Department of Revenue

Programs Selected For
Fiscal Year 1996 Statewide Audit

April 1997

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Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

97-21

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STATE OF MINNESOTA
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JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Deanna Wiener, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. James Girard, Commissioner
Department of Revenue

We have audited selected areas of the Department of Revenue for the fiscal year ended June 30, 1996, as further explained in Chapter 1. The work conducted in the department is part of our Statewide Audit of the State of Minnesota's fiscal year 1996 financial statements. The Comprehensive Annual Financial Report for the year ended June 30, 1996, includes our report, issued thereon dated December 2, 1996. The following Summary highlights the audit objectives and conclusions. We discuss our concerns more fully in the individual chapters of this report.

We conducted our audit in accordance with generally accepted auditing standards and *Governmental Auditing Standards*, as issued by the Comptroller of the United States. Those standards require that we obtain an understanding of management controls relevant to the audit. The standards require that we design the audit to provide reasonable assurance that the Department of Revenue complied with provisions of laws, regulations, contracts, and grants that are significant to the audit. Management of the Department of Revenue is responsible for establishing and maintaining the internal control structure and complying with applicable laws, regulations, contracts, and grants.

This report is intended for the information of the Legislative Audit Commission and the 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 April 18, 1997.

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 31, 1996

Report Signed On: April 11, 1997

SUMMARY

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Department of Revenue

Programs Selected for Fiscal Year 1996 Statewide Audit

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Background Information

The Department of Revenue is responsible for managing the state's tax systems. Minnesota relies on the voluntary compliance of its citizens with those tax laws. The department works to win compliance through a balanced interaction of efforts that focuses on developing sound tax policies, educating citizens, providing expedient customer service, and providing administrative and enforcement services in the areas of tax collection and assessment. The department collected more than $9.6 billion in tax dollars during fiscal year 1996. In fiscal year 1996, the department operated under the direction of acting commissioner Mr. Matt Smith. On July 1, 1996, the governor appointed Mr. James Girard as the commissioner.

Selected Audit Areas and Conclusions

Our audit scope was limited to those areas material to the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1996. Our primary objective was to render an opinion on the state of Minnesota's financial statements. As part of our work, we were required to gain an understanding of the internal control structure and ascertain whether the Department of Revenue complied with laws and regulations that may have a material effect on its financial statements.

The Department of Revenue's financial activity for fiscal year 1996 was fairly presented in the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1996. In addition, the department had recorded its tax revenues, refunds, and local government aids on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. We are concerned that the department has not taken a more aggressive role in verifying the integrity of withholding tax information obtained from employers to the wage detail information on file with the department. In addition, the department needs to improve certain processing controls over estimated corporate income taxes. The department has not resolved certain system weaknesses affecting data integrity and inadequate audit trails in its sales tax system.

We found the department had complied, in all material respects, with most finance related legal provisions addressed in the scope of our audit. However, the department did not assess late payment charges on all tax types as required in Minn. Stat. Section 289A.26, Subd. 4, Section 289A.60, Subd. 1, and Section 270.75. The department also did not assess penalties against taxpayers that paid by check when Minn. Stat. Section 270.78 requires payment under the EFT method. In addition, controls over Electronic Funds Transfers (EFT) in place under a contract for services with a local bank may not prevent the occurrence of an unauthorized withdrawal.

Table of Contents

Audit Participation

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

John Asmussen, CPA	Deputy Legislative Auditor
Tom Donahue, CPA	Audit Manager
David Poliseno, CPA, CISA	Auditor-in-Charge
Mary Annala, CPA	Senior Auditor
Geniene Herrlich, CPA	Senior Auditor
Dale Ogren, CPA	Senior Auditor
Susan Kachelmeyer	Staff Auditor
Tammy Schmidt	Staff Auditor
Becky Hoese	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 April 2, 1997:

James Girard	Commissioner
Matt Smith	Deputy Commissioner
Bev Driscoll	Assistant Commissioner, Operations
Dwight Lahti	Assistant Commissioner, Income Tax
Stephen Stedman	CIO and Director of Information Systems
Edward Eccleston	Director Profile Access and Security
JoAnne Furey	Director, Withholding Tax
Steve Kraatz	Director, Accounting
Kathleen Stewart	Director, Corporate Franchise Tax
Dennis Louis	Director, Document Processing
Sharon McMurray	Director, Human Resources
Carole Wald	Income Tax System Manager
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Mary Jo Alexander	Management Analyst IV
Jean Jochim	Financial Accounting Supervisor
Jim Maurer	Internal Audit Manager
Stephan Krovitz	Internal Audit Principal Auditor

Chapter 1. Introduction

The Department of Revenue is responsible for managing the state's tax systems. Minnesota relies on the voluntary compliance of its citizens with those tax laws. The department works to win compliance through a balanced interaction of efforts that focuses on developing sound tax policies, educating citizens, providing expedient customer service, and providing administrative and enforcement services in the areas of tax collection and assessment. In fiscal year 1996, the department operated under the direction of acting commissioner Mr. Matt Smith. On July 1, 1996, the governor appointed Mr. James Girard as the commissioner.

The department collected more than $9.6 billion in tax dollars during fiscal year 1996. Our audit scope focused on the 1996 revenues, expenditures, and tax refunds of the department included in Table 1-1.

Table 1-1
Department of Revenue
Selected Financial Activity
Fiscal Year 1996

Income Taxes:	
Withholding taxes	$3,519,182,856
Individual taxes	1,115,621,192
Corporate taxes	774,481,280
Sales and Consumption Taxes	
Sales tax	$3,082,308,833
Petroleum tax	578,357,017
MnCare tax	168,291,656
IRRRB Taconite tax	28,496,939
Special Taxes:	
Tobacco/cigarette tax	$190,263,304
Gross insurance premium tax	148,247,480
Document registration tax	96,647,369
Charitable gambling tax	73,178,288
Alcoholic beverages tax	56,085,027
Estate tax	50,902,214
Tax Refunds:	
Individual tax refunds	$522,125,561
Property tax refunds	166,680,234
Cambridge Bank refunds	114,956,503
Corporate tax refunds	63,142,554
Sales tax refunds	59,081,452
Withholding refunds	4,631,730
Indian sales tax refunds	3,851,631
Local Government Aid Payments:	
Homestead Agriculture and Credit Aid	$452,604,554
Local Government Aids	339,321,957
Police State Aid	38,694,499
Fire State Aid	11,295,837

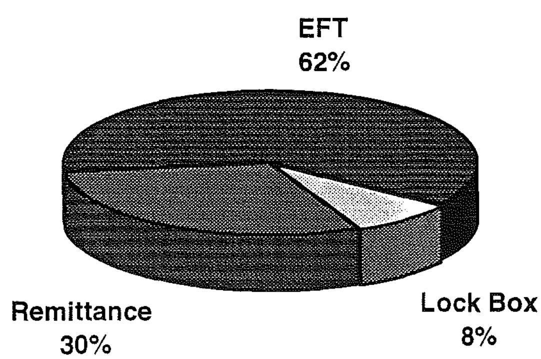
Source: Minnesota Accounting and Procurement System (MAPS) Reports.

