

BOARD OF ESTIMATE AND TAXATION
350 South 5th Street - Room 327M
Minneapolis MN 55415-1315

Office (612) 673-2029
TTY 673-2157

INTERNAL AUDIT

Office (612) 673-2863
TTY 673-2157



May 14, 2004

The Honorable Barbara Johnson, Chair
Ways & Means Committee
City of Minneapolis
307 City Hall
Minneapolis, MN 55415

Dear Council Member Johnson:

The enclosed report, "Review of Third Party Revenue – Local Taxes", was presented to the Board of Estimate and Taxation (BET) on May 12, 2004, and is transmitted to you for your review.

Because of the inherent limitations in any system of internal accounting controls, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Mr. Bjorklund, the Internal Auditor, will be available upon notice, telephone 673-2863, to respond to your questions concerning the audit.

Sincerely,

A handwritten signature in cursive script, appearing to read "Wallace K. Swan".

Wallace K. Swan
President – Board of Estimate & Taxation

**CITY OF MINNEAPOLIS
REVIEW OF THIRD PARTY REVENUE
– LOCAL TAXES**

MARCH 2004

**INTERNAL AUDIT
CITY OF MINEAPOLIS
ROBERT BJORKLUND, DIRECTOR OF INTERNAL AUDIT**

**REVIEW OF THIRD PARTY REVENUE – LOCAL TAXES
CITY OF MINNEAPOLIS
MARCH 2004**

PURPOSE:

The purpose of this review was to analyze and assess the procedures, processes and related internal controls over the manner in which third party revenue – local taxes (i.e. sales & use tax, entertainment tax, lodging tax, liquor/food tax) are collected by the Minnesota State Department of Revenue and subsequently paid to the City of Minneapolis.

OBJECTIVE(S):

The objectives of this audit were twofold. One, to ensure that gross collections are correct; and two, to ascertain that collections are assigned to the correct jurisdiction.

SCOPE:

The scope of this review was January through June 2003. Total local tax revenue paid to the City of Minneapolis for this period was \$23,669,109 after deduction of administrative/processing expenses.

METHODOLOGY:

The methodology included discussions with City of Minneapolis, Convention Center and Minnesota Department of Revenue personnel. Additionally, Internal Audit conducted substantive testing on revenue for the months of January - June 2003.

CONCLUSIONS AND RECOMMENDATIONS:

- **Based on the tests and reconciliation's conducted, it appears that A) gross collections, as collected and compiled, are correct and B) that collections were assigned to the correct jurisdiction.**
- **We recommend that the City of Minneapolis Finance Department work with the Minnesota Department of Finance in obtaining backup documentation on an annual basis, which will support their administrative fee formula, rates/percentages compiled and administrative fees charged.**
- **We recommend the City of Minneapolis Regulatory Services Department continue working on the preparation of a master listing of those individuals/entities purchasing license's which would result in their paying local taxes. This master listing would be sent to the Minnesota Department of Revenue for subsequent matching against their taxpayer files.**

BACKGROUND:

This audit topic was reviewed and approved by both the Audit Management Committee and the Board of Estimate & Taxation.

The Minnesota Department of Revenue currently administers and collects the local taxes for ten cities and one county within Minnesota (Hermantown, Mankato, Minneapolis, New Ulm, Proctor, Rochester, St. Cloud/St. Cloud Area, St. Paul, Two Harbors, Winona, and Cook County).

The local taxes for the City of Minneapolis include the Sales & Use Tax 0.5%, Downtown Liquor Tax 3%, Lodging Tax 3%, Downtown Restaurant Tax 3% - these taxes fund the Minneapolis Convention Center and related facilities. Additionally, there is an Entertainment Tax of 3% which goes to the General Fund, however, these monies are still pledged against the convention center bonds.

REVIEW OF TAX REVENUE:

Initially, a business will acquire a sales tax identification number from the State of Minnesota's Sales Tax registration office. This process can be done in person, over the phone, or electronically via their website. Once that is accomplished, they then apply for the appropriate license(s) from the City.

On a monthly basis, each entity then files/pays their taxes to the State Department of Revenue in St. Paul. Internal Audit was told that 80% of these filings are accomplished electronically.

The State Tax Unit of the Department of Revenue processes these monthly filings and prepares a daily processing report. From there, a summary report is prepared every five to seven days (as time allows) by an Intermediate Accounting Officer within the Financial Reporting Unit of the Financial Management Division which groups the daily processing reports.

