

Department of Revenue

Programs Selected For Fiscal Year 1997 Statewide Audit

February 1998

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**Financial Audit Division
Office of the Legislative Auditor
State of Minnesota**

98-8



STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
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, 1997, 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 1997 financial statements. The Comprehensive Annual Financial Report for the year ended June 30, 1997, includes our report, dated December 8, 1997. 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 *Government Auditing Standards*, as issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of management controls relevant to the audit. The standards also 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 February 20, 1998.

A handwritten signature in black ink, appearing to read "James R. Nobles".

James R. Nobles
Legislative Auditor

A handwritten signature in black ink, appearing to read "Claudia Gudvangen".

Claudia Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: November 26, 1997

Report Signed On: February 16, 1998

SUMMARY

State of Minnesota
Office of the Legislative Auditor
1st Floor Centennial Building
658 Cedar Street • St. Paul, MN 55155
612/296-4708 • FAX 612/296/4712
TDD Relay: 1-800-627-3529
email: auditor@state.mn.us
URL: <http://www.auditor.leg.state.mn.us>

Department of Revenue

Programs Selected for Fiscal Year 1997 Statewide Audit

Public Release Date: February 20, 1998

No. 98-8

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 \$10.5 billion in tax dollars during fiscal year 1997. Mr. James Girard, the current commissioner of the department, was appointed by the Governor on July 1, 1996.

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, 1997. 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 1997 was fairly presented in the state of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1997. In addition, the department had properly recorded its tax revenues, refunds, and local government aids on the Minnesota Accounting and Procurement System (MAPS). 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 did not perform a critical withholding tax reconciliation for part of the year. The department did not adequately safeguard its cash receipts. We also found that, in certain circumstances, the department made duplicate refund payments.

We found that for the items we tested, the department had complied, in all material respects, with finance related legal provisions addressed in the scope of our audit. However, we found that the department did not deposit its cash receipts timely in accordance with Minn. Stat. Section 16A.275.

The department agreed with the audit report findings and recommendations and is taking actions to resolve the issues.

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Audit Participation

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

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Tom Donahue, CPA	Audit Manager
David Polisen, CPA, CISA	Audit Director
Dale Ogren, CPA	Senior Auditor
Scott Tjomsland	Senior Auditor
Susan Kachelmeyer, CPA	Senior Auditor
Brad Falteysek	Staff Auditor
Michelle Breault	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 6, 1998:

Jim Girard	Commissioner
Matt Smith	Deputy Commissioner
Dwight Lahti	Assistant Commissioner: Income Tax
Jenny Engh	Assistant Commissioner: Legal and Tax Policy
Kathleen Stewart	Director - Corporate Franchise
Joanne Furey	Director - Withholding Tax Division
Amy Jorgenson	Business Tax Section Manager
Joe Lefto	Supervisor - Taxpayer Account Management
Stephen Krovitz	Internal Audit

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 worked 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 Governor appointed Mr. James Girard, the current commissioner, on July 1, 1996.

The department collected more than \$10.5 billion in tax dollars during fiscal year 1997. Our audit scope focused on the 1997 revenues, expenditures, and tax refunds of the department included in Table 1-1.

Table 1-1
Selected Financial Activity
Fiscal Year 1997

Income Taxes:	
Withholding Taxes	\$3,795,175,783
Individual Taxes	1,446,200,759
Corporate Taxes	743,063,755
Sales and Consumption Taxes:	
Sales Tax	\$3,212,138,442
Petroleum Tax	575,097,024
MnCare Tax	157,258,036
IRRRB Taconite Tax	31,782,349
Special Taxes:	
Tobacco/Cigarette Tax	\$172,361,297
Gross Insurance Premium Tax	154,910,989
Document Registration Tax	95,421,209
Charitable Gambling Tax	63,103,508
Alcoholic Beverages Tax	55,719,917
Estate Tax	41,200,601
Tax Refunds:	
Individual Tax Refunds	\$538,641,439
Property Tax Refunds	173,321,199
Sales Tax Refunds	126,819,538
Corporate Tax Refunds	91,026,335
Cambridge Bank Refunds	85,446,976
Withholding Tax Refunds	5,128,512
Local Government:	
Homestead Agriculture and Credit Aid	\$596,841,324
Local Government Aids	497,305,600
Police State Aid	49,668,053
Fire State Aid	15,457,500

Source: Minnesota's Comprehensive Annual Financial Report (CAFR) and
Minnesota Accounting and Procurement System (MAPS) Reports.

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These financial activities were material to the state's financial statements. The department's operations were financed through General Fund appropriations. However, operational activity of the department was outside the scope of this audit.

Department Auditing Functions

The Department of Revenue's various tax divisions also perform their own auditing function. In addition to conducting audits, division auditors provided education and guidance to taxpayers. Each division has its own process and set of procedures for selecting and conducting audits of taxpayers.

The division auditors conduct most of their audits in the field. Auditors verify taxpayer compliance with the filing requirements of the tax law. Based on the results of the audit, auditors may assess an additional tax liability, determine a refund is due, or refer the case to the criminal investigation unit.

Table 1-2 provides a breakdown of net additional taxes assessed by each division.

