

February 20, 1997

President R. Lane Beattie
Representative Byron Harward
Senator Craig Peterson
Members of the Legislative Process Committee
State Capitol Bldg
Salt Lake City UT 84114

Subject: **Local Sales Tax Administration** (Report #94-06)

Dear Legislators:

This letter addresses the service fee that the Tax Commission charges local governments to collect and distribute local option sales tax. The Tax Commission retains 2.5 percent of local sales tax revenues to reimburse itself for the administrative costs associated with the tax. Total fee charges were \$6.6 million in fiscal year 1994, but local government officials feel actual Tax Commission costs were much less than that amount. In response to the local governments' concerns, Senate Bill 47 passed during the 1994 General Session directed the legislative auditor general to "conduct an audit of the collection services provided by the commission . . . to determine actual collection and distribution costs."

In addition to an audit of local sales tax administration, a separate request asked us to evaluate due process at the commission. That work is still in progress, and will be the subject of a subsequent report.

Any determination of local sales tax costs depends largely on how the cost of functions that simultaneously benefit both state and local governments are allocated. When the local sales tax was established in 1959, the state had already been collecting a state sales tax since 1933. A variety of functions which previous to 1959 served only a state purpose (e.g., rule making, forms processing, auditing, collections, and adjudication), subsequently served a dual state and local purpose. The costs of functions which provide a dual benefit are known as common costs and may be allocated between the state and local governments in a variety of ways. Other functions which are unnecessary to the state tax (e.g., identifying where sales occur and

distributing revenue to local entities), result in marginal costs because they

are performed only because of the local tax. Logically, local governments should pay all the Tax Commission's marginal costs. However, policy must guide who pays for common costs.

The first section of this letter provides the information needed by the Legislature to make a policy decision about the fee level. Three possible policy choices are that the fee should recover:

1. all marginal costs only,
2. all marginal costs and a proportional (to revenue) amount of common costs, or
3. all marginal costs and half of the common costs.

Local officials advocate the first of these options while Tax Commission practice conforms to the third. The reasonableness of the current fee depends on the state's cost-recovery policy. The current fee level is only justified under the third policy option, and it is excessive if either of the other two options are chosen. If the Legislature decides on a policy which reduces the fee, it also needs to address the budgetary impact of that change on the Tax Commission.

The second section of this letter discusses a problem with the distribution of local tax revenue which we discovered during our work. Because of a computer programming error, some sales tax revenue due local governments has never been distributed. The Tax Commission is now working to remedy the problem and distribute past due amounts of about \$4 million.

Legislative Policy Clarification Is Needed To Resolve Fee Dispute

Depending on how much of the common costs are allocated to local governments, the current sales tax administrative fee level may be reasonable or it may be much too high. The level of the sales tax administrative fee is disputed because of a policy disagreement about whether the fee is intended to recover common costs. If the policy issue is resolved, a study completed by the Tax Commission's Budget Section provides an adequate basis to estimate local sales tax costs. The Legislature can resolve the dispute by clarifying what costs should be recovered by the fee and, if the fee is reduced, increasing the Tax Commission's appropriation to supplant lost funding.

In addition to the local sales and use tax, five other sales-based local taxes are now

imposed. For all local taxes, the Tax Commission retains the maximum 2.5 percent of collections allowed by law. Figure I shows the fiscal year 1994 collections and distributions from state and local sales taxes.

Figure I			
Fiscal Year 1994 Revenue from Utah Sales and Use Tax Act			
TITLE	Revenue Collected	Administrative Fee Retained	Amount Distributed
State Sales and Use Tax	<u>\$976,990,504</u>	N/A	<u>\$976,990,504</u>
Local Taxes:			
Local Sales & Use	195,650,937	\$4,866,840	190,784,097
Transient Room	10,414,585	260,544	10,154,041
Resort Communities	2,674,253	67,831	2,606,422
Public Transit	41,270,484	1,040,988	40,229,496
Tourism, Rec, Cult, & Conv Facilities	15,524,964	388,487	15,136,477
Botanical, Cultural, & Zoological Orgs	0	0	0
Rural County Hospital	<u>465,229</u>	<u>11,631</u>	<u>453,598</u>
Subtotal Local Taxes	<u>266,000,452</u>	<u>6,636,321</u>	<u>259,364,131</u>
TOTAL	<u>\$1,242,990,956</u>	<u>\$6,636,321</u>	<u>\$1,236,354,635</u>

Fee Dispute Is Policy Based

Ambiguity in the **Utah Code** has allowed state and local government officials to adopt differing views about what costs should be covered by the fee. State and local officials do not agree on the meaning of the following language.

