
Department of Revenue

Programs Selected for Fiscal Year 1998 Statewide Audit

January 1999

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

99-4

SUMMARY

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Department of Revenue

Programs Selected for Fiscal Year 1998 Statewide Audit

Public Release Date: January 22, 1999

No. 99-4

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 \$10.2 billion in tax dollars during fiscal year 1998. In fiscal year 1998, the department operated under the direction of Mr. James Girard, 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, 1998. 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.

We qualified our report dated December 1, 1998, on the State of Minnesota's Comprehensive Annual Financial Report because insufficient audit evidence exists to support the State of Minnesota's disclosures with respect to the year 2000 issue. Auditing the state's year 2000 compliance efforts was not an objective of this audit. As a result, we do not provide assurance that the Department of Revenue is or will be year 2000 ready, that its year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Department of Revenue does business will be year 2000 ready.

For the areas audited, the Department of Revenue's financial activity for fiscal year 1998 was fairly presented in the State of Minnesota's Comprehensive Annual Financial Report for the year ended June 30, 1998. We remain concerned that the department is not verifying the withholding tax information obtained from employers to the wage detail information on file with the department.

The Department of Revenue agreed with the audit finding and is working towards its resolution.

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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 Polisenno, CPA, CISA	Audit Director
Dale Ogren, CPA, CISA	Senior Auditor
Scott Tjomsland, CPA	Senior Auditor
Mike Willis	Staff Auditor
April Snyder	Auditor Intern

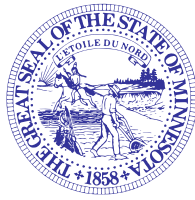
Exit Conference

The finding and recommendation in this report was discussed with the following officials of the Department of Revenue at the exit conference held on January 4, 1999:

Matthew Smith	Acting Commissioner
Dwight Lahti	Assistant Commissioner, Income Tax
Joanne Furey	Director, Withholding Tax Division
Rick Groger	Supervisor, Withholding Compliance
Stanley Radosevich	Internal Audit

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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. Matthew Smith, Acting Commissioner
Department of Revenue

We have performed certain audit procedures at the Department of Revenue as part of our audit of the financial statements of the State of Minnesota as of and for the year ended June 30, 1998. We emphasize that this has not been a comprehensive audit of the Department of Revenue.

Tables 1-1 and 1-2 identify the financial activities within the Department of Revenue that were material to the state's financial statements. We performed certain audit procedures on these Department of Revenue programs as part of our objective to obtain reasonable assurance about whether the State of Minnesota's financial statements for the year June 30, 1998, were free of material misstatements.

Table 1-1
Department of Revenue
Revenue Programs Material to the State's Financial Statements
Fiscal Year 1998
(in thousands)

	<u>Gross Revenues</u>	<u>Tax Refunds</u>	<u>Net Revenue</u>
Income Taxes:			
Withholding Taxes	\$4,165,707	\$ 8,130	\$4,157,577
Individual Taxes	1,318,100	430,238	887,862
Corporate Taxes	816,332	91,458	724,874
Sales and Consumption Taxes:			
Sales Tax	\$3,451,602	127,356	3,324,246
Petroleum Tax	608,684	Note 2	608,684
MnCare Tax (see note 1)	144,045	Note 2	144,045
Special Taxes:			
Tobacco/Cigarette Tax	\$195,273	Note 2	195,273
Gross Insurance Premium Tax	165,513	Note 2	165,513
Document Registration Tax	124,550	Note 2	124,550
Charitable Gambling Tax	65,766	Note 2	65,766

Note 1: The MnCare Tax amount only includes the hospital, provider, and wholesale drug tax categories.

Note 2: The tax refunds for these tax types were immaterial and not included in the audit scope.

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

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Table 1-2
Department of Revenue
Expenditure Programs Material to the State's Financial Statements
Fiscal Year 1998
(in thousands)

Grants:	
Property Tax Rebates	\$417,029
Property Tax Refunds	173,678
Local Government Aids:	
Homestead Agriculture and Credit Aid	\$272,767
Local Government Aids	214,142
Police State Aid	49,412
Fire State Aid	16,110
Cambridge Bank Refunds	12,407

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

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Conclusions

We issued a qualified report dated December 1, 1998, on the State of Minnesota's Comprehensive Annual Financial Report. Our report was qualified because insufficient audit evidence exists to support the State of Minnesota's disclosures with respect to the year 2000 issue. The year 2000 issue is the result of shortcomings in many electronic data-processing systems and other equipment that may adversely affect operations in the year 1999 and beyond. On January 1, 2000, information technology experts believe that many application systems may fail as a result of erroneous calculations and data integrity problems. These failures may occur if computers cannot process date information beyond December 31, 1999. The state is currently addressing year 2000 issues related to its computer systems and other electronic equipment. During fiscal year 1996, the state established the Minnesota Year 2000 Project Office to develop and monitor the overall statewide effort for executive branch agencies. The project office is tracking over 1,300 mission-critical applications owned by state agencies. As of September 1998, the project office believed that 75 percent of the applications were compliant or had completed the necessary modifications. However, because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter.