These financial activities were material to the state's financial statements. The department finances its operations through general fund appropriations, however, operational activity of the department was outside the scope of this audit.

Taxpayer Payment Methods

The Department of Revenue collects tax revenues through one of three ways: Electronic Funds Transfer (EFT), lock box, and Remittance Processing, which also includes NCR (sales tax scanning). Figure 1-1 shows the percentage of payment methods used by taxpayers in fiscal year 1996.

Figure 1-1
Taxpayer Payment Methods
Fiscal Year 1996



Source: Auditor analysis of fiscal year 1996 MAPS activities.

The department requires taxpayers to utilize the EFT payment method when the expected or actual annual tax liability exceeds a specific threshold set by statute. Table 1-2 shows the thresholds for each tax type.

Table 1-2
Summary of EFT Thresholds
Fiscal Year 1996

Tax Type	EFT Threshold Amount
Withholding Tax	$ 50,000
Sales Tax	120,000
Corporate Tax	20,000
MnCare Tax	80,000
Estate Tax	120,000
Charitable Gambling Tax	120,000
Document Registration Tax	120,000
Tobacco/Cigarette Tax	120,000
Alcohol/Wine/Fermented Beverages Tax	120,000
Petroleum Tax	*

* All petroleum taxes use EFT, with certain exceptions, as stated in the statutes.

Source: Minnesota statutes.

The amount of tax dollars submitted to the department through EFT has increased significantly over the past few years. This is due in part to decreases in the thresholds and the widespread acceptance and use of EFT. During fiscal year 1996, the department collected approximately $5.9 billion through EFT.

The lock box system is used to collect withholding taxes from employers who do not file through EFT. The department collected about S800 million in fiscal year 1996 through the lock box.

Remittance processing is the third method of submitting taxes to the department. This method involves the taxpayer filing a return and payment directly to the department, generally through the U.S. mail. It also includes any returns that cannot use the lock box method, such as situations where a check applies to more than one type of return. During fiscal year 1996, the department collected approximately $1.9 billion through remittance processing. In addition, the department collects tax through a scanning process (NCR) which only involves the sales tax area and non EFT filers. Taxpayers send in their returns and tax amounts to the department. The department collected approximately $1 billion in sales tax during fiscal year 1996 through the scanning process.

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Chapter 2. Income Tax

Chapter Conclusions

Withholding, individual and corporate income tax revenues collected by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. In addition, the department accurately recorded withholding and individual and corporate income tax revenues on the Minnesota Accounting and Procurement System (MAPS). However, since the department does not compare withholding tax information submitted by employers to wage detail information on file with the department, the integrity of withholding taxes collected remains in question. Also, the department needs to improve its processing controls over estimated corporate income tax.

The income tax system includes income tax on individuals, corporations, small businesses, partnerships, fiduciaries, estates, withholding tax, and limited liability companies. Our audit focused on individual and corporate income and withholding taxes.

Table 2-1 shows the income tax revenues within each tax type that we reviewed during this audit.

Table 2-1
Summary of Income Tax Revenues
For the Fiscal Year Ended 1996

	1996 Amount
Withholding Tax Revenues	$3,519,182,856
Individual Income Tax System Revenues:	
Individual Estimated Tax	651,527,883
Individual Miscellaneous Tax	404,105,647
Individual Extension Tax	59,987,662
Corporate Tax System Revenues:	
Corporate Estimated Tax	621,857,473
Corporate Extension Tax	78,307,307
Corporate Miscellaneous Tax	74,316,500

Source: Minnesota Accounting and Procurement System (MAPS) Reports.

Withholding Tax

Withholding tax is income tax withheld from an employee's wages by their employer. The department generally requires employers who withhold federal income tax from their employee's wages to withhold Minnesota income tax as well. The department deposits withholding taxes into the General Fund. There are approximately 120,000 employers who submit withholding taxes to the state each year.

The department requires each employer to file either quarterly or annual return and to remit the tax withheld from employees either on a quarterly or annual basis. To be an annual filer, the employer must have an annual liability of under $500 and be notified by the Department of Revenue that they qualify as an annual filer. All other employers must file quarterly.

Individual Income Tax

In addition to withholding tax, individual income tax revenue may arise if the taxpayer's actual tax liability exceeds the amount withheld. These tax returns are due by April 15. There are approximately 2.1 million individuals who file a Minnesota individual income tax return each year. Estimated taxes and taxes paid as a result of requesting an extension are also considered income tax revenue.

The estimated tax is a self-withholding tax and is paid in quarterly installments due in April, June, September, and January. There are approximately 160,000 individual taxpayers who pay Minnesota estimated income tax during each year.

Corporate Income Tax

The department requires corporations conducting business in Minnesota to pay Minnesota corporate franchise taxes. There are approximately 55,000 corporations who file Minnesota corporate tax returns each year. Out of the 55,000 returns filed, about 40 percent, or 22,000 filers, paid corporate tax. According to department statistics, generally about 10 percent of the corporate taxpayers pay about 90 percent of the total corporate taxes collected.

A corporation determines the portion of its income that is taxable in Minnesota by calculating the percentage of its total sales, property, and payroll that derive from business activity in Minnesota. They use this percentage, along with their federal taxable income, to determine the portion taxable in Minnesota.

Audit Objectives and Methodology

We focused on the following objectives during our audit of income tax for the fiscal year ended June 30, 1996:

- Were withholding, individual and corporate income tax revenues fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996?

- Did the Department of Revenue record withholding and individual and corporate income tax revenues on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy?

Department of Revenue

To answer these questions, we interviewed department staff to gain an understanding of the control structure in place for withholding and individual and corporate income tax revenues and how each tax type is processed. We performed analytical procedures, including trend analysis, on each specific tax type to identify potential material misstatements. We tested withholding and individual and corporate income tax transactions, reviewed department reconciliations, analyzed the department's cashier function, traced tax receipts to MAPS, and tested compliance with applicable legal provisions.

Conclusions

We concluded that the withholding and individual and corporate income tax revenues collected by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. In addition, the department accurately recorded withholding and individual and corporate income tax revenues on the Minnesota Accounting and Procurement System (MAPS). However, as explained in Finding 1, the department does not compare withholding tax information submitted by employers to wage detail information on file with the department. In Finding 2, the department needs to improve its processing controls over estimated corporate income taxes. Findings 1 and 2 are prior findings we identified in our previous audit report.

1. **PRIOR AUDIT RECOMMENDATION: The department did not adequately verify the integrity of withholding taxes remitted by employers.**

The department does not compare withholding tax information submitted by employers to wage detail information on file with the department. Without this comparison, the accuracy of information submitted by employers is subject to question. Employers withhold income tax from employee payroll and submit the withheld amount to the department for deposit. Employers submit most withholding taxes with a form authorized by the department (MW-5 coupon) or through wire transfer methods. The amount submitted should be the actual taxes withheld. The department verifies the amount deposited to the MW-5 coupon or wire transfer reports and enters the information onto its computer system.