...the commission shall charge the city, town, or county for the commission's services specified in this part an amount sufficient to reimburse the commission for the cost to it in rendering the services. This charge may not exceed an amount equal to 2-1/2% of the sales or use tax imposed by the ordinance of the applicable city, town, or county (Utah Code 59-12-206)

Most of the other local taxes include language similar to that above.

Local government officials feel only marginal costs should be recouped by the fee. In requesting this audit, the Utah Advisory Council on Intergovernmental Relations (UACIR) stated that "because the state collects a state sales tax, the Tax Commission would undertake the costs of collecting, auditing, and accounting for sales tax even if there were no local option tax." Therefore, the UACIR asked "What is the marginal cost of collecting local option sales taxes?," and also "What is the actual cost of local option sales tax distribution?" Because it feels the fee exceeds marginal costs, the UACIR included the administrative fee in its study of how to reduce the impact of state mandates on local units of government.

Tax Commission staff feel local governments have little understanding or appreciation for the service they provide. Tax Commission staff emphasize that if local governments collected their own taxes, they would have to perform all the functions now performed by the commission, not just those resulting in marginal costs. Furthermore, Tax Commission staff feel that even though local sales tax collections are much less than state collections, the cost of performing work functions is the same regardless of the amount collected. Therefore, Tax Commission staff feel the administrative fee should fund half of the common costs as well as all marginal costs.

Tax Commission Study Provides Adequate Cost Estimates

In addition to resolving the policy issue about what costs the fee should cover, the sales tax administrative costs must be quantified. Because the Tax Commission does not have a cost accounting system by tax type, a special study is needed to estimate sales tax costs. The commission's Budget Section completed a sales tax cost study in December 1992. We reviewed the study and feel it provided a fair and reasonable estimate of sales tax costs. Therefore, we decided to rely on the commission's results rather than conduct a new study. Since the common costs of sales tax administration are much greater than the marginal cost due to the local tax, the importance of possible inaccuracies in the study data is minor compared to the policy issues previously discussed.

The study relied on Tax Commission staff in each division to estimate how much time was spent in four categories:

1. sales tax functions specifically due to local sales tax,
2. sales tax functions common to state and local tax,
3. all other tax type functions (e.g., income tax, gas tax, etc.), and
4. support functions not directly attributable to any tax type.

Non-personnel costs were directly assigned when possible. All costs not directly attributable to a specific tax type were allocated. Figure II shows the study's results in percentage of costs by each division in three categories.

Figure II			
Tax Commission Sales Tax Study Results			
December 1992			
Division	Local Tax Marginal Costs	State and Local Tax Common Costs	Other Tax Type Costs
Administration	5%	19%	76%
Auditing	3	40	57
Technology Mgmt	12	8	80
Operations	8	12	80
Seasonal	0	0	100
Collections	0	51	49
Property Tax	0	2	98
Motor Vehicle	1	5	94
M.V.E.D.	0	6	94

The commission applied the study's results to its \$40 million budget for fiscal year 1993. The estimated marginal cost of local sales tax collection and distribution was about \$2 million and the common cost of sales tax administration was about \$7.5 million. The remaining \$30.5 million was attributed to other tax types. Based on the study data, the Tax Commission

concluded the fiscal year 1993 cost of local sales tax administration was \$5.7 million. In contrast, under the policy position of local governments the cost would be only \$2 million.

In order to compare fiscal year 1994 administrative fee collections with costs, we applied the commission's study results to year-end expenditures. Figure III shows the commission's sales tax costs by division based on the commission's study percentages.

