STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

DEPARTMENT OF REVENUE

Performance Audit Report

November 2017

Justin P. Wilson, Comptroller

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November 1, 2017

The Honorable Randy McNally
Speaker of the Senate
The Honorable Beth Harwell
Speaker of the House of Representatives
The Honorable Mike Bell, Chair
Senate Committee on Government Operations
The Honorable Jeremy Faison, Chair
House Committee on Government Operations
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable David Gerregano, Commissioner
Department of Revenue
1100 Andrew Jackson State Office Building
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a performance audit of selected programs and activities of the Department of Revenue for the period December 1, 2014, through July 31, 2017. This audit was conducted pursuant to the requirements of the Tennessee Governmental Entity Review Law, Section 4-29-111, *Tennessee Code Annotated*.

Our audit disclosed certain findings that are detailed in the Audit Conclusions section of this report. Management of the department has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

This report is intended to aid the Joint Government Operations Committee in its review to determine whether the department should be continued, restructured, or terminated.

Sincerely,

Deborah V. Loveless

Deborah V. Loveless, CPA
Director

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Division of State Audit

Department of Revenue Performance Audit November 2017

Our mission is to make government work better.

AUDIT HIGHLIGHTS

Department of Revenue's Mission

To efficiently fund public services by fostering compliance with Tennessee's tax and motor vehicle title and registration laws through education, fair enforcement, and excellent customer service.

Scheduled Termination Date:
June 30, 2018

We have audited the Department of Revenue for the period December 1, 2014, through July 31, 2017. Our audit scope included a review of internal controls and compliance with laws, regulations, policies, and procedures in the following areas:

- the department's records disposition authorization process;
- the department's audits of qualified headquarters facility tax credits and the job tax credits;
- the Vehicle Services section's reconciliation of revenue collections with license plates and decals issuance records;
- the department's requirements to distribute excise tax apportionments to local governments as required by Sections 67-4-2020 through 67-4-2022, *Tennessee Code Annotated;*
- procedures for consolidated net worth elections of franchise and excise taxpayers;
- the department's tax audit process and tax liability assessment;
- registration of state vendors as required by Section 12-3-306, *Tennessee Code Annotated*;
- information systems; and
- internal audit's review of timely deposits.

Key Conclusions

Findings

- The department has not fully assessed its public records to determine if it should create, amend, or retire records disposition authorizations (RDA); as a result, the department did not create RDAs to address new public records and improperly disposed of tax audit records without an existing RDA (page 8).

- The department's Audit Division did not provide sufficient evidence to support the approved tax credits and, in some cases, approved tax credits that did not meet the definition of qualified tangible personal property (page 16).

- As noted in the prior audit, department management did not adequately document the tax audits related to the job tax credits and ultimately could not provide evidence that the audited companies complied with state law (page 22).*

- As noted in prior audits, Vehicle Services management was unable to reconcile motor vehicle registration revenue collections to license plate and decal issuance records during most of the audit period (page 26).*

- The Department of Revenue and the Department of Finance and Administration's Strategic Technology Solutions did not provide adequate internal controls in one area (page 39).

Observations

The following topics are included in this report because of their effect on the operations of the Department of Revenue and the citizens of Tennessee: for three years, the department did not distribute funding to cities and counties in accordance with state law, which the department corrected in February 2017 (page 30); the department did not ensure that taxpayers complied with consolidated net worth election requirements in *Tennessee Code Annotated* (page 33); since the prior audit, the department took corrective action and reduced the number of unregistered state contractors to 5% (page 37); and the department risks noncompliance with timely deposits of tax collections (page 40).

* Repeated audit finding.

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Department of Revenue

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INTRODUCTION

AUDIT AUTHORITY

This performance audit of the Department of Revenue was conducted pursuant to the Tennessee Governmental Entity Review Law, *Tennessee Code Annotated,* Title 4, Chapter 29. Under Section 4-29-239, the department is scheduled to terminate June 30, 2018. The Comptroller of the Treasury is authorized under Section 4-29-111 to conduct a limited program review audit of the agency and to report to the Joint Government Operations Committee of the General Assembly. This audit is intended to aid the committee in determining whether the department should be continued, restructured, or terminated.