The department requires employers to submit quarterly MW-1 reports and enters the information onto its computer system. The quarterly MW-1 report summarizes the employers' withholding and depositing activities. Computer edits identify any differences between the quarterly reports and the actual payments (MW-5 coupons or wire transfers). The department resolves the discrepancies and enters the necessary adjusting entries. For the tax years prior to 1996, the department required that employers submit an annual MW-3 report that reconciled the quarterly withholding tax submitted by the employers with their actual tax liability for the year. In response to our prior audit recommendation, the department combined the fourth quarter form MW-1 and the annual reconciliation form MW-3 into a single MW-6 form called the year end withholding return/reconciliation. This change provides only a marginal improvement in the department's reconciliation process. The department still does not compare withholding tax information submitted by employers to wage detail information on file with the department.

The department has been working over the past couple of years with the Internal Revenue Service and the Social Security Administration to streamline wage reporting, filing, and paying into one national database. The withholding section will eventually use data received from the federal government along with data available in the department to compare the withholding tax information submitted by employers to wage detail information. This review will enable the withholding section to identify non-filers and differences in liability amounts for both the individual and employer levels. However, the department did not complete the project during fiscal year 1996. Pending completion, the department should consider auditing some of this information.

Recommendation

- *The Department of Revenue should institute procedures to verify the integrity of employer submitted withholding tax information to wage detail information.*

2. PRIOR AUDIT RECOMMENDATION: Corporate income tax processing controls over estimated taxes need improvement.

The department's review of estimated taxes paid by corporations continues to be weak in two areas. First, the department does not charge interest to corporations that submit delinquent quarterly estimated payments. Second, the department does not record the disposition of error messages displayed for underpayments identified by system edits.

Minn. Stat. Section 289A.26, Subd. 2, requires taxpayers to pay quarterly estimates by the fifteenth day of the third, sixth, ninth, and twelfth month of their fiscal year. The department has the authority to charge interest for late payments under Minn. Stat. 289A.55, Subd. 2. Minn. Stat. Section 289A.26, Subd. 4, requires the department to charge corporations interest on the underpayment of estimated taxes. Late payments automatically become underpayments for the same time period.

The department did not edit estimated returns for timely payment in the previous audit period as well as the current one. In response to the previous year's finding, the department stated that it agreed with our recommendation, and would explore methods for improvements in voluntary compliance, as well as the detection of the worst offenders in this area, as current resources permit. The department also anticipated a future rewrite of the corporate tax system that would permit automatic identification of late payments and automatic assessment of interest. However, we found that the department had made no improvements in these areas during the audit period.

During this audit period as well as the last, the department did not record actions taken to resolve system edits designed to detect overclaimers in the taxpayer history file. The edit displays an error message on the operator's terminal that prompts an action to correct the error. The computer program allows employees to either delete the message or make a correcting entry. Typically, a log of deleted error messages provides evidence that edits are operating properly. A log also provides the opportunity for supervisory review of the decision to delete an error message. The department does not record or log error messages that operators bypass. In addition, the department does not link adjustments made by operators to resolve the error messages to the individual taxpayer files. Both instances result in inadequate audit trails. Until the department addresses this problem, it cannot ensure that adequate safeguards are in place to detect cases where additional taxes may be due or refunds may be payable.

Recommendations

- *The department should edit quarterly payments for timely submission and assess penalties as required by statute.*

- *The department should ensure that audit trails through history files exist for actions taken to resolve error messages.*

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Chapter 3. Sales and Consumption Taxes

Chapter Conclusions

Sales and use tax, petroleum tax, and health care access tax revenues collected by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. In addition, the department accurately recorded sales and use tax, petroleum tax, and health care access tax revenues in the Minnesota Accounting and Procurement System (MAPS). However, the department has not resolved certain sales tax system design weaknesses identified in our previous audit report. In addition, the department needs to improve controls over consolidated sales tax returns.

Sales and consumption taxes are part of the sales and special tax system. They included state sales and use tax, petroleum tax, and special taxes such as taxes on tobacco, liquor, wine, and beer, solid and hazardous waste, and lawful gambling activities. It also includes taxes on receipts from insurance premiums and the Minnesota Health Care tax. Chapter 4 discusses the special taxes in more detail.

Table 3-1 summarizes the sales and consumption taxes collected during the fiscal year ended June 30, 1996.

Sales and Use Taxes

The state imposes a sales tax of 6.5 percent of the gross receipts from certain sales or services that occur in Minnesota. The state allocates the 6.5 percent in the following manner: two percent goes to the Local Government Trust Fund and 4.5 percent goes to the General Fund. In addition to the 6.5 percent tax, local cities such as Minneapolis and St. Paul further impose a 0.5 percent tax on retail sales in their cities. The department collects this amount with the other sales tax revenue, and then transfers the full amount back to the respective city. The department requires taxpayers to obtain sales and use tax permits and to remit the sales tax collected to the department.

In fiscal year 1994, the department implemented new computer systems to process and record sales tax transactions more efficiently. The department's goals were to increase the speed of processing transactions, reduce the cost of recording transactions, and make the information from the transactions available sooner. The department processes sales tax through one of three mediums: Electronic Funds Transfer (EFT), Scanning (NCR), and remittance processing.

Table 3-1
Summary of Sales and Consumption Taxes
For the Year Ended June 30, 1996

	1996 Amount
Sales Taxes	
General sales and use tax	$2,081,146,399
Local sales tax option	886,390,274
Minneapolis city sales tax	39,395,421
St. Paul city sales tax	10,049,265
Rochester city sales tax	7,104,037
Mankato city sales tax	2,282,323
St. Cloud city sales tax	851,261
Cook county sales tax	577,318
Petroleum Taxes	
Gasoline tax	462,635,235
Special fuel tax	97,421,305
Petroleum tank release clean-up tax	18,300,477
Health Care Access Taxes	
Provider tax	83,400,863
Hospital tax	55,575,060
Wholesale drug tax	28,201,649
Pharmacy tax	682,533
Surgery center tax	431,551
Taconite Tax (IRRRB)	28,496,939

Source: Minnesota Accounting and Procurement System (MAPS) Reports.

Petroleum Tax

The Petroleum Division collects the excise tax assessed on gasoline, special fuel, and aviation fuels. The Division also collects inspection and other fees on petroleum products received in Minnesota which includes the Petroleum Tank Release Clean-up Fund. It licenses distributors, special fuel dealers, and motor carriers. In addition, it administers the road tax laws and issues refunds to qualified purchasers of gasoline and special fuel.

Gasoline and Special Fuel

Licensed distributors or special fuel dealers must pay the excise tax on gasoline and special fuel. The licensing period for gasoline distributors is July 1 to June 30. The licensing period for special fuel dealers is December 1 to November 30. The law requires each licensed distributor or special fuel dealer to file a monthly tax return. The tax rate for the majority of petroleum products is 20 cents per gallon. However, recent changes in state statutes have set varying rates for alternative fuels.

Special Fuels are all combustible gases or liquid petroleum products other than gasoline. The majority of special fuels purchased are diesel fuel and heating oil. Roughly 40 percent of special fuels are subject to tax at the distributor level. The remaining 60 percent is dyed red to insure compliance with State and Federal tax laws.