Table 1-2			
Summary of Additional Taxes Assessed			
<u>Division</u>	<u>Period</u> <u>Assessed Tax</u>	<u>Months</u> <u>in Period</u>	<u>Net Additional</u> <u>Taxes Assessed</u>
Corporate Franchise	07/07/96-06/30/97	12	\$60,722,239
Individual Income	01/01/97-09/30/97	9	4,235,067
Petroleum	01/01/97-09/30/97	9	723,840
Sales and Use	01/01/97-10/31/97	10	69,597,495
MnCare	07/01/96-06/30/97	12	10,915
Withholding	07/01/96-06/30/97	12	2,316,924
Special Taxes:			
Alcohol	10/24/94-11/04/97	36	39,709
Cigarette	01/01/96-10/31/97	22	858,261
Environment	07/07/96-06/30/97	12	5,486,563
Non Profit Corps			No Figures Available
Lawful Gambling			No Figures Available
Insurance			No Figures Available

Source: Department of Revenue's division auditors.

The division auditors refer certain activities discovered during an audit to the department's Criminal Investigations Unit. This unit investigates the matter to determine if possible criminal activity has occurred. This unit also receives information and tips from its tipline, direct calls and letters from the public, and the newspapers. According to the department, the Investigations Unit receives about 150 to 200 tips or referrals a year. Of those, about 20 are prosecuted.

Chapter 2. Income Tax

Chapter Conclusions

Individual and corporate income tax revenues collected by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded income tax revenues in the Minnesota Accounting and Procurement System (MAPS). Also, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions. However, since the department did not compare withholding tax information submitted by employers to wage detail information on file with the department, the integrity of withholding taxes remitted remains in question. Also, the department did not reconcile withholding tax information in a timely manner. Finally, the department needs to improve controls over cash receipts.

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

Revenue from income taxes reported on MAPS during fiscal year 1997 was approximately \$5.98 billion. Table 2-1 shows the income tax revenues within each tax type that we reviewed during this audit.

Table 2-1
Summary of Selected Income Tax Revenues
For the Year Ended June 30, 1997

<u>Tax Type</u>	<u>Amount</u>
Individual Income Tax Revenues:	
Withholding Tax Revenues	\$3,795,175,783
Individual Estimated Tax	890,404,094
Individual Miscellaneous Tax	555,796,665
Corporate Tax Revenues:	
Corporate Estimated Tax	578,459,277
Corporate Miscellaneous Tax	85,728,937
Corporate Extension Tax	78,875,541

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

The department assesses penalties and interest against taxpayers who do not pay their income tax liabilities and/or file tax returns by specific deadlines. The department applies receipts from a

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taxpayer as follows: first, to any late payment or late filing penalties assessed to the taxpayer; second, to any interest assessed to the taxpayer; third, to the unpaid tax; and lastly, to any other charges.

Individual Income Tax

Individual income tax revenue is due when a taxpayer's actual tax liability exceeds the amount withheld. Individuals report their tax liability on individual income tax returns due by April 15 of each year. For the 1996 tax year, the department extended the deadline to May 30, 1997, because of extensive flooding during the spring of 1997. According to department records, approximately 2.2 million individuals filed Minnesota income tax returns for 1996. Of the total returns filed, about 600,000 reported tax liabilities in excess of amounts withheld.

Table 2-2 identifies individual income tax rates for the 1996 tax year.

Table 2-2
Individual Income Tax Rates for Tax Year 1996

<u>Filing Status</u>	<u>6% Up To</u>	<u>8% Between</u>	<u>8.5% Over</u>
Married Joint	\$23,490	\$23,491-93,340	\$93,340
Married Separate	11,750	11,751-46,670	69,670
Single	16,070	16,071-52,790	52,790
Head of Household	19,780	19,781-79,500	79,500

Note: Amounts reflect taxable income.

Source: Minnesota Tax Handbook - 1996 Edition.

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 employees' wages to withhold Minnesota income tax as well. The department deposits withholding taxes into the General Fund. According to department records, approximately 130,000 employers submitted withholding taxes to the state in fiscal year 1997.

The department requires each employer to file either quarterly or annual returns. The time periods in which employers remit withholding taxes collected range from semi-weekly to annually. To be an annual filer, an employer must have an annual liability of under \$500 and be notified by the department that it qualifies. All other employers must file quarterly.

During 1997, the department significantly enhanced its withholding tax system. The system became operational in February 1997 and provided on-line edits which allowed users to resolve errors electronically instead of manually. The system compares the data submitted on quarterly reports (MW-1) to the MW-5 coupon and identifies any discrepancies requiring attention. The system has the ability to identify non-filers and taxpayers that are not in compliance with the filing requirements and to assess interest and penalties, particularly to non-EFT filers. As of October 1997, the department had sent out 10,142 letters to taxpayers not in compliance, assessed \$1,090,548 in interest and penalties, and collected \$523,745 of the assessed amount.

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Estimated tax is a prepayment tax for taxpayers whose income is not subject to withholding. Taxpayers estimate their total incomes for the year, calculate their total income tax, and pay the tax in quarterly installments due in April, June, September, and January. Taxpayers must pay at least 90 percent of their current year's tax liability or 100 percent of the previous year's tax liability in order to avoid a penalty for underpayment of estimated tax. For 1996 taxes, the penalty for underpayment of estimated tax was six percent of the amount of the underpayment. Department records indicated that approximately 194,000 individual taxpayers paid estimated income tax for 1996 taxes.

Corporate Income Tax

Corporations conducting business in Minnesota pay Minnesota corporate franchise taxes. According to department records, approximately 52,000 corporations filed Minnesota corporate income tax returns in 1996. Of the total returns filed, about 36,000 reported corporate tax liabilities.

