21, 1990.

The results of our tests indicate that, except for findings 2 and 3, with respect to the items tested, the Department of Revenue complied, in all material respects, with the provisions referred to in the scope paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the Department of Revenue had not complied, in all material respects, with those provisions.

This report is intended for the information of the Legislative Audit Commission and management of the Department of Revenue. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 30, 1990.

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

END OF FIELDWORK: December 30, 1989

REPORT SIGNED ON: March 26, 1990

DEPARTMENT OF REVENUE

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AUDIT PARTICIPATION

The following members of the Office of the Legislative Auditor prepared this report:

John Asmussen, CPA	Deputy Legislative Auditor
Tom Donahue	Audit Manager
Jack Hirschfeld, CPA	Auditor-in-Charge
Beth Hammmer	Senior Auditor
Mary Lentsch	Senior Auditor
Sandy Linn	Senior Auditor
Ron Mavetz	Senior Auditor
Carl Otto, CPA	Senior Auditor
Jeff Smith	Auditor Intern
Kim Chirhart	Auditor Intern

EXIT CONFERENCE

The findings and recommendations in this report were discussed with the following officials of the Department of Revenue at the exit conference held on February 21, 1990:

John James	Commissioner
Babak Armajani	Deputy Commissioner
Dwight Lahti	Assistant Commissioner
Dennis Erno	Assistant Commissioner
Jim Maurer	Director, Internal Audit
Jerry McClure	Director, Collections Division
Gerry Caulfield	Director, Criminal Investigation
Steve Kraatz	Director, Revenue Accounting
Don Trimble	Director, Special Taxes
Dick Ristow	Director, Fiscal Services
Connie Nelson	Revenue Administration Program
Kathleen J. Stewart	Manager
Charlie Anderson	Security

DEPARTMENT OF REVENUE

INTRODUCTION

The Department of Revenue is responsible for providing administrative and enforcement services in the areas of tax collection and assessment. The primary clients of the department are individuals and organizations who are required to pay taxes to the state and local governments. Five major program units carry out those responsibilities. The Administrative Program manages and provides support services to all programs, and serves as the focus of communication with the public and with other units and branches of government. The Tax Policy Program provides technical and legal analysis of tax laws and proposed changes to them, and calculates and pays aid to local governments. The Taxpayer Service Program provides information and service to taxpayers, supervises the classification and appraisal of properties for assessment of property taxes and administers state commodity taxes. The Operations Program processes tax returns and remittances, and provides accounting, records management, and administrative services. The Tax Compliance Program audits tax returns and records, and collects delinquent taxes.

The department operates under the direction of a commissioner who is appointed by the Governor. John James is the current Commissioner of Revenue.

The department collected over $4.77 billion in net tax revenues from the following sources:

	NET REVENUES
Individual Income Taxes	$2,491,602,000
Corporate Income Taxes	500,177,000
Sales Taxes	1,779,569,000
TOTAL	$4,771,348,000

Source: *Minnesota Comprehensive Annual Financial Report.*

Department operations are primarily financed through the General Fund appropriations. Fiscal year 1989 administrative expenditures for these programs are highlighted in the following schedule.

PROGRAM	GENERAL FUND
Administration	$17,070,722
Tax Policy	2,991,506
Taxpayer Service	10,936,775
Operations	9,185,246
Tax Compliance	22,408,491
TOTAL	$62,592,740

Source: *Managers Financial Report - Fiscal Year 89 Closing.*

II. CURRENT FINDINGS AND RECOMMENDATIONS

1. Controls over the Collection Division's seized property activities are inadequate.

The Department of Revenue does not have adequate controls over the processing, storing, and selling of seized property. The collection division seizes property owned by delinquent taxpayers and sells it to satisfy the tax liability. However, there is a lack of separation of duties over the seized property. The same individual that seizes the property is also responsible for storing and selling the property. These responsibilities are incompatible and increase the risk that errors or misuse of the property will occur. Someone independent of the collection process should be responsible for the storage of seized property. And someone independent of the collection and storage responsibilities should sell the property to satisfy the tax liability.

Seized personal property is stored in a secure room within the Department of Revenue building; however, a listing of all items in storage is not kept. In addition, the collection division does not tag all items in the storage room. A list identifying the nature of the item and from what delinquent taxpayer the property was seized, reduces the risk that errors will occur or property will be misused, lost or stolen. The collection division should tag all items in the storage room to identify the ownership of the property.

The collection division sometimes improves the condition of the acquired property to make it more saleable. By improving the property, the likelihood of a sale or receiving more money for the property is increased. However, the collection division did not obtain bids for improvements to certain properties during fiscal year 1989. For instance, over $1,600 in landscaping services were purchased to improve the marketability of real estate property in Mankato without obtaining bids. Minn. Stat. Section 16B.07 requires competitive bids for purchases of materials and services.

The fiscal services division does not maintain adequate financial records to determine the amounts due from the collection division. The collection division incurs various costs associated with the acquiring and selling of property. Costs include purchasing ownership in the property, repairs, maintenance fees, and selling fees. To fund these activities the department has established a separate account in the General Fund. The collection division submits invoices and memos to the fiscal services division authorizing it to make appropriate payments out of the account. Although fiscal services pays the invoices, it does not maintain a record summarizing the payment amounts for each activity. Several years may pass before the collection division sells the property. All payments previously made out of the general fund are to be repaid from the proceeds of the sale of the property. Minn. Stat. Section 270.708, Subd. 1 requires that the department first apply the proceeds from the sale of property against the expenses incurred in seizing and selling the property. The fiscal services division has a responsibility to ensure that the collection division repays the general fund for any amounts expended during its collection activities. Fiscal services could develop an accounts receivable system which would include the accumulation of all costs incurred for each collection activity.