Petroleum Tank Release Clean-up Fund

The Petroleum Tank Release Clean-up Act requires the state to reimburse owners for most of their costs to clean up contamination from leaks and spills from petroleum tanks. The Petroleum Fund Board and the Department of Commerce oversee this fund. The department collects fees for the Petroleum Tank Release Clean-Up Fund from the distributors. When the fund balance drops below $4,000,000, the department notifies the distributors that it will begin assessing the two cents per gallon fee and the duration of the assessment. The distributors remit the fee to the department along with their regular monthly return and taxes. During fiscal year 1996, the department collected approximately $18.3 million in taxes.

Health Care Access Tax

The department assesses the health care access tax, or MnCare tax, on the total receipts of hospitals, surgery centers, and other health care providers. It also assesses the tax on total receipts from the wholesale of prescription drugs and the retail sale of medical supplies and equipment. The MnCare tax on hospitals and surgery centers went into effect on January 1, 1993. The MnCare tax on health care providers, wholesalers of prescription drugs, and retailers of medical supplies and equipment went into effect on January 1, 1994. The funds collected by this tax help provide affordable health insurance to Minnesotans without insurance, and to reform Minnesota's health care system. Our focus was on the taxes collected and did not include a review of how the funds were spent.

MnCare consists of three separate components: (1) MnCare, a program for the uninsured; (2) small group and individual insurance reforms; and (3) regulatory oversight. MnCare, the program for the uninsured, is a subsidized health insurance program for low income, working Minnesotans. All enrollees contribute at least a portion of the premium based on their income. The program provides health care coverage to more than 90,000 previously uninsured Minnesotans. The availability of state funds determines the number of enrollees.

The MnCare tax is a flat two percent and is paid by hospitals and surgery centers, health care providers, retailers of medical supplies, and wholesalers of prescription drugs. The department can also tax the prescription drug type, but it currently does not assess it. The hospitals, surgery centers, and health care providers pay the tax on payments received from providing health care services. Retailers pay the tax on the payments received from the sale of medical equipment and supplies, and wholesalers pay the tax on the payments received from the sale of prescription drugs.

Hospitals and surgery centers pay the tax in monthly installments, with an annual return due by March 15 of the following year. Health care providers, retailers of medical supplies, and wholesalers of prescription drugs pay the tax in quarterly installments, with an annual return due by March 15 of the following year.

Department of Revenue

Taconite Tax (IRRRB)

As part of our audit of the Department of Revenue, we reviewed the taconite tax revenue that pertains to the IRRRB. Our main focus was on the Department of Revenue's role in calculating the taconite taxes. The tax calculation is based on information submitted by the taconite companies. Generally, the state assesses the companies a rate of $2.054 per gross ton of merchantable iron ore concentrate produced.

The Department of Revenue then bills each company for their share. The companies wire-transfer the funds to the state, and the department allocates the amounts to each IRRRB account based on the statutory allocation formula. IRRRB uses the funds for various projects in the region. A joint labor management team of the companies and the state reviews and approves potential projects. Again, our audit focused on only the tax calculation conducted by the department and did not include a review of how the funds were spent.

Audit Objectives and Methodology

We focused on the following objectives during our audit of sales and consumption taxes as identified in Table 3-1 for the fiscal year ended June 30, 1996:

- Were sales and use tax, petroleum tax, and health care access tax revenues fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996?

- Did the department record sales and use tax, petroleum tax, and health care access tax revenues on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy?

To answer these questions, we interviewed department staff to gain an understanding of the control structure in place for sales and use tax, petroleum tax, and health care access tax revenues and how each tax type was processed. We performed analytical procedures, including trend analysis, on each specific tax type to identify potential material misstatements. We tested sales and use tax, petroleum tax, and health care access tax transactions, reviewed department reconciliations, analyzed the department's cashier function, traced tax receipts to MAPS, and tested compliance with applicable legal provisions.

Conclusions

We concluded that the sales and use tax, petroleum tax. and health care access tax revenues collected by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. In addition, the department accurately recorded sales and use tax, petroleum tax, and health care access tax revenues in the Minnesota Accounting and Procurement System (MAPS). However, as explained in Finding 3, the department has not resolved certain sales tax system design weaknesses we identified in our previous audit report. In addition, the department needs to improve controls over consolidated sales tax returns as discussed in Finding 4.

3. PRIOR AUDIT RECOMMENDATION PARTIALLY IMPLEMENTED: The department did not resolve sales tax system design weaknesses.

The Profile System has several weaknesses affecting data integrity, such as improper record retention and an inadequate audit trail. The department also does not adequately restrict access to the system. The department uses an optical scanning system to process sales tax returns and remittances. The data obtained through the optical scanning system is recorded in the sales tax system (Profile). Profile edits and uploads data to TPA, the taxpayer accounting system, and CACS, the computerized accounting system.

The department destroyed sales tax returns from July 1995 through December 1995 without proper authorization as required by Minn. Stat. Section 138.17, resulting in an inadequate audit trail. Also, the department destroyed the returns without first verifying that the scanner properly scanned data into the system. There was no trail between the original source documentation and the various subsystems where the department posts data.

Recommendation

- *The department should establish a quality assurance process to verify that sales tax data is recorded consistently with information on taxpayer remitted returns.*

4. Controls over consolidated returns are not adequate to detect basic errors by taxpayers.

The department does not have an adequate process to ensure that taxpayers filing consolidated returns remitted the full amount of sales tax. We found instances in which the consolidated summary return did not equal the total of the individual locations. These instances resulted in potential sales tax underpayments and overpayments of $1,354 and $1,173, respectively. Companies that do business at more than one location send in a sales tax return for each location as well as a consolidated return for all locations. The sales tax system does not mathematically verify the accuracy of the summary return to the total of the location returns. Without the verification, the department cannot detect errors committed by taxpayers.

Recommendation

- *The department should develop a process to verify the accuracy of taxpayer payments for consolidated returns.*

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Chapter 4. Special Taxes

Chapter Conclusions

Special tax revenues collected by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The department recorded special tax revenues on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. Also, the department complied, in all material respects, with applicable finance related legal provisions pertaining to special taxes.

The special taxes are part of the Sales and Special Taxes System. The division collects taxes, maintains records, conducts audits, and ensures that taxpayers meet statutory bonding, licensing, and pricing requirements. Table 4-1 summarizes the actual amount of taxes collected for the specific programs audited.

Table 4-1
Summary of Special Tax Revenues
For the Year Ended June 30, 1996

	1996 Amount
Tobacco Taxes	
Cigarette tax	$178,681,745
Tobacco products tax	11,577,559
Gross Insurance Premium Tax	148,247,480
Document Registration Taxes	
Mortgage registry tax	51,231,465
Deed transfer tax	45,415,904
Charitable Gambling Taxes	
Lawful gambling tax	39,924,224
Pull tab and tipboard tax	33,254,064
Alcoholic Beverage Taxes	
Intoxicating liquor tax	37,166,739
Fermented malt beverage tax	14,985,566
Wine tax	3,932,722
Estate tax	50,902,214

Source: Minnesota Accounting and Procurement System (MAPS) Reports.