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 are derived from business activity in Minnesota. It uses this percentage, along with its federal taxable income, to determine its taxable income in Minnesota.

Audit Objectives and Methodology

The primary objectives of our review of income tax were as follows:

- To determine if withholding, individual, and corporate income tax revenues were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997.
- To determine if the department properly recorded withholding, individual, and corporate income tax revenues on MAPS.
- To determine if the department complied, in all material respects, with applicable finance-related legal provisions.

To meet these objectives, we interviewed department employees to gain an understanding of the control structure in place over withholding, individual, and corporate income tax revenues, and how the department processed each tax type. We performed analytical procedures, including trend analysis, on each specific tax type to identify potential material misstatements. We also reviewed, on a sample basis, withholding, individual, and corporate income tax transactions. Finally, we reviewed department reconciliations, analyzed the department's cashier function, and traced tax receipts to MAPS.

Conclusions

We concluded that individual and corporate income tax revenues collected by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year

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ended June 30, 1997. The department properly recorded individual and corporate income tax revenues on MAPS. Finally, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions. However, as explained in Finding 1, the department did not compare withholding tax information submitted by employers to wage detail information on file with the department. Finding 2 discusses the department's inability to reconcile withholding tax information timely. Finally, as explained in Finding 3, the department needs to improve controls over cash receipts.

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

The department did 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. Additionally, the department requires that employers submit an annual MW-6 report that reconciles 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 enhanced its withholding tax system which allowed it to perform the reconciliations electronically and utilized more on-line edits. This change improved the department's reconciliation process. However, 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 1997. Pending completion, the department should consider additional auditing of this information.

Recommendation

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

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2. The department did not perform a critical withholding tax reconciliation for part of the year.

The department did not perform its standard reconciliation between MAPS, the general ledger, and the taxpayer accounts (TPA). The department performs this three way reconciliation to ensure that the money deposited into the state treasury was properly reflected in the state's accounting system. The department also performs the reconciliation to ensure that taxpayers' accounts are properly recorded for historical purposes. Each month, the revenue accounting unit performs this three-way reconciliation for all tax types. However, since the department implemented a new withholding tax system in February 1997, it has been unable to perform the withholding tax reconciliation in a timely manner. As of December 1997, it had reconciled the withholding tax information through March 1997. Without the reconciliation, the department has no assurance that the three systems are in balance.

Recommendation

- *The department should reconcile its withholding tax collections to MAPS, the general ledger, and taxpayer accounting on a timely basis.*

3. The department needs to improve controls over cash receipts.

The department did not adequately control certain cash receipts. The cashier received cash during the day from various taxpayers. Generally, when the receipts approached \$6,000, the cashier took the cash and corresponding tax returns to the document processing division. Within that division, one employee prepared the deposit, forwarded the returns to the processing area, and hand delivered the receipts to the bank. This procedure had the following weaknesses:

- The department did not adequately safeguard cash receipts and placed an employee at unnecessary risk. Most cash deposits were between \$4,000 and \$9,000. However, during the period of the State Fair, cash receipts exceeded \$94,000. Since the employee transported cash receipts to the bank alone, that employee was at risk of physical harm, and the cash receipts were at risk of theft.
- The department did not adequately separate duties. One employee prepared the deposit slips, had access to the cash receipts, and had access to tax returns before they were processed. The department did not perform any independent reconciliations between the cashier's records of cash receipts and cash receipts actually deposited into the bank. Without the reconciliation, undetected theft of cash receipts could occur.
- The department did not promptly deposit cash receipts. The department did not deposit the receipts until they approached \$6,000. Most cash deposits ranged from \$4,000 to \$9,000. As a result, the department deposited cash receipts between one and three days after it collected the receipts. Minn. Stat. Section 16A.275 states that all receipts exceeding \$250 must be deposited daily.

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Recommendations

- *The department should establish a procedures over cash receipt deposits to ensure the physical security of the receipts and its employees.*
- *The department should adequately segregate duties over cash receipts.*
- *The department should deposit cash receipts timely in accordance with Minn. Stat. Section 16A.275.*

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 in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department accurately recorded sales and use tax, petroleum tax, and health care access tax revenues in the Minnesota Accounting and Procurement System (MAPS). Also, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions.

Sales and consumption taxes are part of the Sales and Special Taxes System. It includes sales and use tax, petroleum tax, health care access tax, and special taxes such as taxes on tobacco, alcohol, and charitable gambling activities. Table 3-1 summarizes the actual amount of taxes collected for the specific programs audited.

Table 3-1
Summary of Selected Sales and Consumption Tax Revenues
For the Year Ended June 30, 1997

<u>Tax Type</u>	<u>Amount</u>
Sales Taxes	
General sales and use tax	\$3,155,632,950
Minneapolis city sales tax	36,805,293
St. Paul city sales tax	9,521,219
Petroleum Taxes	
Gasoline tax	\$447,750,873
Special fuel tax	95,055,356
Petroleum tank release clean-up tax	32,290,795
Health Care Access Taxes	
Provider tax	\$90,897,237
Hospital tax	38,788,428
Wholesale drug distributor tax	28,012,014
Taconite Tax (IRRRB)	\$31,782,349

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

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Sales and Use Taxes

Minnesota statutes require taxpayers to obtain sales and use tax permits and to remit the sales tax collected to the department. The state imposes a sales tax of 6.5 percent on the gross receipts of certain sales or services that occur in Minnesota. The department deposits sales taxes collected into the General Fund. During fiscal year 1997, as required by law, the department transferred \$2.5 million of sales tax revenue into the Debt Service Fund. In addition to the 6.5 percent tax amount, cities such as Minneapolis and St. Paul impose an additional 1/2 percent tax on retail sales in their jurisdictions. The department collects this amount, along with other sales tax revenue, and then transfers the full amount back to the respective city.