RECOMMENDATIONS

- **The Department of Revenue should improve its internal controls over the seizing, storing and selling of seized property by:**

  - **providing for a separation of duties over the storage and selling of seized property;**

  - **developing a listing and tagging of all items in storage;**

  - **developing adequate financial records of collection activities in fiscal services; and,**

  - **obtaining bids for services or materials relating to acquired property;**

2. <u>The Department of Revenue is not processing withholding overpayment tax orders on a timely basis</u>.

The Department of Revenue has not reviewed 4,200 overpayment tax orders dating back to 1986. These tax orders could represent refunds due to employers. Employers who pay wages to employees must deduct a withholding tax and make periodic deposits with the department. At the end of each quarter employers file the Minnesota Employer Quarterly Withholding Return detailing the deposits and listing any tax due or amount overpaid. A tax order is generated when the actual monthly deposits differ from the amount reported on the quarterly reports. The tax order details the record of deposits and the final tax due or the overpayment made. The department audits those tax orders with amounts due to ensure that the claim is accurate.

The department is three years behind in auditing overpayment tax orders. However, the department believes that many orders may not result in refunds to taxpayers because of the errors or mistakes. The department does not inform the employer on a timely basis if an overpayment has been made and a refund is due. As a result, the employer is not aware of the overpayment and cannot exercise its option on receiving a refund or accepting a tax credit.

Minn. Stat. Section 290.92, Subd. 11 requires that the Department of Revenue pay a refund or a tax credit to the employer when an overpayment occurs. It also requires that the refund shall bear interest computed from the date of payment until the date the Department of Revenue pays the refund. The department may be incurring an additional liability for the interest on overpayment tax orders not processed.

RECOMMENDATION

- **The Department of Revenue should process timely all withholding tax orders with overpayment amounts.**

3. Interest is not paid on telephone gross earnings tax refunds.

The Department of Revenue is not paying interest to refunds resulting from the overpayment of gross earnings tax. Eighteen companies chose to receive refunds totaling $1,495,000 in fiscal year 1989. The department failed to pay approximately $18,000 of interest on those refunds, as required by state law.

The Department of Revenue requires telephone companies to remit four quarterly estimated tax payments each calendar year. A final return stating the actual tax liability for the calendar year is due the following April 15. If a company submits more in taxes than their actual liability, they have the choice of a credit or a refund.

Minn. Stat. Section 270.76 provides that any overpayment shall bear interest from the date of payment of the tax until the date the refund is paid or credit is made. If the department applies the credit to the following years first quarter estimated payment due on March 15, no interest will accrue; however, interest should accrue on all refunds issued after April 15.

RECOMMENDATION

- The department should pay interest on telephone gross earnings tax refunds in accordance with Minn. Stat. Section 270.76.

STATE OF MINNESOTA

DEPARTMENT OF REVENUE

March 23, 1990

Mr. James Nobles
Legislative Auditor
Office of the Legislative Auditor
Veterans Service Building
St. Paul, Minnesota 55155

Dear Mr. Nobles:

The following are our responses to the findings and recommendations, concerning the Department of Revenue, that are contained in your FY'89 statewide audit report.

FINDING #1: Controls over the Collection Division's seized property activities are inadequate. Recommendations: The Department of Revenue should improve its internal controls over the seizing, storing and selling of seized property by: (a) providing for a separation of duties over the storage and selling of seized property; (b) developing a listing and tagging of all items in storage; (c) developing adequate financial records of collection activities (relating to seized properties) in fiscal services; and, (d) obtaining bids for services or materials relating to acquired property.

RESPONSE: The department agrees with the findings and recommendations. The Fiscal Services Division has implemented a system to record and recover expenditures for the seizing, storing and selling of seized properties.

The Collections Division will implement the remaining recommendations, as follows, by April 16, 1990: provide for separation of duties over the storage and selling of seized property; develop a listing and tagging of all items in storage, and; obtain bids for services or materials relating to acquired property.

FINDING #2: The Department of Revenue is not processing withholding overpayment tax orders on a timely basis. Recommendation: The Department of Revenue should process timely all withholding tax orders with overpayment amounts.

RESPONSE: Due to constraints of the current processing systems, many invalid withholding tax orders are generated. These tax orders must be manually reviewed to determine those that are valid. Analysis of these tax orders indicates that less than 40% are valid. The vast majority of the valid tax orders can be identified early in the manual review; thus, they are worked first in order. The relatively few remaining valid tax orders require extensive review to determine their validity.

Due to resource limitations (new tax orders are system-generated at approximately the same rate as they can be resolved), the difficult-to-identify valid tax orders will settle into the unworked tax orders. Of the unworked tax orders, over 90% are less than three years old. The new Revenue computer systems should eliminate these problems; in the meantime, however, we will allocate additional manpower to the problem, when possible.

FINDING #3: Interest is not paid on telephone gross earnings tax refunds. Recommendation: The department should pay interest on telephone gross earnings tax refunds in accordance with Minn. Stat. Section 270.76.

RESPONSE: We accept the findings of the Legislative Auditor and have implemented a process for paying interest on all Gross Earnings refunds issued after April 15, 1990.

Sincerely,

John James
Commissioner

cc: Babak Armajani, Deputy Commissioner
Connie Nelson, Assistant Commissioner
Dwight Lahti, Assistant Commissioner
Dennis Erno, Assistant Commissioner
Jim Maurer, Internal Audit Director