Department of Revenue

Cigarette and Tobacco Taxes

Cigarette and tobacco taxes are assessed separately by the department. The cigarette tax pertains solely to cigarettes while the tobacco tax affects everything else. The department collects taxes from distributors by requiring them to purchase stamps. The distributors affix stamps, currently at a cost of 48 cents per stamp, to each pack of cigarettes sold in Minnesota. The department allocates the revenue generated from the stamps among three separate funds. State law requires the department to deposit approximately the first $15 million collected into the Debt Service Fund to pay off various bonds. The department splits the remaining revenue between the Minnesota Resources Fund and the General Fund. The Minnesota Resources Fund receives about seven million dollars to fund various products and the rest remains with the General Fund as non-dedicated revenue.

The tobacco tax does not use stamps. Instead, the Department of Revenue assesses tobacco distributors a 35 percent tax on all purchases within the state. The department collects approximately $11 million of tobacco taxes annually and deposits it into the General Fund as non-dedicated revenue.

Gross Insurance Premium Tax

The department assesses the gross insurance premium tax on gross premiums less return premiums received on all business in Minnesota. Of the 1,450 insurance companies currently conducting business in Minnesota, approximately 1,300 must pay the gross premium tax. All insurance companies and providers licensed during the tax year must file a premium tax return even if they did not actually transact insurance business in Minnesota during the tax period. In addition, insurers and providers with a premium tax liability of $500 or more must pay estimated taxes three times a year.

The Department of Commerce licenses all insurance companies doing business in Minnesota. The Department of Revenue assesses a tax on all premiums that insurance companies collect in Minnesota except for certain exempted organizations. The general tax rates for most premiums is two percent. The department deposits the tax into the General Fund as non-dedicated revenue. The state also assesses a 0.5 percent tax on certain premiums for the fire marshal's tax, and the department disburses the proceeds to local fire and police departments. Effective January 1, 1996, nonprofit health service plan corporations and health maintenance organizations (HMO) paid an additional one percent on premiums. The proceeds go to the Health Care Access Fund, or MnCare (see discussion in Chapter 3).

Document Registration Tax

The document registration tax consists of the mortgage registry tax and the deed transfer tax. These taxes are collected by counties who remit them to the department. The tax base for the mortgage tax is principal debt which it secures by a mortgage of real property in the state. The lender who records or registers a mortgage of real property is responsible for paying the tax at or before the time of filing the mortgage for record or registration. Mortgage tax equals 23 cents per each $100 of principal debt or obligation which is or may be secured by any mortgage of real property situated within the state.

The tax base for deed tax is the transfer of real estate by any deed, instrument, or writing. Any person who grants, assigns, transfers, or conveys real estate is responsible for payment at the time of transfer. Both require a disposition of 97 percent to the state General Fund and 3 percent to the county Revenue Fund. The state assesses a deed tax on each deed, instrument, or writing by which any lands, tenements, or other realty in this state is granted, assigned, or transferred. The tax is $1.65 for any lien or encumbrance valued at $500 or less. If the lien or encumbrance exceeds $500, the tax shall be $1.65 plus $1.65 for each additional $500 or fraction of that amount.

Charitable Gambling Tax

Charitable gambling allows non-profit organizations to raise money for their organizations through various gaming events. The department assesses those organizations with a charitable gambling tax. The lawful gambling tax and the pull tab and tipboard tax are part of the charitable gambling tax. The lawful gambling tax consists of bingo, raffle, and paddle wheels. The department assesses the tax on the gross receipts of a licensed organization for lawful gambling less prizes actually paid out. The current rate is ten percent. Organizations submit monthly tax returns along with the taxes owed. The department deposits the tax revenue into the General Fund.

The tax base for the pull tab and tipboards is the gross of each pull tab or tipboard deal sold by a distributor. A "deal" is each separate package, or a series of packages, consisting of one game of pull tabs or tipboards. The tax rate is two percent. The state also has a combined receipts tax which it defines as gross receipts of an organization from lawful gambling other than bingo, raffles, and paddle wheels. Currently, the combined receipts tax is charged on gross receipts from pull tabs and tipboards. Receipts below $500,000 do not get taxed. After $500,000, the department taxes them at either two, four, or six percent, depending on the level of receipts.

Alcoholic Beverage Tax

The tax base for alcoholic beverage tax comprises distilled spirits, beer, malt beverages, wine, and premixed alcoholic beverages manufactured or received for sale in Minnesota. Distilled spirits or intoxicating liquor includes beverages such as whiskey, brandy, and vodka. Beers and malt liquors basically comprise the fermented malt beverages. The department assesses the taxes on each beverage separately as follows:

- Taxes on distilled spirits are $5.03 per gallon or $1.33 per liter.
- Beer taxes are $2.40 per barrel with alcohol content less than or equal to 3.2 percent or $4.60 per barrel with alcohol content greater than 3.2 percent.
- Wine taxes are also dependent on alcohol content and range from $.30 to $3.52 per gallon or $.08 to $.93 per liter.
- There is also a separate one cent tax for each bottle or container of distilled spirits and wine.

Small brewers of fermented malt beverages receive a $4.60 credit per barrel for the first 25,000 barrels produced for sale within Minnesota. To receive the credit, the brewer must have manufactured less than 100,000 barrels in the preceding year. State law exempts certain beverages from tax, such as home brewed wine or beer, sacramental wine, brewery samples, and pharmaceutical alcohol.

The proprietors and distributors of alcoholic beverages submit monthly tax returns and payments to the department by the 18th day of the following month. The distributors of intoxicating liquor and wine report their liability on a combined tax return. However, fermented malt beverage returns only reflect the "beer" tax liability.

Estate Tax

Estate tax is a tax imposed upon the transfer of estates, usually to a person's descendants. A taxpayer must submit a return if they file a federal estate tax return. The taxpayer must file the return and the taxes owed within nine months after the date of death. The department deposits the revenue into the General Fund as non-dedicated revenue.

Audit Objectives and Methodology

We focused on the following objectives during our audit of special taxes as identified in Table 4-1 for the fiscal year ended June 30, 1996:

- Were special tax revenues fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996?
- Did the department record special tax revenues on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy?
- Did the department comply, in all material respects, with the applicable finance related legal provisions pertaining to special taxes?

To answer these questions, we interviewed department staff to gain an understanding of the control structure in place for the special taxes identified in Table 4-1 and how each tax type was processed. We performed analytical procedures, including trend analysis, on each specific tax type to identify potential material misstatements. We tested special taxes transactions, reviewed department reconciliations, analyzed the department's cashier function, traced tax receipts to MAPS, and tested compliance with applicable legal provisions.

Department of Revenue

Conclusions

We concluded that the special tax revenues collected by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The department recorded special tax revenues on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. Also, the department complied, in all material respects, with applicable finance related legal provisions pertaining to special taxes.

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Chapter 5. Tax Refunds

Chapter Conclusions

Tax refunds paid out by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The department recorded tax refunds in the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. Also, the department complied, in all material respects, with finance related legal provisions pertaining to the calculation and payment of tax refunds.