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 four mediums: electronic funds transfer (EFT), scanning, manual processing (remittance processing), and electronic data interchange (EDI).

Use taxes occur when a taxpayer (business or individual) purchases taxable goods or services for personal use, and the seller does not collect the sales tax. For example, the seller may fail to collect the tax or the seller may be an out-of-state seller, or the sale may be through mail order, a shopping channel, or the Internet. Taxpayers are responsible for paying use tax on their purchases. The state charges the same rate for both the sales and use tax. In 1997, the state allowed individuals to purchase up to \$770 in taxable items without owing a use tax. However, if the taxpayer purchased more than \$770 in taxable items, the taxpayer owed a use tax on all taxable items purchased that year.

Petroleum Tax

The department's 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. 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. According to department records, the state had about 650 licensed distributors and 216 special fuel dealers in fiscal year 1997. 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.

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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.

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 of Revenue collects fees for the Petroleum Tank Release Clean-Up Fund from the distributors. When the fund balance drops below \$4,000,000, the distributors are assessed a two cents per gallon fee. The distributors remit the fee to the department along with their regular monthly return and taxes. During fiscal year 1997, the department collected approximately \$38.5 million in taxes. It collected about \$12.7 million for the months of July and August on an assessment made during the prior year. It then collected about \$25.8 million from an assessment made during October through January of this fiscal year.

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 sale 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.

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 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.

Taconite Tax (IRRRB)

As part of our audit of the Department of Revenue, we reviewed the taconite tax revenue that is collected for the Iron Range Resources and Rehabilitation Board (IRRRB). Our main focus was on the Department of Revenue's role in calculating the taconite taxes. The tax calculation is

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based on information submitted by the taconite companies. Generally, the state assesses the companies a rate of \$2.094 per gross ton of merchantable iron ore concentrate produced.

The Department of Revenue then bills each company for their share of the tax. 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

The primary objectives of our review of sales and consumption taxes were as follows:

- To determine if sales and consumption tax revenues were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997.
- To determine if the department properly recorded sales and consumption tax revenues on MAPS.
- To determine if the department complied, in all material respects, with applicable finance-related legal provisions.

To meet these objectives, we interviewed department employees to gain an understanding of the control structure in place over sales and consumption tax revenues and how the department processed each tax type. We performed analytical procedures, including trend analysis, on each specific tax type to identify potential material misstatements. We also tested sales and consumption transactions, reviewed department reconciliations, analyzed the department's cashier function, and traced tax receipts to MAPS.

Conclusions

We concluded that sales and consumption tax revenues collected by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded sales and consumption tax revenues on MAPS. Finally, for the items tested, the department complied in all material respects, with applicable finance-related legal provisions.

Chapter 4. Special Taxes

Chapter Conclusions

Special tax revenues collected by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded special tax revenue in the Minnesota Accounting and Procurement System (MAPS). Also, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions.

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 Selected Special Tax Revenues
For the Year Ended June 30, 1997

<u>Tax Type</u>	<u>Amount</u>
Tobacco Taxes	
Cigarette tax	\$179,680,500
Tobacco products tax	13,292,322
Gross Insurance Premium Tax	154,910,989
Document Registration Taxes	
Mortgage registry tax	48,815,126
Deed transfer tax	46,606,083
Charitable Gambling Taxes	
Lawful gambling tax	32,392,425
Pull tab and tipboard tax	30,711,083
Alcoholic Beverage Taxes	
Intoxicating liquor tax	37,237,256
Fermented malt beverage tax	14,957,672
Wine tax	3,524,989
Estate Tax	41,200,601

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

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Cigarette and Tobacco Taxes

The department assesses cigarette and tobacco taxes separately. The cigarette tax pertains solely to cigarettes while the tobacco tax pertains to all other tobacco products. The department collects cigarette taxes from distributors by requiring them to purchase stamps. Distributors affix a stamp, which currently costs 48 cents, to each pack of cigarettes sold in Minnesota. The department allocates cigarette tax revenue among three separate funds: the General Fund, the Minnesota Future Resources Fund, and the Debt Service Fund. In fiscal year 1997, the department deposited approximately \$13 million into the Debt Service Fund in compliance with applicable legal provisions. State law also requires the department to deposit an amount, equal to approximately 2 cents per pack of cigarettes sold, into the Minnesota Future Resources Fund. This was approximately \$6.4 million in fiscal year 1997. The department deposited the remaining cigarette tax revenues into the General Fund.

The department collected tobacco tax at a rate of 35 percent on all purchases within the state. Unlike cigarette tax, the department does not use stamps to collect tobacco tax. Instead, distributors file tobacco tax returns reporting tobacco sales and the tobacco tax liability. The department deposits tobacco taxes into the General Fund.

Gross Insurance Premium Tax

All insurance companies and providers licensed in Minnesota must file a gross insurance premium tax return regardless of whether they did business in Minnesota during the tax year. According to department records, 1,670 insurance companies conducted business in Minnesota during fiscal year 1997. Of those, approximately 1,610 paid the gross insurance premium tax. Also, the department requires insurance companies and providers with a gross insurance premium tax liability of at least \$500 to pay estimated taxes. Estimated tax payments are due in April, June, and December.

