

Letter Report

**Sales and Use Tax
Distributions**

Department of Revenue

December 2005



Legislative Audit Bureau

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Janice Mueller
State Auditor

December 22, 2005

Senator Carol A. Roessler and
Representative Suzanne Jeskewitz, Co-chairpersons
Joint Legislative Audit Committee
State Capitol
Madison, Wisconsin 53702

Dear Senator Roessler and Representative Jeskewitz:

As requested, we have performed a preliminary review of the Department of Revenue's (DOR's) administration of the sales and use taxes levied by 58 counties and 2 professional sports districts on the same goods and services that are subject to the State's 5.0 percent sales and use tax. In 2005, DOR expects to distribute more than \$306 million to the local units of government that levy these taxes.

The Integrated Tax System (ITS) DOR implemented in December 2002 is used to process sales and use taxes and to calculate the counties' and districts' shares of reported sales and use taxes. DOR has faced many challenges in implementing ITS, including an initial processing backlog, various programming errors, and incorrect calculations. In 2003 and 2005, two major adjustments were made to recoup funds from counties that had been overpaid and to distribute additional funds to those that had been underpaid. In this review, we identified a new concern related to processing certain audit adjustments and other transactions that resulted in additional overpayments.

DOR has negotiated with the vendor that developed ITS for a limited amount of service to be provided at no additional cost to the State, including further system testing that is expected to be completed by March 31, 2006. Later in 2006, after completion of a review of various system assurances that should have been, but were not, included in the original system design, the vendor is also expected to provide additional computer programming services.

To correct for the new error we identified and for other errors that have not yet been corrected, DOR calculates that 33 counties are owed a total of \$1.8 million, which it plans to pay along with sales and use tax distributions for December 2005. DOR also calculates that 25 counties and the two professional sports districts were overpaid a total of \$2.8 million. We believe it would be prudent to proceed cautiously on any overpayment collections until ITS testing is completed and confidence in the system can be assured. We recommend the Joint Legislative Audit Committee monitor efforts in this area and direct DOR to provide monthly status reports.

We appreciate the courtesy and cooperation extended to us by DOR staff during our review.

Sincerely,

A handwritten signature in cursive script that reads "Janice Mueller".

Janice Mueller
State Auditor

JM/BN/ss

Enclosure

SALES AND USE TAX DISTRIBUTIONS

In addition to the State's 5.0 percent sales and use tax:

- 58 Wisconsin counties currently impose a county sales and use tax of 0.5 percent;
- the Southeast Wisconsin Professional Baseball Park District imposes a 0.1 percent sales and use tax in Milwaukee, Ozaukee, Racine, Washington, and Waukesha counties to fund principal and interest payments related to the construction of Miller Park; and
- the Green Bay/Brown County Professional Football Stadium District imposes a 0.5 percent tax in Brown County to fund principal and interest payments related to the renovation of Lambeau Field.

Most sales and use taxes are collected from retailers by the Department of Revenue (DOR), although some are paid directly by individuals who report certain out-of-state, Internet, and catalogue purchases on their income tax returns. In addition, the Department of Transportation collects sales and use taxes on new and used vehicles that are registered in Wisconsin, and the Department of Natural Resources collects sales and use taxes on new and used boats and other recreational vehicles upon registration. These taxes—including the additional county and professional sports district taxes—are remitted to DOR along with information identifying the counties in which taxpayers reside or vehicles are registered.

DOR's Integrated Tax System (ITS) was implemented in December 2002 at a cost of \$37.1 million. The system's uses include processing collections and calculating and distributing the counties' and districts' shares of sales and use taxes each month. Because the counties and districts rely on these taxes to fund their operations or repay debt, it is important that ITS calculate and distribute them accurately and in a timely manner. However, DOR has experienced many challenges related to the implementation of ITS, and concerns have been raised regarding both the accuracy and the timeliness of sales and use tax distributions to the counties and districts.