Tax refunds represent money that the state owes the taxpayers. Except for property tax refunds, the refunds generally represent excess money the taxpayer has paid to the state and later requested that the department return to them or apply toward future tax liabilities. The department determines property tax refunds based on tax tables using the taxpayer's household income and the property tax assessed amount. Table 5-1 shows the amount of refunds made to taxpayers during fiscal year 1996.

Table 5-1
Summary of Tax Refunds
For the Year Ended June 30, 1996

	1996 Amount
Cambridge Bank refund	$109,825,374
Property tax refunds	
Renters	88,744,256
Homeowners	77,935,978
Individual tax refunds	522,125,561
Sales tax refunds	85,224,638
Corporate tax refunds	63,142,554
Withholding tax refunds	4,631,730
Indian sales tax refunds	3,851,631

Source: Minnesota Accounting and Procurement System (MAPS) Reports.

The department processes refunds through its Refund Payment Management System. The department records the refund data into the Refund Payment Management System from its other systems such as Individual Income Tax System. The Refund Payment Management System applies various edits against the data before it issues a refund. For instance, one edit reviews the taxpayer's history for claim information. The system identifies other debts against the taxpayer from many sources. The Refund Payment Management System posts the refund amount against outstanding claims the department is aware of first and then creates a warrant for the balance of the refund.

Cambridge Bank Refund

The Cambridge Bank Refund resulted from a Supreme Court ruling. The Minnesota case was filed following a ruling in a similar case brought by the Memphis Bank against the state of Tennessee. In the Memphis Bank case, the court held unconstitutional a Tennessee tax law which included interest on federal obligations in the computation of net income, which is the measure of the tax. However, it exempted interest on all obligations of state and political subdivisions. The plaintiffs in the Minnesota case also claimed that bank excise taxes were unconstitutional because it excluded interest on certain obligations of the state and its political subdivisions from the computation of the tax while including interest on federal obligations. In December 1994, the Supreme Court reached a final decision in the Cambridge State Bank case. The court ruled that the state must refund a portion of Minnesota bank excise taxes (including interest) paid by financial institutions for the years 1979 through 1983.

In order to receive a refund, financial institutions (taxpayer), had to be either part of the court case (litigant) or file annual claims or waivers with the department (non-litigants). The department reviewed each claim and calculated any refund plus interest due the taxpayer. The department estimated that it will have to refund about $230 million in claims. We reviewed only the payment of claims by the department. As of June 30, 1996, the department paid out about $110 million to 245 taxpayers. Other aspects of the litigation were considered in our audit of the Department of Finance. The state issued revenue bonds to satisfy the claims and judgments resulting from litigation.

Property Tax Refunds

Homeowners and renters receive property tax relief based on the relationship of property taxes on a home or rental unit to total household income. To be eligible for a refund, a taxpayer's property tax must be more than a specified percentage of household income. For fiscal year 1996 (tax year 1995), the maximum refund amount was $440 for homeowners and $1,030 for renters. The percent of income, percent of state payment, and maximum refund depend on the taxpayer's income. As the taxpayer's income increases, the amount the state pays decreases. State law limits eligibility for the property tax refund to taxpayers with incomes under $61,930 for homeowners and $36,120 for renters. The department indexes the income thresholds and maximum refund amounts for inflation.

Individual, Sales, Corporate, and Withholding Refunds

These refunds result from taxpayers initially paying in too much taxes or from errors in the calculation of the tax. The taxpayer generally has the option of receiving the refund, or applying it against future obligations.

Department of Revenue

Indian Sales Tax Refunds

The department makes refunds to Indian tribes based on agreements set up by the State of Minnesota and the Tribal Reservations' Business Committee. Among the terms of the agreements, it establishes a mechanism for refunding back to the band portions of the tax payments made to the state by tribal members that are not subject to the state's taxing authority. It also establishes a mechanism for collecting and sharing state taxes covered by this agreement and taxes owed or paid by non-tribal members resulting from reservation activities.

Refunds occur based on several different factors. One type of refund is the per capita refund. Per capita refunds result from tribal members paying sales tax to companies located off the reservation that are exempt from paying sales tax per the agreement. The department issues the refunds in quarterly payments to the tribe based on a formula contained in the agreement. Another type of refund is the revenue sharing refund. These refunds result from sales taxes collected on the reservation from purchases made by tribal members. The reservations collect and remit the sales taxes to the department for all purchases on the reservation. According to the agreement, the department calculates the portion of the taxes paid by the members and refunds that amount to the reservation.

Audit Objectives and Methodology

We focused on the following objectives during our audit of tax refunds as identified in Table 5-1 for the fiscal year ended June 30, 1996:

- Were tax refunds fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996?
- Did the department record tax refunds on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy?
- Did the department comply, in all material respects, with applicable finance related legal provisions pertaining to the calculation and payment of tax refunds?

To answer these questions, we interviewed department staff to gain an understanding of the control structure in place over tax refunds and how each tax refund was processed. We performed analytical procedures, including trend analysis, on each specific tax refund to identify potential material misstatements. We tested tax refund transactions, reviewed department reconciliations, traced tax refunds to MAPS, and tested compliance with applicable legal provisions.

Conclusions

We concluded that tax refunds paid out by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The department recorded tax refunds in the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. Also, the department complied, in all material respects, with finance related legal provisions pertaining to the calculation and payment of tax refunds.

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Chapter 6. Local Government Aid Payments

Chapter Conclusions

Local government aid payments paid out by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The department recorded local government aid payments on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. Also, the department complied, in all material respects, with applicable finance related legal provisions pertaining to the calculation and payment of local government aids.

In administering state aids to local governments, the department collects and maintains assessment and levy information from all local taxing authorities each year. The department determines state aid payments for each county, city, town, and special taxing district under a variety of statutory formulas and makes the aid payments by the statutory deadlines each year. It also assists and monitors local governments in implementing the annual Truth in Taxation process and verifies and issues state deeds for tax forfeited properties. The department determines the annual levy limits applicable to taxing authorities and educates and assists county auditors and treasurers on requirements and procedures for tax computation and collection.

Table 6-1 identifies the individual programs audited and the total aid payments made during fiscal year 1996

Table 6-1
Summary of Local Government Aid Payments
For the Year Ended June 30, 1996

	1996 Amount
Homestead and Agricultural Credit Aid (HACA)	
Real Property	$449,383,009
Mobile Home	3,221,543
Local Government Aid (LGA)	339,321,957
Police State Aid	38,694,499
Fire State Aid	11,295,837

Source: Minnesota Accounting and Procurement System (MAPS).

Department of Revenue

Homestead and Agricultural Credit Aid (HACA)

HACA provides relief from property taxes for Unique Taxing Districts (UTD), which includes: counties, cities, towns, school districts, and special taxing districts. The division calculates HACA for all UTD's. The department processes payments for UTD's, excluding schools. The department sends information to the Department of Education for payment to school districts.

The division calculates and disburses HACA on a calendar year basis. The Property Tax Division certifies HACA amounts to the UTD's by September 1. UTD's use the certification amounts to prepare their next fiscal year budget. The certification process begins when county auditors submit tax abstracts to the Property Tax Division. The division runs edit programs against the abstracts to detect any errors and subsequently calculates the formula. The division produces a preliminary report of HACA payments and runs it against various edits to detect and correct any errors. The division then submits certification amounts to the UTD's. HACA for mobile homes does not require certification as the amounts are immaterial in relation to the overall HACA payments. The division makes two equal payments per year to the appropriate UTD's. HACA for mobile homes are only disbursed once a year.