The Department of Commerce licenses all insurance companies doing business in Minnesota. The Department of Revenue assesses gross insurance premium taxes on all premiums that insurance companies collect in Minnesota except for certain exempt organizations. The gross insurance premium tax rates for most taxpayers was 2 percent, although rates for small businesses were 1 or 1.26 percent. The rate for nonprofit health service plan corporations and health maintenance organizations was 1 percent. For surplus line agents, the rate was 3 percent. The department deposits most gross insurance premium taxes into the General Fund. However, the department also deposits gross insurance premium taxes collected from nonprofit health service plan corporations and health maintenance organizations into the Health Care Access Fund. It deposited approximately \$24 million into this fund during fiscal year 1997. The department also assesses a 1/2 percent tax on certain fire insurance premiums and disburses it to local fire and police departments.

Document Registration Tax

The document registration tax consists of the mortgage registry tax and the deed transfer tax. The counties collect these taxes and remit the state's portion of 97 percent to the department.

Department of Revenue

The tax base for the mortgage registry tax is principal debt secured by a mortgage of real property in the state. The lender who records or registers a mortgage of real property located in the state must pay the tax at or before the time of filing the mortgage for record or registration. The mortgage registry tax rate equaled 23 cents per \$100 of principal debt. The department deposits the tax into the General Fund.

The tax base for the deed transfer tax is the transfer of real estate by any deed, instrument, or writing. Any person who grants, assigns, transfers, or conveys real estate located in the state must pay the tax at the time of transfer. 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. The counties also collect these taxes and remit the state's portion of 97 percent to the department. The department also deposits this tax into the General Fund.

Charitable Gambling Tax

Charitable gambling allows nonprofit organizations to raise money for their organizations through various gaming events. The department assesses those organizations with a charitable gambling tax. However, organizations are exempt from the tax if they conduct charitable gambling activities less than six times per year and total prizes are under \$50,000 for the year. The department requires organizations to file monthly tax returns along with the taxes owed. The department deposits the tax into the General Fund.

The charitable gambling tax consists of the lawful gambling tax, the pull-tab and tipboard tax, and the combined receipts tax. Lawful gambling activities include bingo, raffles, and paddlewheels. The department assesses the lawful gambling tax on the gross receipts of a licensed organization from lawful gambling, less prizes actually paid out. The lawful gambling tax rate was 10 percent during fiscal year 1997.

The tax base for the pull-tab and tipboard tax is the gross of each pull-tab or tipboard deal sold by a distributor. A "deal" is defined as each separate package, or series of packages, consisting of one game of pull-tabs or tipboards. The department requires distributors to pay the tax at a rate of 2 percent. The department assesses the combined receipts tax on the gross receipts of an organization from pull-tabs and tipboards. The combined receipts tax rates were 0 percent on the first \$500,000; 2 percent on receipts between \$500,001 and \$700,000; 4 percent on receipts between \$700,001 and \$900,000; and 6 percent on receipts in excess of \$900,000.

Alcoholic Beverage Tax

The tax base for the alcoholic beverage tax is the amount of distilled spirits, beer, malt beverages, wines, and premixed alcoholic beverages manufactured or received for sale in Minnesota. The department assessed the taxes on each beverage separately as follows:

- Taxes on distilled spirits were \$5.03 per gallon or \$1.33 per liter.

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- Taxes on beer were \$2.40 per barrel with an alcohol content on 3.2 percent or less, and \$4.60 per barrel with an alcohol content greater than 3.2 percent.
- Taxes on wine were also dependent on alcohol content and ranged from \$.30 to \$3.52 per gallon or \$.08 to \$.93 per liter.
- There was also a separate one cent tax for each bottle or container of distilled spirits and wine.

Small brewers of beer receive a credit of \$4.60 per barrel on the first 25,000 barrels produced each year. If a brewer manufactured less than 100,000 barrels in the preceding year, the department considered it a small brewer. State law also exempts sacramental wine, home brewed wine or beer, alcohol sold to food processors and pharmaceutical firms, and brewery samples from the tax.

Wholesalers, distributors, and manufacturers must file monthly tax returns along with taxes owed. The department deposited the tax into the General Fund.

Estate Tax

The department assessed estate tax upon the transfer of estates, usually to a person's descendants. A taxpayer must file a tax return if the federal gross estate exceeds \$600,000. The department required taxpayers to file tax returns and taxes owed within nine months after the date of death. The taxpayers calculated their estate tax liability by multiplying the federal maximum credit for state death taxes by the proportion of Minnesota gross estate to federal gross estate. The department deposited the tax into the General Fund.

Audit Objectives and Methodology

The primary objectives of our review of special taxes were as follows:

- To determine if special tax revenues were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997.
- To determine if the department properly recorded special tax revenues on MAPS.
- To determine if the department complied, in all material respects, with applicable finance-related legal provisions.

To meet these objectives, we interviewed department employees to gain an understanding of the control structure in place over special tax revenues and how the department processed each tax type. We performed analytical procedures, including trend analysis, on each specific tax type to identify potential material misstatements. We also tested special tax transactions, reviewed department reconciliations, analyzed the department's cashier function, and traced tax receipts to MAPS.