As part of our annual audit of the State's financial statements, we performed additional procedures to review these concerns. To do so, we interviewed DOR staff with oversight responsibility for ITS, reviewed selected sales and use tax returns for five businesses that submitted the largest returns, performed limited testing of other transactions, recalculated various ITS reports, and analyzed fluctuations in sales and use tax data for selected counties and months.

As shown in Table 1, retailers file sales and use tax returns either annually, quarterly, or monthly, depending on their tax liability. As compensation for collecting these taxes and filing tax returns, they retain what is referred to as the retailer's discount, which is the greater of \$10 or 0.5 percent of all sales taxes reported and remitted in a timely manner.

Table 1

Retailer Reporting Requirements for Sales and Use Taxes

Tax Liability	Filing Frequency	Filing Requirements
Less than \$300 annually	Annually	Last day of the month following the close of the calendar or fiscal year
\$301 to \$2,400 annually	Quarterly	Last day of the month following the quarter in which taxes were collected
\$2,401 to \$14,400 annually	Monthly	Last day of the month following the month in which taxes were collected
Over \$14,400 annually	Monthly	20 th of the month following the month in which taxes were collected

DOR calculates the counties' and professional sports districts' portions of reported sales and use tax collections on or around the 15th of each month and makes distributions by the end of the month. The calculation is based on tax returns that were successfully processed through ITS and includes two deductions:

- the \$10 or 0.5 percent discount retained by retailers, which is prorated among the State, the counties, and the districts; and
- an administrative fee, which is specified in statutes as 1.75 percent of sales and use taxes reported for the counties and 1.5 percent of sales and use taxes reported for the districts and is retained by DOR to fund a portion of ITS development costs, as well as staff positions for processing and auditing the county sales and use tax, postage, printing fees, computer charges, collection fees, and bad debt expenses.

From calendar year 2003 to 2004, total distributions of county and district sales and use taxes increased 8.8 percent. As shown in Table 2, the counties' share increased 9.5 percent. However, distributions will increase less than 1 percent in 2005. Individual counties' distributions can fluctuate even more widely, as shown in Appendix 1. The largest fluctuation is for Lafayette County, where county sales and use tax distributions increased 25.6 percent from 2003 to 2004 but declined 10.5 percent from 2004 to 2005.

Table 2

**Initial Distributions of County and District Sales and Use Taxes
2003 through 2005**

	2003	2004	Change from 2003 to 2004	2005	Change from 2004 to 2005
Counties	\$237,376,249	\$259,899,227	9.5%	\$261,009,958	0.4%
Professional Football District	19,998,302	20,832,616	4.2	20,862,877	0.1
Professional Baseball District	23,371,607	24,800,296	6.1	24,867,755	0.3
Total	\$280,746,158	\$305,532,139	8.8	\$306,740,590	0.4

These fluctuations are of concern because during the same period, sales and use tax payments to the State increased at a steady rate: 3.8 percent from 2003 to 2004, and 4.0 percent from 2004 to 2005, when they totaled an estimated \$4.1 billion. For a number of reasons, including timing differences, sales and use tax payments cannot be expected to correspond directly with distributions to the counties and districts. For example:

- Distributions to counties and districts are based on information that is reported by the retailers when they file monthly, quarterly, or annual sales and use tax returns. These tax returns need to be fully processed by ITS before the counties' and districts' shares are distributed. The State may collect payment before the returns are fully processed and the counties and districts receive their shares.
- Retailer payments in one month may include delinquent taxes from prior months, as well as audit adjustments.

Furthermore, the State's collections also include interest and penalties on delinquent taxes, as well as sales and use taxes for all Wisconsin counties, including the 14 counties that do not assess additional county sales and use taxes.

Previously Identified Concerns

Even before the implementation of ITS, concerns had been raised regarding DOR's distributions of county and district sales and use taxes. For example, in report 01-10, issued in May 2001, we discussed \$13.0 million in underpayments to counties that occurred when tax returns that had been submitted in January and February 2000 were overlooked in processing. Implementation of DOR's new, integrated system was expected to end such problems. However after the implementation of ITS in December 2002, four other issues were identified.