Local Government Aid (LGA)

LGA provides relief from property taxes for cities and towns. The department calculates the amounts on a calendar year basis and certifies the LGA amounts to cities and towns by September 1. Cities and towns use the certification amounts to prepare their fiscal year budget. The division calculates LGA for each entity based on the appropriate statutory requirements. The division uses software spreadsheets to make the calculations and verifies the amounts twice prior to entering them on the subsystem for further processing by the payment section.

State law requires the department to pay LGA to cities and towns by July 20 and December 26. The division can adjust the certified LGA amounts for any legislative action passed after September 1 affecting LGA payments. The payment section runs a series of programs to separate amounts into two equal payments and proofs the amounts. The Department of Revenue's subsystem captures the payment amounts to summarize entries into MAPS using the Interface Warrant Print subsystem interface. The Property Tax Division sends payment information to Intertech for payment processing and distribution. When required, the department may process manual payments. This occurs when a city or town requests an early payment or the State Auditor places a hold on a payment to a city or town due to noncompliance with certain rules.

Police and Fire State Aid

The Police and Fire State Aid exists to subsidize service pensions, disability benefits, and survivor benefits to local police officers and firefighters. The department receives tax revenues from auto and fire insurance premiums to fund the aid payments. The Insurance Taxes Section of the Special Taxes Division determines the amount of tax revenues to distribute to police and fire departments or relief associations.

Department of Revenue

Local Government Services of the Property Tax Division calculates the disbursement of Police and Fire Aid to each recipient. Local Government Services receives the certification from the Insurance Taxes Section and allocates the aid to each recipient according to a formula. The department calculates the Police State Aid based on the number of months worked by police officers, while area market value and population determine Fire State Aid.

The Database Management Section of the Property Tax Division administers the payment of Police and Fire State Aid. It must process the payment by September 1. Database Management Section runs a series of programs to process and edit the payment amounts. The Department of Revenue's subsystem captures the payment amounts to summarize entries into MAPS. The Property Tax Division sends the payment information to Intertech for warrant printing and distribution. However, the Database Management Section may process manual payments of Police and Fire Aid when the State Auditor requests a hold of payment. The State Auditor has the authority to hold payment if the entity did not comply with certain rules. The Payment Division receives notice from the State Auditor when the entity may receive payment.

Audit Objectives and Methodology

We focused on the following objectives during our audit of local government aid payments as identified in Table 6-1 for the fiscal year ended June 30, 1996:

- Were local government aid payments fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996?

- Did the department record local government aid payments on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy?

- Did the department comply, in all material respects, with applicable finance related legal provisions pertaining to the calculation and payment of local government aids?

To answer these questions, we interviewed department staff to gain an understanding of the control structure in place over local government aid payments and how each local government aid payment was processed. We performed analytical procedures, including trend analysis, on each local government aid payment to identify potential material misstatements. We tested local government aid payment transactions, reviewed department reconciliations, traced local government aid payments to MAPS, and tested compliance with applicable legal provisions.

Conclusions

We concluded that local government aid payments paid out by the department were fairly presented on the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1996. The department recorded local government aid payments on the Minnesota Accounting and Procurement System (MAPS) with reasonable accuracy. Also, the department complied, in all material respects, with applicable finance related legal provisions pertaining to the calculation and payment of local government aids.

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Chapter 7. Other Issues

Chapter Conclusions

Controls over Electronic Funds Transfer (EFT) in place under a contract for services with a local bank may not prevent the occurrence of an unauthorized withdrawal. The department did not assess late payment charges on all tax types as required by Minn. Stat. Section 289A.60, Subd. 1, and Section 270.75. The department also did not consistently assess penalties against taxpayers that pay by check when Minn. Stat. Section 270.78 requires filing under the EFT method.

The department manages three main tax systems: income, sales, and property. We have discussed the various tax systems in previous chapters. The department managed over 150 separate taxes and served over three million taxpayers during fiscal year 1996. The department supports the tax systems by various operations such as collections, communications, computer system support, and document processing.

During the audit, we reviewed specific aspects of all of the computer systems, including controls and legal compliance over electronic funds transfer (EFT) transactions.

5. Controls over EFT transactions are weak.

The Department of Revenue has not established adequate controls to prevent the occurrence of an unauthorized debit from the ACH credit option of EFT. On January 1, 1996, the state, through the Department of Finance, began contracting with a new bank to provide EFT services for the Department of Revenue as well as other state agencies. The change in banks resulted in certain activities, such as debit transactions, not being adequately controlled.

The ACH credit option allows the taxpayers to initiate the transfer of money from their bank account to the state's bank account. The taxpayer controls the movement of the money. Debit transactions are transactions initiated by the customers to correct or adjust a previously entered credit transaction such as a deposit. The previous bank used a "debit filter" to identify debit transactions and then notified the department for approval of the transaction. The current bank does not have such a control in place. Currently, the bank only notifies the department of a pending debit transaction and does not require prior approval to allow the transaction. The bank receives about two or three debit transaction requests per week. The contract required certain system controls to detect and prevent unauthorized debit entries from occurring. According to the department, the current bank has not provided that level of service.

Without the controls in place, there is an increased risk that fraudulent transactions could occur and not be detected timely. The department, along with the Department of Finance, should require the new bank to provide sufficient controls, such as a "debit filter," to ensure that only authorized debit transactions occur. Until the bank installs the filter, the department should require the bank to only complete the debit transaction after it receives a positive confirmation from the department. If the department does not implement these controls, unauthorized transactions could occur.

Recommendation

- *The Department of Revenue needs to improve controls over EFT transactions.*

6. PRIOR AUDIT RECOMMENDATION PARTIALLY IMPLEMENTED: The department did not consistently assess penalties and interest on EFT tax payments.

The department did not consistently identify and assess penalties and interest against taxpayers that submit a late tax payment using the EFT payment method. It assessed late payment charges for sales, petroleum, and special taxes that violated the EFT requirements, but did not assess these charges on the remaining tax types. According to Minn. Stat. Section 289A.60, the department should be assessing late payment charges on all tax types.

Minn. Stat. Section 289A.26, Subd. 2a, requires businesses with an annual tax liability of $20,000 or more to submit their tax payments using EFT. Under Minn. Stat. Section 270.07, the department initially waived the enforcement of the interest and penalty charges for late payments from January through October of 1992. It waived charges based on the need for taxpayers to become familiar with the new reporting requirements. However, since October of 1992, the department has not actively attempted to detect and collect interest or penalties on late EFT payments.

The department also does not consistently assess penalties against taxpayers that pay by checks when the statutes require payment under the EFT method. Minn. Stat. Section 270.78 imposes a penalty of five percent on taxpayers failing to pay using the EFT method. The department has not consistently enforced the penalty since its enactment on October 1, 1993.