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Conclusions

We concluded that special tax revenues collected by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded special tax revenues on MAPS. Finally, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions.

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Chapter 5. Tax Refunds

Chapter Conclusions

Tax refunds paid out by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded tax refunds in the Minnesota Accounting and Procurement System (MAPS). Also, for the items tested, the department complied, in all material respects, with finance-related legal provisions pertaining to the calculation and payment of tax refunds. However, we discovered a weakness in the department's controls that resulted in duplicate refunds to taxpayers.

Tax refunds represent money the state owes taxpayers. Except for property tax refunds, refunds represent money taxpayers paid to the state in excess of their tax liability. The department determined property tax refunds using tax tables based on taxpayers' household income and the assessed property tax amount. Table 5-1 shows the refunds paid to taxpayers, for selected tax types, during fiscal year 1997.

Table 5-1
Summary of Selected Tax Refunds
For the Year Ended June 30, 1997

<u>Refund Type</u>	<u>Refund Amount</u>
Cambridge Bank refunds	\$ 85,446,976
Property tax refunds	
Renters	88,927,456
Homeowners	79,712,994
Special	4,680,749
Individual income tax refunds	543,769,951
Sales tax refunds	126,819,538
Corporate income tax refunds	91,026,335

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

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

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Tennessee. In the Memphis Bank case, the court held unconstitutional a Tennessee tax law that 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 the financial institutions for the years 1979 through 1983.

In order to receive a refund, financial institutions (taxpayer), had to either be 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 would have to refund about \$220 million in claims. We reviewed only the payment of claims by the department. However, we did find one claim that was paid in error that resulted in a refund of approximately \$43,000. The department noted that the bank failed to file its claim within the specified time period, but was nevertheless paid a refund. We reviewed the settlement agreement which makes the settlement final. As of June 30, 1997, the department had paid out approximately \$195 million in refunds; about \$110 million in fiscal year 1996 and about \$85 million in fiscal year 1997. The state issued revenue bonds to satisfy the claims and judgments resulting from litigation.

During the refund process, with the exception of the error mentioned above, the department denied refunds to numerous banks that did not follow the required filing requirements. In response, several banks which had their claims denied, filed a lawsuit against the Commissioner of Revenue for a refund. The filed complaint identified 131 banks seeking refunds from the state. The District Court ruled the commissioner must pay the refunds. The state could be ordered to pay over \$38 million to these banks. The department is considering an appeal.

Property Tax Refunds

Homeowners and renters received property tax relief based on the relationship of property taxes on a home or rental unit to total household income. In addition, homeowners whose property taxes increased more than 12 percent over the previous year were eligible for special property tax refunds. To be eligible for a refund, a taxpayer's property tax was more than a specified percentage of household income. As a taxpayer income increases, the refund decreases. The department disbursed 1995 property tax refunds to renters after August 14, 1996, and after September 29, 1996, to homeowners. Taxpayers with household income in tax year 1995 over \$37,150 (renters) and \$63,690 (homeowners) were not eligible for property tax refunds. For tax year 1995, the maximum refund amount was \$1,060 for renters, \$450 for homeowners, and \$1,000 for special property tax refunds.

Individual, Sales, and Corporate Refunds

Regular tax refunds result when taxpayers remit amounts in excess of their tax liability. When filing a final tax return, taxpayers may request refund warrants, or they may instruct the department to apply refunds toward future tax liabilities. If the department does not disburse

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refunds to taxpayers in a timely manner, it adds interest to the refund based on criteria specific to each refund type.

In fiscal year 1997, the department implemented a new corporate tax subsystem. A programming error caused the system to miscalculate interest owed to taxpayers for corporate tax refunds. The system incorrectly calculated interest from the tax return's original due date to the refund date, instead of from 90 days after the department received the tax return to the refund date. The department did not discover the error until after it disbursed 864 corporate tax refunds. Those refunds included a total of \$397,140 in interest. The correct amount of interest the department should have paid was \$44,649. Of the overpaid interest of \$352,491, the department decided to pursue repayment from taxpayers only for those refunds with an overpayment error greater than \$100. As a result, the department billed 250 of the 864 taxpayers for \$335,662 in overpaid interest. As of the end of fieldwork, the department had collected a portion of the overpaid interest.

Audit Objectives and Methodology

The primary objectives of our review of tax refunds were as follows:

- To determine if tax refunds were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997.
- To determine if the department appropriately disbursed tax refunds and properly recorded tax refunds on MAPS.
- To determine if the department complied, in all material respects, with applicable finance-related legal provisions.

To meet these objectives, we interviewed department employees to gain an understanding of the control structure in place over tax refunds and how the department processed each tax refund. We also reviewed, on a sample basis, tax refund transactions of each refund type. Finally, we reviewed system processing and output reports, traced tax refunds to MAPS, and reviewed department reconciliations.

Conclusions

We concluded that tax refunds paid by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department appropriately disbursed tax refunds and properly recorded tax refunds on MAPS. Finally, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions. However, as explained in Finding 4, the department needs to improve controls over certain tax refunds to detect and correct duplicate refunds.

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4. The department did not establish adequate controls over tax refunds to detect certain duplicate refund transactions.