Figure III				
Sales Tax Costs by Division				
Tax Commission Study Percentages				
Applied to Actual Fiscal Year 1994 Expenditures				
Division	Local Tax Marginal Costs	State and Local Tax Common Costs	Other Tax Types Costs	Total Division Costs
Administration	\$345,900	\$1,227,700	\$5,027,500	\$6,601,100
Auditing	191,000	2,357,400	3,409,100	5,957,500
Technology Mgmt	1,092,700	691,500	7,401,700	9,185,900
Operations	546,500	770,600	5,170,800	6,487,900
Seasonal	0	800	794,100	794,900
Collections	0	2,514,100	2,455,600	4,969,700
Property Tax	0	61,800	3,070,300	3,132,100
Motor Vehicle	77,300	286,100	4,914,000	5,277,400
M.V.E.D.	<u>0</u>	<u>94,000</u>	<u>1,431,500</u>	<u>1,525,500</u>
TOTAL	\$2,253,400	\$8,004,000	\$33,674,600	\$43,932,000

Based on actual expenditures for fiscal year 1994, total sales tax costs were about \$10.25 million. About \$2.25 million were marginal costs due to the local tax. Another \$8 million were common costs that need to be divided between the state and local governments. In comparison, \$6.6 million of local revenue was retained as an administrative fee.

Legislative Policy Direction Is Needed

The proper fee that local governments should pay the Tax Commission to collect and distribute local sales taxes depends on a legislative policy choice of how common costs should be allocated. In addition to the positions advanced by state and local officials, a third approach, allocating common costs according to revenue, also should be considered. Based on the cost estimates shown in Figure III, this section shows the approximate fee percentage indicated by different policy alternatives and budgetary impact a fee change would have on the Tax Commission. However, any percentage fee should be periodically reviewed because costs and revenues are not directly related.

Other Allocation Methods Are Available. There are many different ways to allocate common costs. Besides the policies advocated by local and state officials, we think the Legislature should consider a policy of sharing common costs in proportion to revenue. In fiscal year 1994, 21.4 percent of sales tax revenues were local. Under the proportional sharing approach, local governments would be assigned 21.4 percent of common costs in addition to all marginal costs.

The proportional approach is appealing in those instances when management decisions are influenced by revenue amounts. For example, the Collections Division treats accounts differently depending on how much is owing. Even though a given collection action may cost the same regardless of the amount owed, a different action may be chosen depending on whether the larger state tax or smaller local tax amount were considered.

An example using the Auditing Division helps illustrate the impact of the proportional policy compared to the other two. Because cost estimates are available for each division, the impact of policy alternatives on each division can be separately analyzed. The Auditing Division examines the records of businesses responsible to pay sales and use tax. When the division discovers an underpayment, it makes an assessment of the deficiency for which additional payment is required. Actual payments are somewhat less than assessments because some amounts later may be forgiven by the commission, or defaulted by the business. Figure IV shows the impact of three policy options on the Auditing Division.

Figure IV
Comparison of Policy Options on Auditing Division
Using Fiscal Year 1994 Data

	Marginal Costs Only	Marginal Plus Proportional Common Cost	Marginal Plus Equal Sharing Common Costs
Net Assessments:*			
Local (estimated as 21.4%)	\$2.46	\$2.46	\$2.46
State (estimated as 78.6%)	<u>9.03</u>	<u>9.03</u>	<u>9.03</u>
Total	11.49	11.49	11.49
Sales Tax Audit Costs:*			
Local	\$0.19	\$0.70	\$1.37
State	<u>2.36</u>	<u>1.85</u>	<u>1.18</u>
Total	2.55	2.55	2.55
Percent Cost of Assessments:			
Local	7.7%	28.5%	55.7%
State	<u>26.1%</u>	<u>20.5%</u>	<u>13.1%</u>
Total	22.2%	22.2%	22.2%
<i>*In millions</i>			

Depending on the policy applied, the relationship between costs and assessments varies greatly. Figure IV shows that total costs are 22 percent of total assessments; however, the percentages that costs are of assessments for the state and local portions depend on the policy option. The proportional policy most nearly equalizes the percentages between local and state governments. Under the policy advocated by local officials, they reap the benefit of the entire sales tax auditing effort, but pay only marginal costs. Under current Tax Commission practice, local governments pay over half the costs of sales tax audits yet receive only about one-fifth of the net assessments. Depending on whether eventual collections are significantly less than assessments, and whether additional cost are incurred to resolve audit appeals and take collection actions, it is possible that local governments realize a net loss when common costs

are divided equally.

Fee Percentage Can Be Calculated. Once the state policy on common-cost recovery is known and sales tax costs are quantified, an appropriate fee percentage is easily calculated. Figure V relates the local revenue amounts shown in Figure I with these cost estimates shown in Figure III. The data in the two figures are comparable because they are both based on fiscal year 1994. Since we do not know what the state policy should be, we calculated a fee percentage for each of the three alternatives. The fee percentages indicated by the three policy alternatives are 0.85 percent, 1.49 percent, or 2.35 percent of local revenue.