Overpayments Based on a Processing Backlog

Because ITS included many processes and forms that were new to retailers and to DOR staff, a significant processing backlog occurred during the initial months of implementation. Retailers who were unfamiliar with the tax forms made errors. Follow-up was delayed because some DOR staff were also new to the system's operations. Although sales and use tax collections were received and deposited to the State's bank account, the information needed to calculate counties' and districts' shares was incomplete. Therefore, distributions were based on estimates from December 2002 through May 2003. Because DOR's estimates were too high, the counties and districts were overpaid by approximately \$24.6 million.

The backlog diminished as retailers and DOR staff became accustomed to the new system, and more efficient processes and procedures were developed. In summer of 2003, DOR reconciled its records and adjusted the county and district distributions to recoup \$24.6 million in overpayments.

Underpayments for Use Taxes on Out-of-State Motor Vehicle Purchases

From the time ITS was implemented until March 2004, the use taxes collected when vehicles purchased from out-of-state car dealers were registered in a Wisconsin county were erroneously excluded from calculations of the counties' and districts' shares of sales and use tax distributions. DOR staff discovered this error in April 2004, while following up on a routine inquiry from a taxpayer. A computer program was corrected, and use tax on cars purchased from out-of-state dealers is now taken into consideration when calculating sales and use tax distributions. DOR estimated that counties and districts were owed \$3.1 million for use taxes on cars purchased from out-of-state dealers between December 2002 and March 2004.

Underpayments Related to Registration and Titling System Problems

In December 2004, the Department of Transportation implemented its new Registration and Titling System. Implementation difficulties caused errors and omissions to the vehicle sales and use tax data that this system makes available to DOR. It was not until November 2005 that DOR considered the Registration and Titling System's data related to vehicle registration to be reliable. At that time, DOR reprocessed these data and determined that the counties and districts were owed an additional \$6.0 million.

Overpayments Based on Secondary Processing and Other Errors

DOR has identified various computer programming errors that have affected the counties' and districts' shares of sales and use taxes. For example, errors can occur when paper tax forms are scanned into a computer-readable format. If a processed return is later determined to have a scanning error, the error is corrected and the return is reprocessed through secondary processing programs within ITS. Upon reprocessing, various subsystems within ITS are updated, including an accounting subsystem that calculates distributions to counties and districts. However, DOR determined that the counties' and districts' shares of tax distributions were incorrect because incomplete or incorrect information was sent to the revenue accounting subsystem for

distribution. The system also incorrectly calculated county and district shares of the retailer discount, and various rounding errors occurred.

Of approximately 8.0 million transactions processed since ITS was implemented, approximately 380,000 have been identified by DOR as having secondary processing and other errors that resulted in \$4.7 million in overpayments to the counties and districts. DOR has taken steps to correct computer programming and the errors that have been identified. Staff have recently developed system assurance reports that are intended to ensure that all sales and use tax information is correctly carried forward from one processing subsystem to another, and DOR plans to hire a one-half time position to review future monthly assurance reports and investigate any variances.

New Concerns

To review previously identified concerns, we tested whether selected sales and use tax returns from the five largest businesses that submitted them were correctly processed through ITS and properly considered in distribution calculations. In addition, we tested the mathematical accuracy of DOR's Sales and Use Tax Detail Distribution Report, which lists the retailers and taxes reported for each county and district and from which the county and district distribution amounts are determined. This report is produced monthly and is available to the counties and districts at their request. While we generally found that ITS correctly processed the returns, we identified additional problems related to the calculation and reporting of the counties' and districts' shares of sales and use taxes.

Overpayments Related to Negative Sales and Use Tax Processing Problems

If audit or other adjustments have been made, it may be necessary for ITS to process negative sales and use tax entries. We found that ITS did not properly take these negative amounts into consideration when calculating the counties' and districts' shares of the taxes. For example, certain negative dollar amounts were considered positive, resulting in overpayments to counties and districts. Other errors included incorrect calculations of the counties' and districts' portions of the retailer discount, resulting in underpayments.