The department did not have an adequate process to review taxpayer accounts in its Taxpayer Accounting System (TPA) to identify duplicate refund transactions. We found instances where the department processed a duplicate sales tax refund of \$682 and an individual income tax refund of \$19,880 to taxpayers. In each instance, the department manually transferred refunds to other ledgers in TPA. However, the department did not cancel the refund requests in its Refund Processing Module (RPM), and RPM processed the refunds a second time. The duplicate refund transactions created debit refunds payable balances in those taxpayers' accounts in TPA. The department has the ability to generate reports listing all accounts with debit refund payable balances, but it did not regularly generate and review such reports. The department processed the duplicate sales tax refund in fiscal year 1997 and the duplicate individual income tax refund in fiscal year 1995. The department did not detect either error.

Recommendations

- *The department should establish procedures to regularly review TPA accounts with debit refunds payable balances to identify possible duplicate refunds.*
- *The department should develop a process to cancel refund requests in RPM for all manual refund transfer transactions input into TPA.*
- *The department should pursue repayment of the duplicate refunds identified.*

Chapter 6. Local Government Aid Payments

Chapter Conclusions

Local government aid payments paid out by the department were fairly presented in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded local government aid payments on the Minnesota Accounting and Procurement System (MAPS). Also, for the items tested, 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, township, 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; verifies and issues state deeds for tax forfeited property; determines annual levy limits applicable to taxing authorities; and educates and assists county auditors and treasurers on requirements and procedures for tax computation and collection.

In 1997, the Legislature passed an act for relief to counties that the Federal Emergency Management Agency (FEMA) had declared disaster areas due to flooding in the spring of 1997. FEMA declared 58 of Minnesota's 87 counties flood disaster areas. The act instructed the department to disburse the first calendar year 1997 Homestead and Agricultural Credit Aid (HACA) and Local Government Aid (LGA) payments, scheduled for payment on July 20, 1997, early. The act made the disaster area counties and all cities and townships within those counties eligible for the early payment. On May 8, 1997, the department disbursed the payments to eligible taxing jurisdictions. Those taxing jurisdictions not eligible for early payment received their aid as originally scheduled.

Table 6-1 identifies the individual programs audited and the total aid payments made during fiscal year 1997.

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Table 6-1
Summary of Local Government Aid Payments
For the Year Ended June 30, 1997

<u>Aid Type</u>	<u>Amount</u>
Homestead and Agricultural Credit Aid - Real Property (HACA) (1)	\$596,841,324
Local Government Aid (LGA) (2)	497,305,600
Police State Aid	41,428,309
Fire State Aid	15,457,500

(1) Includes early calendar year 1997 HACA payments of \$169,952,287.

(2) Includes early calendar year 1997 LGA payments of \$148,134,217.

Source: Minnesota Accounting and Procurement System (MAPS).

Homestead and Agricultural Credit Aid (HACA)

HACA provides property tax relief for unique taxing jurisdictions, such as: counties, cities, townships, school districts, and special taxing districts. The department calculates HACA for all taxing jurisdictions on a calendar year basis, based on the appropriate statutory requirements. By September 1, the department certifies to the taxing jurisdictions the appropriate HACA amounts for the following year. Taxing jurisdictions use the certifications to prepare their fiscal year budgets. State law requires the department to pay HACA to taxing jurisdictions in two equal payments; the first on July 20 and the second on December 26.

The department only calculates HACA for school districts. For fiscal year 1997, the department certified \$117,498,543 to the Department of Children, Families & Learning. The Department of Children, Families & Learning then administered those amounts.

Local Government Aid (LGA)

LGA provides property tax relief for cities and townships. The department calculates LGA for a calendar year, based on the appropriate statutory requirements. By September 1, the department certifies LGA amounts for the following year to the cities and townships. Cities and townships use the certifications to prepare their fiscal year budgets. State law requires the department to pay LGA to cities and townships in two equal payments; the first on July 20 and the second on December 26. The State Auditor has the authority to order the department to withhold LGA payments from cities or townships until they conform with financial reporting standards.

Police and Fire State Aid

Police and Fire State Aid subsidizes 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 department first determines the amount of tax revenues to distribute to police and fire departments and relief associations. It then calculates

Department of Revenue

Police and Fire State Aid for cities and townships based on the appropriate statutory requirements. The department calculates Police State Aid based on the number of months worked by police officers and the retirement obligations of the cities and townships. Fire State Aid is based on area market values and the population of the cities and townships.

State law requires the department to pay Police and Fire Aid to cities and townships by October 1. However, the State Auditor has the authority to withhold payments from cities and townships until they comply with certain rules.

Audit Objectives and Methodology

The primary objectives of our review of local government aid payments were as follows:

- To determine if the department fairly presented local government aid payments in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997.
- To determine if the department properly recorded local government aid payments on MAPS.
- To determine if the department complied, in all material respects, with applicable finance-related legal provisions pertaining to the calculation and payment of local government aids.

To meet these objectives, we interviewed department staff to gain an understanding of controls in place over local government aid payments. We performed analytical procedures on each type of local government aid payment to identify potential material misstatements. We also tested local government aid payment transactions, traced local government aid payments to MAPS, and tested compliance with applicable legal provisions.

Conclusions

We concluded that the department fairly presented local government aid payments in the state's Comprehensive Annual Financial Report for the fiscal year ended June 30, 1997. The department properly recorded local government aid payments on MAPS. Finally, for the items tested, the department complied, in all material respects, with applicable finance-related legal provisions.

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Status of Prior Audit Issues

As of November 26, 1997

The Office of the Legislative Auditor audits annually those Department of Revenue tax programs that are material to the state of Minnesota's Comprehensive Annual Financial Report.