Figure V			
Comparison of Policy Options			
Using Fiscal Year 1994 Data			
	Marginal Costs Only	Marginal Plus Proportional Common Costs	Marginal Plus Half Common Costs
Local Revenues*	\$266	\$266	\$266
Costs Assigned Local:*			
Marginal Costs	\$2.25	\$2.25	\$2.25
Common Costs	<u>0</u>	<u>1.71</u>	<u>4.00</u>
Total Costs	2.25	3.96	6.25
Total Costs As Percent of Revenue	0.85%	1.49%	2.35%
* In millions			

None of the three percentages shown is inherently better than the other two. The different percentages result from common costs being allocated differently. Common costs are incurred in completing functions necessary to collect the local tax, but that would be incurred by the state regardless to collect the state tax. Local government officials claim they should pay no common costs because they are not additional costs caused by the local tax. Even if there were no local taxes, the state would still incur all common costs in collecting the state tax. Tax Commission staff claim local governments should pay one-half (\$4 million) of common costs

because the functions completed are essential to administering the local tax. Even though the local tax is much less than the state tax, commission staff feel the workload to process a form, audit a business, or collect on an account is the same regardless of the amount. The proportional allocation assigns about one-fifth (\$1.7 million) of common costs to local governments. The proportional approach recognizes that in some instances management decisions are influenced by the amounts in question. Besides the three allocations shown in Figure V, many others could be developed. Accounting theory requires that all common costs be allocated, but does not provide a correct way to do so.

If the fee percentage is reduced, the budgetary impact on the Tax Commission must be considered. Every 0.5 percent reduction in the fee percentage represents a \$1.3 million transfer from the commission to local governments. The Tax Commission points out that regardless of the fee level, its costs remain the same. Thus, a new funding source is needed to supplant any additional amounts transferred to local governments.

Any Fee Percentage Needs Periodic Review. If the administrative fee is based on a percent of revenue collected, it should be periodically reviewed. Although both other states and Utah base administrative fee collections on revenue collected, actual expenditures are not directly linked to revenues. Therefore, a fee that is fair at one point in time may later become unfair. Both statewide economic conditions and policy decisions about tax rates may affect costs and revenues differently.

We surveyed other states and found no consensus on fee levels. We found that other states also base their fees on a percentage of collected revenue, and that Utah's fee level is within range of other states. For example, Alabama charges five percent, while Nebraska and New Mexico each charge three percent. On the other hand, Wyoming charges only one percent. In Colorado and Arizona, many large cities collect their own taxes; however, for smaller cities, the state collects local taxes for no charge. The variability in the rates charged by other states show that each state's policy is the determining factor. Regardless of how the costs are divided between state and local governments, the taxpayers of each state collectively bear the full cost of tax administration.

Changes in costs do not necessarily parallel changes in revenue. In recent years, Utah's strong economy has caused a rapid growth in sales tax revenue. Local governments officials have seen the resultant rapid increase in fees and felt that costs could not grow that fast. Such local concerns are valid, and help lead to this report. However, the opposite also may occur. The administrative fee may be reduced by a decrease in sales tax collections due to poor economic conditions. Administrative expenditures might increase even though less funding from the local fee were received.

Tax policy decisions also may affect fee amounts and costs very differently. It is noteworthy that the rate of fee collections on Utah's local sales and use tax has doubled since its inception. From 1959 to 1975, the local sales tax rate was 0.5 percent. Although the tax rate has since doubled to 1.0 percent, the administrative fee has remained at 2.5 percent of collections. Thus, the percentage of sales retained by the commission has doubled from 0.0125 percent of sales to 0.025 percent of sales. While the fee rate doubled, the local tax rate increase has little effect on on-going costs. Whenever the tax rate increases, it is appropriate to consider a corresponding reduction in the fee percentage.

In conclusion, the appropriate fee that local governments should pay for services rendered by the Tax Commission depends on the state's policy of how common costs should be shared. Accounting theory does not provide a correct way to allocate common costs. We calculated three possible fee percentages based on fiscal year 1994 data. However, because future revenue and cost changes are not directly related, the percentages shown should not be considered permanent. Therefore, the Legislature may want to round the fee percentage to the nearest 0.5 percent. While it is important to establish an equitable fee, the necessary administrative costs must still be paid by the taxpayers of the state, whether on a local or statewide basis.