During the first week of the following month a wire transfer in the amount of \$3,500,000 is made to the City's account at Wells-Fargo Bank. This amount represents an estimate (as the City's tax revenues nearly always exceed \$3,500,000) to get a payment out, while final processing and adjustments are made. Initial notification from the State of this deposit is made to the City's Treasury Division via a fax. The State also sends along a breakdown of the amounts to the various tax categories. An Accountant II at the Convention Center prepares the cash receipt (CR) document for approval.

The amount wired is based upon tax returns the State receives for a given (preceding) month. There is no way to verify what the total on the City side should be – only that it's reasonable. All funds received go into the convention center sales tax fund, as part of the financing of the bonds and convention center operation. The entertainment tax is handled slightly differently but is still pledged against the bonds as well.

Sometime over the next one to two months a second "final" wire transfer payment is made. This represents all taxes collected less administrative fees, adjustments, and the initial \$3,500,000 estimate payment.

Internal Audit selected the six month period of January-June 2003 as the test period to confirm the revenue received and processed by the State was paid (less administrative fees) to the City of Minneapolis. Internal Audit visited the State Department of Revenue Office location in St. Paul and traced amounts from the daily processing reports (TAR91106), to the summary reports, and finally to the monthly reports. Those amounts were then compared to the dollar amount wire transferred to the City.

For that six month period, a total of \$24,041,390 was recorded as being processed and receipted in. After allowing for monthly administrative expenses and some minor adjustments (such as posting errors), Internal Audit was able to “tie out” local taxes received for this period to within approximately 1/100 (.001066) of one percent. The difference amounted to slightly more than \$25,000 to the City’s favor.

Based on the outcome of this test and reconciliation, Internal Audit feels comfortable the two objectives of this review: a) verifying gross collections are correct, and b) that collections are assigned to the correct jurisdiction, were satisfied.

REVIEW OF ADMINISTRATIVE EXPENSES CHARGED:

The State Department of Revenue charges an administrative fee for the collection, processing and administering of these local taxes. The formula used to calculate these fees is a blended-weighted rate.

As mentioned, the DOR currently collects taxes for nine cities, one county, and one local area tax (St. Cloud area). The formula used is based 1/3 on total monthly revenue (i.e. taxes collected) and 2/3 on total lines (i.e. one line per type of tax on each return). Minneapolis therefore has six lines. Of course, not all who pay these taxes are paying all six types.

For example, for the test month used (February 2003), the City of Minneapolis had \$3,644,885 collected as local tax revenue; the entire amount collected for all 11 entities was \$6,332,286. Hence, Minneapolis had approximately 57.56% of the total amount collected. Then, 57.56% (x) the 1/3 (33.33) = 19.18678%. This percentage then represents 1/3 of the total administrative percentage expense charge for that month.

Internal Audit next attempted to recalculate the remaining 2/3 portion. IA made numerous calls and requests to DOR personnel for supporting information for “lines used” for the test month, however, none of the information was ever provided. IA could only arrive at the conclusion that the DOR could not provide backup documentation to substantiate the percentages used or the amounts charged for the “lines portion” (2/3) of the administrative fees. Since the monthly administrative fees for the test period were always in the \$60,000 to \$65,000 range, this amounts to over \$40,000 monthly which could not be verified by Internal Audit.

RECOMMENDATION:

Internal Audit recommends the City Finance Department work with the State Department of Revenue in obtaining documentation, on an annual basis, which will support their formula, rates used, and the administrative fees charged.

COMPARISON OF MASTER LISTS:

On an annual basis, the State Department of Revenue furnishes the City of Minneapolis Finance Department with a master listing of all individuals/entities/etc who they collected local taxes from for the preceding year. The information, listed in a spreadsheet format, is transmitted via disc.

According to Regulatory Services personnel, some years ago, they also prepared a similar type master list. This document listed those who had purchased a license which would result in them paying local taxes. The report included the individuals revenue number (state tax identification number), etc.

During this review it became apparent that there is no way to determine if all businesses doing business in Minneapolis have a tax identification number, are paying the correct taxes or are paying taxes at all. For the most part, the City must rely on the audit division of the DOR to ensure compliance.

By resurrecting this report and sending it on to the DOR, they would be able to conduct a compare with their files, and thus serving as a crosscheck to aid in monitoring the universe we are, or perhaps are not collecting taxes from.

RECOMMENDATION:

We recommend Regulatory Services, working in conjunction with Finance, reinstate this master list report for the purpose of sending it to the DOR for subsequent cross-checking of taxpayers.

To this end, IA has met with personnel from Finance, Regulatory Services, BIS, and Licenses with additional on-going meeting(s) to follow. Additionally, we have met and will continue to be meeting with Minnesota DOR staff to ensure we are in unison as to what information we have available to report, what information the DOR would need or find useful, and what information can be used with regards to data privacy issues.