BACKGROUND

Created by Section 4-3-1901, *Tennessee Code Annotated*, as Tennessee's chief tax collector, the Department of Revenue collects and administers Tennessee's taxes and fees; ensures taxpayer compliance; and apportions tax revenues to the appropriate state or local entities. In addition, the department provides motor vehicle title and registration services to citizens and commercial vehicle owners and operators. The department educates and assists taxpayers through telephone hotlines, seminars, workshops, and speakers. Finally, the department performs audits to ensure the accuracy of taxpayer liabilities and seeks prosecution of tax-related fraud.

The department has a central office in downtown Nashville and regional offices in Jackson, Memphis, Knoxville, Nashville, Chattanooga, Cookeville, Johnson City, and Shelbyville. The department also has offices in Houston, Texas; Chicago, Illinois; New York City, New York; Atlanta, Georgia; Newport Beach, California; and Philadelphia, Pennsylvania, to assist taxpayers and aid in the administration of tax laws.

ORGANIZATION

Led by its Commissioner, the Department of Revenue is organized into the divisions described on the following pages. Three divisions report directly to the Commissioner, while the remaining divisions, along with the department's Legislative Liaison, Communications Director, Research Director, Policy and Development Director, and Special Projects Director, report directly to an Assistant Commissioner or the Deputy Commissioner.

The department's organizational chart is on page 4.

Divisions That Report to the Commissioner

The Chief Compliance Officer oversees special investigations, internal audit, and consulting services; safeguards confidential information; enforces taxpayer compliance; and performs internal and external investigations.

The Chief Financial Officer oversees financial control and fiscal services and ensures that taxpayer collections are reported; entered into Edison, the state's accounting system; and apportioned correctly. The Chief Financial Officer is also responsible for the department's budgetary and accounting processes. See **Appendix 1** for the department's business unit codes.

The Human Resources division is responsible for all departmental employee matters, such as hiring, disciplining, and terminating employees. The division also assists the Legal and Revenue Compliance divisions with workplace harassment cases.

Divisions That Report to an Assistant Commissioner or the Deputy Commissioner

The Taxpayer Services division serves as the department's front line for taxpayer assistance and education. This section operates six offices across the state, including the main office in Nashville. Most of the general public seeking information on the state's tax policies and statutory requirements make their initial contact with Taxpayer Services staff through the call center. [1] See **Appendix 2** for tax revenues collected by class from fiscal year 2014 through fiscal year 2016.

Total collected revenues for fiscal years 2014 through 2016 were $38 billion.

The Vehicle Services division issues titles and registrations for all new and used vehicles in the state. Working together with 95 county clerks who operate as agents of the state, the division registers more than 6 million vehicles and issues approximately 2 million new titles each year. The division is also responsible for noting and discharging liens, surrendering titles to other jurisdictions, and serving as the central repository of all vehicle records in the state.

The Processing division opens and batches all mail the department receives; scans images; and processes and deposits payments. This division also works with Taxpayer Services to complete customer registrations and provide quality assurance of returns entered in the tax system.

The Audit division provides services related to tax audits, including audit examination, refund processing, penalty waiver processing, and taxpayer discovery. The division conducts tax audits of taxpayers subject to the Tennessee tax law; encourages voluntary compliance with state tax laws; and assists in educating taxpayers regarding tax laws and filing requirements. The division also answers tax questions from the Tennessee Department of Economic and Community Development and directs policy development.

The Legal Office is responsible for the department's legal matters.

[1] See **Appendix 3** for a list of tax definitions and descriptions. In addition, a list of tax credits offered by the state is in **Appendix 4**.

The Administrative Hearing Office oversees administrative hearings involving tax matters.

The Collection Services division is charged with collecting delinquent taxes that result from taxpayers failing to remit payments timely or under-reporting taxes in relation to state tax statutes. The division's ultimate goal is voluntary compliance with the tax collection process and increased state revenues through the collection of delinquent taxes.