Recommendations

- *The department should develop procedures to routinely identify late EFT tax payments, similar to the sales, petroleum, and special taxes.*

- *The department should consistently assess penalties and interest on EFT payments as required by Minn. Stat. Sections 289A.60, Subd. 1, Section 270.75, and Section 270.78.*

MINNESOTA Department of Revenue

Office of the Commissioner

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April 11, 1997

Mr. James Nobles, Legislative Auditor
Office of the Legislative Auditor
1st Floor, Centennial Office Building
658 Cedar Street
St. Paul, MN 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'96 statewide audit report.

1. **PRIOR AUDIT RECOMMENDATION: The department did not adequately verify the integrity of withholding taxes remitted by employers.**

Recommendation

- *The Department of Revenue should institute procedures to verify the integrity of employer submitted withholding tax information to wage detail information.*

DOR RESPONSE

As of the date of this response, several efforts are underway to help identify if there is a widespread problem with the integrity of withholding tax information. One of the efforts is the continued partnership with the IRS and Social Security Administration as noted in the audit report. The IRS/SSA continues to work toward a comprehensive compilation of all electronic and paper W-2 filings filed with the SSA. It is estimated that this tape resource would cost the department around $200,000 for 1998. We have recently begun systematically comparing the 1995 paper W-2s filed with the SSA to employers' filings and payments. We will also begin reviewing a sampling of the electronic filing of W-2s which employers file with the DOR. These efforts should identify some nonfiler employers and some nonpaying, underpaying and overpaying employers.

Responsible Party: Dwight Lahti, Assistant Commissioner for Income Taxes

2. **PRIOR AUDIT RECOMMENDATION: Corporate income tax processing controls over estimated taxes need improvement.**

Recommendations

- *The department should edit quarterly payments for timely submission and assess penalties as required by statute.*

- *The department should ensure that audit trails through history files exist for actions taken to resolve error messages.*

DOR RESPONSE

The new corporate processing system was planned and programmed during 1996 and was put in place March 24, 1997, to process returns received in 1997.

The old processing system did not interface with the Integrated System where estimated payment records are kept. So at the time of processing there was no way to check amounts and dates received. The new system does interface with the Integrated System.

What needs to be looked at is what determines if estimated payments are late? It is not as simple as the payment is due March 15th and was received late on the 28th so it's late. There are many factors involved. First, any late payments can't be determined until the return is filed. Information needed to make a determination includes: a)current years tax amount; b) previous years tax amount; c) any overpayment transferred to the current year, from the previous year; d) amounts of estimated payments made and dates received. Also, there are alternative methods to determine the required installments. Those methods include Annualized Income method, Adjusted Seasonal method and Large Corporations which all have different procedures to determine the estimated payments due dates. A computer program is not able to make judgments regarding these issues. If, during processing, the computer assessed late payment interest strictly on a basis of payments being made a number of days late, many of the billings would be in error, resulting in frustrated taxpayers being erroneously billed and time consuming corrections to be made by the Department of Revenue.

Computer programs to identify potential cases that have late payment interest due, have been created after processing. The list of potential cases is then researched to the extent of the resources we have available, and if it is determined they owe late payment interest, it is assessed. In addition, any time a file is reviewed, for any reason, the tax specialist is required to check for this issue.

Responsible Party: Dwight Lahti, Assistant Commissioner for Income Taxes

3. PRIOR AUDIT RECOMMENDATION PARTIALLY IMPLEMENTED: The

department did not resolve sales tax system design weaknesses.

Recommendation

- *The department should establish a quality assurance process to verify that sales tax data is recorded consistently with information on taxpayer remitted returns.*

DOR RESPONSE

The department has just completed a system enhancement that provides for an audit trail between the original source documents for scanned returns and the sales tax system. In addition, another system enhancement has been developed for scanned returns that logs the scanner and the different processing activities that each specific return goes through, as well as records the name of each operator that may have made changes to the return in the scanning process.
These enhancements will now make it possible for an internal audit of the Sales Tax data capture process to be carried out. This audit will allow for a quality assurance process to be put in place to verify that sales tax data is recorded consistently with information on taxpayer returns.

Responsible Parties: Bev Driscoll, Assistant Commissioner for Tax System Operations and Don Trimble, Assistant Commissioner for Sales & Special Taxes

Additionally, in response to the finding of improper record retention that affects data integrity, the department implemented an approved record retention schedule, effective January 1, 1996.

Responsible Party: Bev Driscoll, Assistant Commissioner for Tax System Operations

4. **Controls over consolidated returns are not adequate to detect basic errors by taxpayers.**

Recommendation

- *The department should develop a process to verify the accuracy of taxpayer payments for consolidated returns.*

DOR RESPONSE

Location information is requested from the taxpayers for statistical purposes only. Our Research office uses this information in preparing many reports concerning the local economies. It has no useful purpose for processing since we do not consider it part of the return. The data from the location reports is entered into a separate database after the Summary return has been processed.

Responsible Party: Don Trimble, Assistant Commissioner for Sales & Special Taxes

5. Controls over EFT transactions are weak.

Recommendation

- *The department needs to improve controls over EFT transactions.*

DOR RESPONSE

The Department has always been aware of the need to disallow any unauthorized debit or withdrawal from the Revenue ACH account. The department identified this requirement in the state wide banking contract negotiations and was assured by the winner of the contract that although this was a unique requirement the bank could meet our needs. The bank was unable to implement the required software. After several meetings with the bank , the Department of Finance and the State Treasurer, the Department of Revenue decided to place a block on any outgoing activity to the specific account.

The block was put in place by the bank on 1/3/97. Along with the block we will continue to balance the account each day and disallow any withdrawal activity to the account. These controls will prevent any unauthorized debit activity to our account.

Responsible Party: Bev Driscoll, Assistant Commissioner for Tax System Operations

6. PRIOR AUDIT RECOMMENDATION PARTIALLY IMPLEMENTED: The department did not consistently assess penalties and interest on EFT tax payments.

Recommendations

- *The department should develop procedures to routinely identify late EFT tax payments, similar to the sales, petroleum, and special taxes.*

- *The department should consistently assess penalties and interest on late EFT payments as required by Minn. Stat. 289A60, Subd. 1, Section 270.75, and Section 270.78.*

DOR RESPONSE

Computer system improvements for withholding tax were completed at the beginning of calendar year 1997 and penalty programs for withholding are now firmly in place. Penalties are now imposed on late deposits and deposits that came in via paper when they were required to be electronic. Penalty actions include some automated assessments/notices and some assessments/notices as a result of manual efforts.

The Corporate Franchise Tax Division has a project in place to identify and contact taxpayers who are not making required corporate tax payments using the EFT payment method. The taxpayers have all been contacted by telephone. The requirements have been explained and subsequent payments monitored with the intent to assess penalties for failure to pay by the required method.

Responsible Party: Dwight Lahti, Assistant Commissioner for Income Taxes

Sincerely,

James L. Girard
Commissioner

cc: Matt Smith, Deputy Commissioner
Dwight Lahti, Assistant Commissioner
Beverly Driscoll, Assistant Commissioner
Don Trimble, Assistant Commissioner
Jim Maurer, Internal Audit Manager