Similarly, we do not provide assurance that the Department of Revenue is or will be year 2000 ready, that its year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Department of Revenue does business will be year 2000 ready.

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In accordance with *Government Auditing Standards*, we have also issued our report, dated December 1, 1998, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. As a result of our audit procedures at the Department of Revenue, we identified the following internal control weakness:

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

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. During fiscal year 1998, the department collected approximately \$4.2 billion in withholding taxes.

The department requires each employer to file either quarterly or annual returns. 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. The time periods in which employers remit withholding taxes range from semi-weekly to annually.

During the audit, we found that 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 several years with the Internal Revenue Service and the Social Security Administration to streamline wage reporting, filing, and paying into one national database. During fiscal year 1998, the withholding section received data from the federal government to compare the withholding tax information submitted by employers to wage detail

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information. This review will enable the withholding section to identify non-filers and differences in liability amounts at both the individual and employer levels. However, not all of the information received from the federal government was in a usable format, and the department was not able to fully complete the project in fiscal year 1998. The department is continuing to work with the federal government to receive data it can use to audit its taxpayer information. Also, the department is currently working with the Departments of Finance and Economic Security to develop a plan to sample employer withholding tax information submitted to the department.

Recommendation

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

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 January 22, 1999.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen
Deputy Legislative Auditor

End of Fieldwork: November 5, 1998

Report Signed On: January 14, 1999

Status of Prior Audit Issues As of June 30, 1998

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 98-8, issued in February 1998, covered fiscal year ended June 30, 1997. The audit scope included those areas material to the State of Minnesota's Comprehensive Annual Financial Report. This report contained four findings. Three of the four findings have been resolved. The one remaining finding is a prior audit finding and is repeated again in our current report as Finding 1. Although the department did improve its withholding tax reconciliation process, we are still concerned that the department did not adequately verify the withholding taxes remitted by employers to wage detail information. 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 97-21, issued in April 1997, covered the fiscal year ended June 30, 1997. 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 as prior audit findings in our Legislative Audit Report 96-21, issued in April 1996.

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January 13, 1999

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:

This is the Department of Revenue's response to the finding of the recently completed FY'98 audit of the Department.

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

The department each year does limited comparisons of W-2 forms submitted by employers against those submitted by individuals with their income tax returns. While thousands of W-2s are reviewed each year, and assessments are made when discrepancies are found, there is no systematic verification process. The department is currently working on three efforts to improve the level of compliance with wage reporting and withholding, but none of these efforts can be completed quickly.

The department is continuing to work with the Social Security Administration and Internal Revenue Service to provide all W-2 information in electronic format for state use. While data reliability and cost have been obstacles, combined reporting has the potential to vastly improve the department's ability to verify withholding information. Discussions are continuing, but there is no set date when, or if, the project will be fully operational.

In order to provide additional information regarding the extent of compliance problems, the department has recently begun work on a project involving W-2

Mr. James Nobles
January 13, 1999
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reporting. A stratified sample of employers has been identified and the withholding returns of these businesses will be compared to the W-2s they submitted. In addition, withholding claimed on the individual income tax returns by their employers. The results of this project will also be used by the Department of Finance to help with state budget forecasting. The project is currently awaiting approval of an information sharing agreement with the Department of Economic Security and results from the project are expected later this year.

Finally, the department has begun a major effort to reengineer its individual income tax system, including withholding returns filed by employers. Three of thirteen reengineering targets are directly related to the legislative audit findings:

- Employer withholding and taxpayer estimated payment information will be reconciled to the income tax return during processing.
- All return information will be available within 14 days of receipt.
- Seventy percent of returns will be electronically filed by the Tax Year 2002.

Procedural and system changes to fully implement these goals may take several years, but the compliance value of these changes would be significant. The department will continue to seek improvements to the verification of withholding information during this reengineering process.

Sincerely,

A handwritten signature in black ink, appearing to read "Matthew G. Smith", written in a cursive style.

Matthew G. Smith
Acting Commissioner