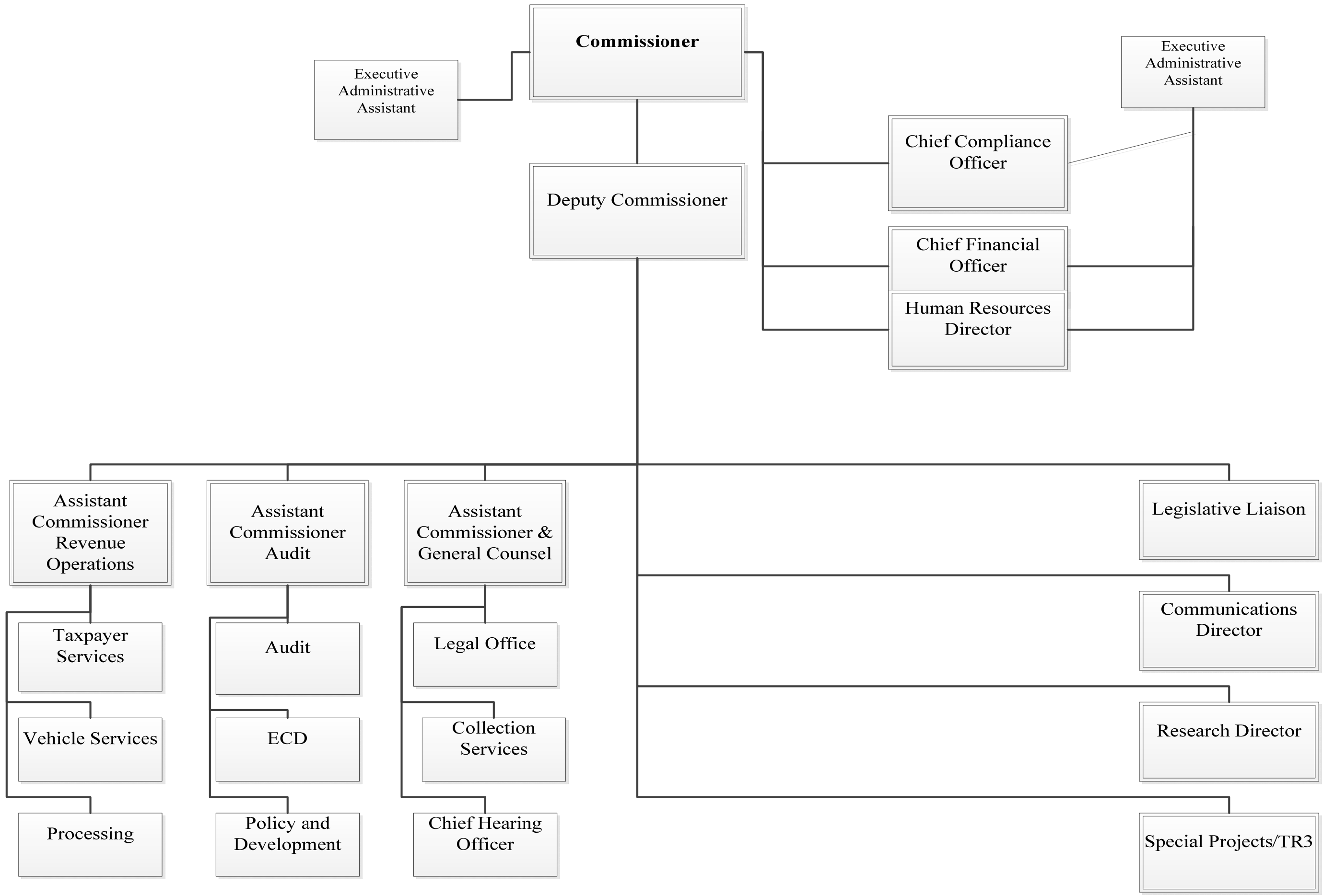
Table 1
Department of Revenue
Fiscal Year 2016 Budget and Actual Expenditures and Revenues

Department of Revenue		FY 2016 Recommended Budget*	FY 2016 Actual Expenditures and Revenues**
Expenditures	Payroll	$ 69,261,200	$ 65,578,700
	Operational	40,331,000	40,453,600
	Total	**$ 109,592,200**	**$ 106,032,300**
Revenues	State	$ 79,635,100	$ 70,536,600
	Federal	20,700	10,200
	Other	29,936,400	36,772,800
	Total	**$ 109,592,200**	**$ 107,319,600**

*Source: Tennessee State Budget, Fiscal Year 2015–2016.