On November 30, 2005, we discussed these concerns with DOR staff. They subsequently identified approximately 100,000 tax returns containing negative sales and use taxes that were not properly considered in the ITS calculations, and \$4.2 million in overpayments to the counties and districts since ITS was implemented in December 2002.

Reporting Inaccuracies

We also found that the ITS Sales and Use Tax Detail Distribution Report did not total correctly. For example, the sum of November 2005 sales and use tax data reported by vendor for Milwaukee County is \$6,194,616. However, DOR reported the total as \$6,206,015, or \$11,399 more than the sum of the detail in the ITS report. DOR staff are currently investigating and testing the report.

Inadequacy of Testing

Finally, we are concerned because the processing errors identified by DOR, along with the errors we identified in our limited review, indicate that DOR and the vendor that developed ITS did not adequately test the sales and use tax distribution calculations before and during the initial implementation of ITS. We reviewed available testing documentation and found that some testing was performed, but many tests were based on simplistic assumptions and scenarios. In addition, DOR and the vendor failed to perform sufficient tests of other processing possibilities.

Recently, DOR negotiated with the vendor to provide—at no additional cost to the State—a limited amount of service related to the computer programs used in ITS. For example, the vendor is creating a variety of test transactions to ensure the system correctly calculates county and district sales and use tax distributions. This review is expected to be completed by March 31, 2006. Later in 2006, after completion of a review of various system assurances that should have been, but were not, included in the original computer design, the vendor is also expected to provide additional computer programming, which will be installed by DOR staff.

Resolution with the Counties and Districts

As noted, DOR first adjusted its distributions of county and district sales and use taxes in 2003, to correct for the \$24.6 million in overpayments that resulted from the processing backlog that arose when ITS was implemented. In July 2005, \$1.3 million was distributed to those counties that, as of April 15, 2005, had been underpaid for taxes collected on vehicles that were purchased from out-of-state dealers, and because of secondary and other processing errors.

DOR has not, however, fully adjusted distributions to those counties and districts that were overpaid sales and use taxes. Furthermore, DOR has not made adjustments for secondary processing and other errors that occurred after April 15, 2005, and for sales and use taxes collected on vehicles that were registered with the Department of Transportation since December 2004. Finally, DOR has not yet adjusted for the errors we recently identified related to negative sales and use taxes. As shown in Table 3, when all adjustments are taken into consideration and the overpayments and underpayments calculated by DOR as of December 20, 2005, are combined, counties and districts have been overpaid a net amount of \$971,678.

Table 3

Summary of Processing Errors

Description	Error Type	Amount
Out-of-State Motor Vehicle Purchases	Underpayment	\$3,119,358
Registration and Titling Systems Problems	Underpayment	6,001,385
Secondary and Other Processing Errors	Overpayment	(4,674,448)
Negative Sales and Use Tax Processing Problems	Overpayment	(4,154,403)
Subtotal		291,892
Less: Payment in July 2005 ¹		(1,263,570)
Net Overpayment		(\$ 971,678)

¹ DOR made the July 2005 payments before the negative sales and use tax processing problems were identified. Therefore, the July 2005 payments were greater than the subtotal.

However some counties were underpaid, and some counties and the two professional sports districts were overpaid. DOR calculates that 33 counties are due a total of \$1.8 million, which it indicates it intends to pay along with sales and use tax distributions for December 2005. As shown in Table 4, DOR also calculates that 25 counties and the two districts were overpaid a total of \$2.8 million. DOR's calculations of amounts owed to or by all counties and districts are shown in Appendix 2.