Recommendations:

1. We recommend that the Legislature express its intent on how common costs should be shared between state and local governments.
2. We recommend that if the sales tax fee is reduced, an additional appropriation be provided the Tax Commission to replace lost funding.

Some Local Revenue Has Not Been Distributed

During our field work we discovered a problem with the distribution of local sales tax revenue. Although the vast majority of sales tax revenue due local governments is properly distributed, a computer programming problem has resulted in some amounts not being distributed. The problem has existed for at least several years and generally involves the failure to distribute a portion of taxpayers' payments on audits. The undistributed amounts have remained in the state's account. Tax Commission staff are now working to remedy the problem and distribute past due amounts, that total about \$4 million dollars.

In some instances the computer program that controls the distribution of local sales tax revenue has not worked as intended. The system is designed to compare amounts paid to amounts due so that amounts identified as over-payments can be withheld from distribution. Unfortunately, the distribution system does not always show the correct amount due. When the Tax Commission auditors find a business has underpaid its sales tax liability, they assess both a tax and an interest amount due. Because of the programming problem, the distribution system has not recognized the interest amount due. As a result, some audit payments have remained in the state's overpayment account rather than being distributed to the appropriate local governments.

When we inquired about the problem we learned Tax Commission staff were already aware of it. In fact, staff report that programming changes made a few years ago were able to reduce the magnitude of the problem. However, full correction of the distribution problem has been postponed because it is not prioritized as highly as other issues.

Although Small Compared to Total Distributions the Unpaid Amounts Are Significant

We conducted some limited testing to evaluate the extent of the distribution problem. Although the problem is small compared to total distributions, it is significant. On almost every audit we tested, whether it was paid years ago or recently, we found a portion of the amount received remained undistributed. In addition, we found a few instances of payments unrelated to audits not being fully distributed.

Only a small percentage of amounts due local governments have not been distributed. The effect of an amount not posting to the distribution system is that it remains in the state's account. According to Tax Commission staff the overpayment account balance is about \$20 million, of which approximately \$4 million is potentially distributable to local governments. In comparison, about \$1.24 billion was collected in sales tax in fiscal year 1994, of which \$259 million was distributed to local governments.

The distribution problem has continued for many years. For example, about \$28,000 paid in 1986 on one audit has never been distributed to the seven counties due it. Another \$37,000 due ten local governments and \$10,000 due the Utah Transit Authority from a 1990 payment has not been distributed. More recently, \$48,000 due Salt Lake City and \$13,000 due the Utah Transit Authority from a February 1994 audit payment remains in the overpayment account, although even larger amounts from the same payment were distributed. The amounts discussed here, while relatively large, are based on only three audits. Based on over 50 examples we identified, it appears that the distribution problem has existed continuously since at least 1986.

Because the problem generally involves the failure to distribute a portion of an audit payment, we reviewed the 20 largest audit assessments from fiscal year 1990. Of those audits, 18 percent of the revenue collected was not distributed. As a result, about \$150,000 in payments on these 20 audits that should have been distributed to local governments was not. We also reviewed 20 other audits, with both large and small assessments, conducted in 1992. About 18 percent of the dollars paid on those audits have not been distributed. Of the 40 audits we reviewed, 7 have not been paid in full. Of the 33 audits with full payments, only 6 were correctly distributed.

While the failure to distribute local revenue usually involves audits, that is not always the case. For example, our spot checking of payments unrelated to audits discovered six instances where amounts owed and paid were not fully distributed. Also, we found an instance where a former business' sales tax payments were not fully distributed. Although the business closed owing nearly \$400,000 in sales taxes, the account shows credit balances for some time periods. Because the distribution system tests for overpayment on a period-by-period basis, a portion of the amount paid on periods with credit balances has not been distributed. On this account, Bountiful City, where the business was located, is due about \$11,000.

Recommendations:

1. We recommend that the Tax Commission correct the programming problem with the sales tax distribution system that causes payments to remain undistributed.
2. We recommend that the Tax Commission review the overpayment account for amounts that should be distributed to local governments and transfer the appropriate amounts.

We hope this letter provides you with the information you need on this issue. A response from the Tax Commission is attached. If you have any questions or need additional information, please let me know.

Sincerely,

Wayne L. Welsh
Auditor General

WLW:RDC/lm