Most Recent Audit

Legislative Audit Report 97-21, issued in April 1997, covered the fiscal year ended June 30, 1996. The audit scope included those areas material to the state of Minnesota's Comprehensive Annual Financial Report. This report contained six findings, four of which were prior audit findings previously reported to the department. Five of the six findings have been resolved. The one remaining finding is a prior audit finding and is repeated again in our current report as Finding 1. We are still concerned that the department did not adequately verify the integrity of withholding taxes remitted by employers. This finding was first reported to the department in our fiscal year ended June 30, 1992, Legislative Audit Report 93-31, issued in June 1993.

Other Audit History

Legislative Audit Report 96-21, issued in April 1996, covered the fiscal year ended June 30, 1995. The audit scope included those areas material to the state of Minnesota's Comprehensive Annual Financial Report. This report contained four audit findings, all of which were reported to the department as prior audit findings in our Legislative Audit Report 95-12, issued in April 1995.

State of Minnesota Audit Follow-Up Process
<p>The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the Metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.</p>

Department of Revenue

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February 12, 1998

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'97 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 develop procedures to verify the integrity of employer submitted withholding tax information to wage detail information.*

DOR RESPONSE

It is very costly to routinely either manually or systematically reconcile employer submitted withholding to employee W-2 information. The department will continue to be an advocate for and partner in the development of the Social Security Administration/Internal Revenue Service project to combine and provide in electronic format all W-2 information for use by state tax administrators. We will continue to seek to identify or obtain funds sufficient to allow us to perform this reconciliation to the satisfaction of the Legislative Auditor. DOR will continue to perform some audit activity in this area to better understand the extent and magnitude of the issue.

Responsible Party: Dwight Lahti, Assistant Commissioner for Income Taxes

2. The department did not perform a critical withholding tax reconciliation for part of the year.

Recommendation

- *The department should reconcile its withholding tax collections to MAPS, the general ledger, and taxpayer accounting on a timely basis.*

DOR RESPONSE

Since the implementation of the new Withholding System, in February 1997, we have been unable to perform cash reconciliations in a timely manner. Initially there were problems with the cash data in the new system including duplicates and transactions posting for incorrect amounts. There were also problems with the Payment Processing System and the new Withholding System accounting reports. We were in a very difficult position because we knew there were errors in the cash data yet we were unable to depend on our accounting reports to help us identify them.

For several months we worked with Withholding System programmers and analysts attempting to get the accounting reports working properly. We finally decided to temporarily abandon that effort. Instead we worked to develop a new reporting capability in TPA so that we could reconcile Withholding deposits directly to the data the Withholding System fed to TPA. This required time to develop, program, test and debug the new process. We were successful and began catching up on our reconciliations. As of today, we are working on October 1997. Our plan is to be current within the next 4 to 6 weeks. At that time we will go back and clear up any remaining issues with the accounting reports from the Withholding System.

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

3. The department needs to improve controls over cash receipts.

Recommendation

- *The department should establish procedures over cash receipt deposits to ensure the physical security of the receipts and its employees.*
- *The department should adequately segregate duties over the cash receipts.*
- *The department should deposit cash receipts timely in accordance with Minn. Stat. Section 16A.275.*

DOR RESPONSE

Beginning in October 1997, the department began using an armored car service to transport cash to the state's designated bank. To more adequately separate duties, the cashier now maintains control over all cash receipts. The cashier provides a cash report to Document Processing personnel, who use it to complete a bank deposit slip and enter cash information to the state's accounting system. The cashier takes the deposit slip and turns it and the cash over to the armored car personnel.

We will be evaluating the cost effectiveness of daily armored car service. If it is not cost effective to maintain daily service, we will pursue obtaining a waiver from the Department of Finance for exemption from Minn. Stat. Section 16A.275.

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

4. The department did not establish adequate controls over tax refunds to detect certain duplicate refund transactions.

Recommendation

- The department should establish procedures to regularly review TPA accounts with debit refunds payable balances to identify possible duplicate refunds.
- The department should develop a process to cancel refund requests in RPM for all manual refund transfer transactions input into TPA.
- The department should pursue repayment of the duplicate refunds identified.

DOR RESPONSE

Since the discovery of the debit refunds payable balances in TPA we have instituted a quarterly procedure to resolve refunds payable debit balances. Furthermore we intend to determine the feasibility of adding a filter (edit) to detect these errors on a daily basis.

Due to the expense involved in creating logic to automatically back out transactions from RPM in relation to the small volume (under 600 annually):

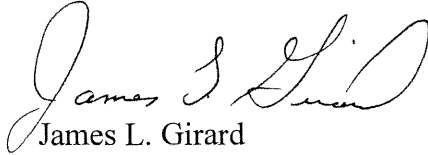
- We will use training opportunities to remind users of their responsibilities when making adjustments related to "refunds payable."
- We will also continue to correct these situations through a filter or quarterly report.

This recommendation will be evaluated for future system enhancements.

We are pursuing repayment in all situations where duplicate refunds are identified and will utilize our collection tools when necessary.

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

Sincerely,

A handwritten signature in cursive script, appearing to read "James L. Girard".

James L. Girard
Commissioner

c.c. Matthew G. Smith, Deputy Commissioner
 Dwight Lahti, Assistant Commissioner
 Don Trimble, Assistant Commissioner
 Beverley S. Driscoll, Assistant Commissioner
 John Lally, Assistant Commissioner
 Jenny Engh, Assistant Commissioner