Table 4

Overpayments to Counties and Districts
(As of December 20, 2005)

County	Amount
Milwaukee	\$1,006,544
Dane	291,264
Portage	158,379
Sauk	140,061
Ozaukee	101,297
Marathon	62,824
Washington	48,862
Monroe	45,452
17 Other Counties that Were Overpaid	169,249
Total Overpayments to Counties	2,023,932
Southeast Wisconsin Professional Baseball Park District	364,765
Green Bay/Brown County Professional Football Stadium District	406,147
Total Overpayments	\$2,794,844

On Wednesday, December 21, DOR began the process of notifying the counties and districts of the most recently detected errors. It is currently considering options to recoup the overpayments. DOR has indicated that any recovery would be over an extended period of time. However, given the significance and unexpected nature of these changes, the affected counties and districts will likely question, dispute, and continue to lack confidence in the accuracy and reliability of DOR's sales and use tax distribution process. Therefore, we believe it would be prudent to proceed cautiously on any overpayment collections until further testing is completed by DOR and the vendor that developed ITS.

Recommendation

We recommend the Joint Legislative Audit Committee monitor the Department of Revenue's progress in producing accurate and reliable county and district sales and use tax distributions through receipt of monthly reports from the Department, beginning February 1, 2006.

Appendix 1

Sales and Use Taxes Distributed to Counties and Districts¹

County or District	2003	2004	Change from 2003 to 2004	2005 ²	Change from 2004 to 2005
Adams	\$ 892,280	\$ 982,910	10.2%	\$ 1,032,327	5.0%
Ashland	957,853	1,020,052	6.5	994,480	-2.5
Barron	3,268,915	3,456,553	5.7	3,412,122	-1.3
Bayfield	743,632	827,872	11.3	817,922	-1.2
Buffalo	513,278	571,389	11.3	537,771	-5.9
Burnett	719,296	862,015	19.8	830,979	-3.6
Chippewa	3,302,372	3,358,768	1.7	3,488,462	3.9
Columbia	3,160,318	3,385,448	7.1	3,472,069	2.6
Crawford	1,177,514	1,270,325	7.9	1,259,565	-0.8
Dane	38,364,437	41,141,077	7.2	41,340,379	0.5
Dodge	4,111,431	4,585,383	11.5	4,782,522	4.3
Door	2,748,771	2,971,221	8.1	2,968,901	-0.1
Douglas	2,572,925	2,956,289	14.9	2,764,560	-6.5
Dunn	2,079,768	2,184,646	5.0	2,212,411	1.3
Eau Claire	7,315,483	7,905,427	8.1	7,655,312	-3.2
Forest	361,195	376,941	4.4	373,790	-0.8
Grant	1,975,285	2,274,119	15.1	2,221,797	-2.3
Green	1,374,806	1,866,494	35.8	1,913,672	2.5
Green Lake	953,524	1,134,238	19.0	1,085,752	-4.3
Iowa	1,389,785	1,660,373	19.5	1,550,226	-6.6
Iron	343,691	386,778	12.5	387,661	0.2
Jackson	948,184	1,004,313	5.9	960,278	-4.4
Jefferson	4,485,478	4,773,729	6.4	4,959,324	3.9
Juneau	1,123,875	1,259,679	12.1	1,265,682	0.5
Kenosha	8,701,170	9,514,183	9.3	9,269,127	-2.6
La Crosse	8,519,245	9,311,371	9.3	9,146,798	-1.8
Lafayette	481,310	604,434	25.6	541,005	-10.5
Langlade	1,207,156	1,256,905	4.1	1,284,142	2.2
Lincoln	1,483,289	1,535,860	3.5	1,541,098	0.3
Marathon	9,759,001	10,595,278	8.6	11,061,668	4.4
Marinette	2,569,826	2,799,484	8.9	2,907,257	3.8
Marquette	646,450	687,631	6.4	705,873	2.7
Milwaukee	58,808,732	61,556,248	4.7	61,971,367	0.7
Monroe	2,220,072	2,479,972	11.7	2,512,525	1.3

