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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

December 1, 2011

Thomas H. Mattox
Commissioner
Department of Taxation and Finance
W. A. Harriman Campus
Building 9
Albany, NY 12227

Re: 2010-S-33 – Sales Tax Audit Practices

Dear Commissioner Mattox:

According to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law, we audited the Department of Taxation and Finance's (Department) sales tax audit practices for the period April 1, 2009 through January 31, 2011.

A. Background

The Department is responsible for collecting tax revenue and providing other services in support of government operations. During the 2009-10 fiscal year, the Department collected $55.1 billion in tax revenue, including $9.9 billion from sales and use taxes. This same year, the Department increased its Audit Division resources by 182 staff to help meet both internal and external revenue goals. Seventy-one of these staff were assigned to do sales tax audits. The influx of new staff, along with increased access to third party data, has allowed the Department to expand and focus its audit and enforcement efforts. During 2009-10, the Department completed over 620,000 audits resulting in tax assessments totaling just under $4 billion. These figures include over 37,500 sales tax audits, about 30 percent of which resulted in assessments totaling over $1 billion.

In most cases when citizens make a taxable purchase, they pay sales tax to the merchant, who then periodically reports their sales to the Department and passes on the tax collected less a small administrative fee. When vendors fail to accurately and completely report their sales, they effectively divert taxes already paid by citizens for their own personal use. In pursuing sales tax collection, the Department has focused significant attention on vendors that do a large portion of their business in the form of cash transactions. Because cash transactions do not create a paper trail of cancelled checks or credit card receipts, past experience has shown there is a greater risk that these entities may not report all of their sales. When audits are conducted, Department policies require staff to base their assessments on a review of the vendor's business records. If these records are either unavailable or found to be incomplete, staff can use alternate procedures to estimate the amount of taxable sales that a vendor should have reported.

B. Audit Scope, Objectives and Methodology

We audited the Department's sales tax audit practices for the period April 1, 2009 through January 31, 2011. The objective of our audit was not to express an opinion on the validity of the audit methodologies employed by the Tax Department, which is a matter that is under the full authority and discretion of the Tax Commissioner. Rather, the objectives of our audit were:

- to determine if the Department's Audit Division has established policies and procedures to consistently guide staff in implementing its new focus on auditing sales tax returns,
- to determine if staff have been properly trained regarding how and when to use alternate methods to estimate sales tax liabilities, and
- to determine if staff routinely comply with these policies and procedures in the conduct of recent audits.

To accomplish these objectives, we met with Department staff to gain an understanding of the sales tax audit and assessment process for small businesses. We reviewed a judgmental sample of 51 sales tax audits that were done between April 1, 2009 and November 3, 2010 and which resulted in tax assessments totaling $15.8 million. We included audits done by 11 of the Department's 12 district offices and its Desk Audit Bureau, as well as audits of businesses that filed for bankruptcy at some time after a sales tax audit was conducted. We reviewed each audit to determine if it was conducted according to Department procedures and whether the businesses' own sales records were used to determine the amount of sales tax owed. Where alternative methods were used, we verified that they were properly applied and documented. We also looked to see that these decisions were evaluated and approved through evidence of supervisory review. Finally, we reviewed the Department's auditor training plans and records to ensure that audit staff had been properly instructed in applying the approved audit methodologies, and visited certain businesses to verify the Department's findings about the lack of availability of original business records.

We conducted our audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform our audits to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds and other payments. In addition, the

Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these functions do not affect our ability to conduct independent audits of program performance.

C. Results of Audit

We found the Department established policies and procedures for performing sales tax audits and using alternate methods for estimating sales tax. Policies require the use of business records unless they are either unavailable or found to be incomplete. We also found that staff had been trained in these policies and procedures, and appropriately used alternate audit methods only when necessary based on the availability of records and other circumstances of the cases.

Alternative methods were used in 35 of the 51 audit cases we sampled, in each case only after the auditors had determined that business records were either unavailable or incomplete. We found auditors either made multiple unsuccessful requests to obtain business records, or determined the records provided were either incomplete or inaccurate, before deciding to use alternate audit methods to estimate taxable sales. In addition, where alternative methods were used, we found Department auditors did not simply focus on broad industry-wide generalizations about expected business activities, but instead took steps to consider factors specific to the businesses being audited.

For example, in one case where detailed sales records were not provided, the auditor found that a business' bank statements showed routine deposits of credit card transactions, but very little in the way of cash sales. The auditor observed the operation of the business for a full day and found that cash transactions actually made up about half of the total sales, indicating that a significant amount of cash sales had likely not been recorded or deposited in the business' bank accounts. As a result, the auditor applied the observed credit card-to-cash sales ratio against the credit card deposits recorded on the bank statement to estimate total taxable sales and issued an assessment based on this analysis. Our review of case files also showed supervisors actively reviewed audit results and when appropriate made adjustments to audit conclusions. Supervisors also reviewed the appropriateness of the alternate audit methods used to ensure that the methods are appropriate and properly applied.

We also visited another merchant whose tax liability had been assessed using an alternative method and who had asserted that auditors failed to consider his own business records. We asked this merchant to show us the sales records that he believed should have been used to determine his tax liability. However, he could not provide us with any such records. We concluded the Department auditors had accurately reflected the lack of business records, which supported the use of an alternate method.

We also reviewed the Department's training program to ensure it was appropriate to keep pace with increases in the number of staff and the changing focus of their audit work. We found the training includes specific instruction on the audit risks associated with audits of cash-based businesses, as well as when and how to use alternate audit methods to estimate sales volume and tax collections. In addition, we also found the training includes specific emphasis on the following areas:

- a review of the Department's guidelines on assessing the adequacy of business records;
- case examples analyzing different types of businesses to give auditors adequate knowledge of how to assess a variety of operations;
- a review of court cases involving the Department's use of alternate audit methods to highlight their proper use; and
- a review of audits overturned by the Tax Appeals Division to prevent similar errors or misjudgments in the future.

The Department also provides staff with training designed to support specific audit initiatives, such as its bank information project. These training sessions provide procedural and technical information, as well as instruction on the use of alternate audit methods specific to the project. Through a review of the Department's training plans and class rosters, we verified that auditors completed the required training.

We provided a draft copy of this report to Department officials for their review and comment. Department officials expressed support for our conclusions. Their response is attached in its entirety at the end of this report.

Major contributors to this report include Walter Irving, Dennis Buckley, Scott Heid, Thierry Demoly, Kelly Evers Engel and Amanda Halabuda.

We wish to thank Department management and staff for the courtesies and cooperation extended to our examiners during this audit.

Sincerely,

John F. Buyce, CPA
Audit Director

cc: Thomas Lukacs, Division of the Budget
James Brunt, Department of Taxation and Finance

State of New York
Department of Taxation and Finance
W A Harriman Campus
Albany NY 12227

Thomas H. Mattox
Commissioner

October 21, 2011

Mr. John Buyce
Audit Director
Office of the State Comptroller
Division of State Government Accountability
110 State Street, 11th Floor
Albany, New York 12236-0001

Dear Mr. Buyce:

Thank you for the opportunity to comment on your draft audit report, "Sales Tax Audit Practices, (2010-S-33)."

We are pleased with your findings that the Department has established policies and procedures for performing sales tax audits and that our staff is properly trained in these policies and procedures. In addition, as noted in your report, our staff appropriately used alternate audit methods, and used them only when necessary.

We would like to thank your auditors for their thorough review of our practices and for their professionalism throughout the process.

Sincerely,

Thomas H. Mattox
Commissioner

Appendix A