County or District	2003	2004	Change from 2003 to 2004	2005 ²	Change from 2004 to 2005
Oconto	1,468,608	1,556,084	6.0	1,534,883	-1.4
Oneida	3,505,124	3,753,174	7.1	3,733,644	-0.5
Ozaukee	5,723,350	6,110,050	6.8	6,030,268	-1.3
Pepin	331,400	352,125	6.3	338,247	-3.9
Pierce	1,288,945	1,510,868	17.2	1,350,855	-10.6
Polk	2,011,543	2,248,208	11.8	2,190,035	-2.6
Portage	4,375,025	4,568,420	4.4	4,635,330	1.5
Price	779,248	834,870	7.1	815,951	-2.3
Richland	873,090	921,917	5.6	954,112	3.5
Rusk	685,629	700,100	2.1	700,031	0.0
Saint Croix	4,548,085	5,282,319	16.1	4,970,212	-5.9
Sauk	5,670,513	6,538,711	15.3	6,701,515	2.5
Sawyer	1,340,227	1,445,196	7.8	1,432,315	-0.9
Shawano	1,876,220	2,016,332	7.5	1,988,919	-1.4
Taylor	887,598	930,877	4.9	905,123	-2.8
Trempealeau	1,159,800	1,256,783	8.4	1,269,034	1.0
Vernon	1,075,641	1,162,134	8.0	1,169,672	0.6
Vilas	1,877,297	2,024,931	7.9	1,988,448	-1.8
Walworth	6,521,873	7,272,968	11.5	7,144,520	-1.8
Washburn	911,745	1,001,457	9.8	977,973	-2.3
Washington	7,467,696	8,224,669	10.1	8,358,662	1.6
Waupaca	2,790,393	2,948,215	5.7	2,976,122	0.9
Waushara	926,852	1,038,494	12.0	997,308	-4.0
Wood ³		3,642,920	0.0	4,617,955	26.8
County Total	237,376,249	259,899,227	9.5	261,009,958	0.4
Green Bay/Brown County Professional Football Stadium District	19,998,302	20,832,616	4.2	20,862,877	0.1
Southeast Wisconsin Professional Baseball Park District	23,371,607	24,800,296	6.1	24,867,755	0.3
Total	\$280,746,158	\$305,532,139	8.8	\$306,740,590	0.4

¹ The 14 counties that do not impose a county sales and use tax are Brown, Calumet, Clark, Florence, Fond du Lac, Kewaunee, Manitowoc, Menominee, Outagamie, Racine, Rock, Sheboygan, Waukesha, and Winnebago

² Excludes the July and December 2005 distributions to correct for errors.

³ Wood County first enacted a county sales and use tax on January 1, 2004.

Appendix 2

Outstanding Amounts Owed to/(from) Counties and Districts

County or District	Amount
Adams	\$ 4,605
Ashland	16,460
Barron	(11,767)
Bayfield	30,431
Buffalo	34,983
Burnett	52,916
Chippewa	(6,149)
Columbia	(28,188)
Crawford	8,232
Dane	(291,264)
Dodge	(10,871)
Door	18,917
Douglas	163,720
Dunn	3,382
Eau Claire	(19,159)
Forest	(15,352)
Grant	146,348
Green	22,829
Green Lake	(5,898)
Iowa	19,616
Iron	15,680
Jackson	(4,998)
Jefferson	(19,257)
Juneau	(19,920)
Kenosha	285,347
La Crosse	(11,734)
Lafayette	32,143
Langlade	9,288
Lincoln	350
Marathon	(62,824)
Marinette	(78)
Marquette	(2,055)
Milwaukee	(1,006,544)
Monroe	(45,452)
Oconto	1,348
Oneida	32,038
Ozaukee	(101,297)
Pepin	13,725
Pierce	151,613
Polk	116,575
Portage	(158,379)

County or District	Amount
Price	\$ (1,924)
Richland	7,371
Rusk	6,023
Saint Croix	361,643
Sauk	(140,061)
Sawyer	22,192
Shawano	14,216
Taylor	(2,002)
Trempealeau	41,756
Vernon	17,985
Vilas	21,659
Walworth	63,369
Washburn	35,933
Washington	(48,862)
Waupaca	(2,270)
Waushara	(7,627)
Wood	50,473
County Total	(200,766)
Southeast Wisconsin Professional Baseball Park District	(364,765)
Green Bay/Brown County Professional Football Stadium District	(406,147)
Total	\$(971,678)