**Source: Tennessee State Budget, Fiscal Year 2017– 2018 (Actual Revenues) and State Audit Information Systems (Actual Expenditures).

Department of Revenue
Organizational Chart
January 2017



ECD – Department of Economic and Community Development.
TR3 – Tennessee Revenue Registration and Reporting System.
Source: Department of Revenue management.

AUDIT SCOPE

We have audited the Department of Revenue for the period December 1, 2014, through July 31, 2017. Our audit scope included a review of internal controls and compliance with laws, regulations, policies, and procedures in the following areas:

- the department's records disposition authorization process;
- the department's audits of qualified headquarters facility tax credits and the job tax credits;
- the Vehicle Services section's reconciliation of revenue collections with license plates and decals issuance records;
- the department's requirements to distribute excise tax apportionments to local governments as required by Sections 67-4-2020 through 67-4-2022, *Tennessee Code Annotated;*
- procedures for consolidated net worth elections of franchise and excise taxpayers;
- the department's tax audit process and tax liability assessment;
- registration of state vendors as required by Section 12-3-306, *Tennessee Code Annotated*;
- information systems; and
- internal audit's review of timely deposits.

Department management is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts.

For our sample design, we used nonstatistical audit sampling, which was the most appropriate and cost-effective method for concluding on our audit objectives. Based on our professional judgment, review of authoritative sampling guidance, and careful consideration of underlying statistical concepts, we believe that nonstatistical sampling provides sufficient appropriate audit evidence to support the conclusions in our report. Although our sample results provide reasonable bases for drawing conclusions, the errors identified in these samples cannot be used to make statistically valid projections to the original populations. We present more detailed information about our methodologies in the individual report sections.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit 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.

PRIOR AUDIT FINDINGS

Section 8-4-109*, Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The prior audit report was dated October 2013. The Department of Revenue filed its report with the Comptroller of the Treasury on May 1, 2014. A follow-up of all prior audit findings was conducted as part of the current audit.

REPEATED AUDIT FINDINGS

The prior audit report included three findings that have not been completely resolved.

- Management has not resolved the following findings, which are repeated as findings in the applicable sections of this report:
  - audits of job tax credits; and
  - reconciliation of the distributions of vehicle plates and decals with revenue collected from the county clerks.
- Management has not completely resolved the following finding, which is reported as an observation in the applicable section of this report:
  - the department's failure to ensure that vendors contracting with the state registered with the department and complied with the Retailers' Sales Tax Act.

AUDIT CONCLUSIONS

RECORDS DISPOSITION AUTHORIZATIONS

The Public Records Commission is required by state law to determine and order the proper disposition of the state's public records and direct the Tennessee Department of State's Records Management Division to initiate any action necessary to establish the regulation of record holding and management in any state agency. Section 10-7-301(6), *Tennessee Code Annotated*, defines public records as

> all documents, papers, letters, maps, books, photographs, microfilms, electronic data processing files and output, films, sound recordings, or other material, regardless of physical form or characteristics made or received pursuant to law or ordinance or in connection with the transaction of official business by any governmental agency.

Public officials are legally responsible for creating and maintaining records that document government business transactions. These records provide evidence of government operations and accountability to citizens. Public officials must maintain this information according to established records disposition authorizations (RDA). According to Section 10-7-509, *Tennessee Code Annotated,*

> The disposition of all state records shall occur only through the process of an approved records disposition authorization. Records authorized for destruction shall be disposed of according to the records disposition authorization and shall not be given to any unauthorized person, transferred to another agency, political subdivision, or private or semiprivate institution.

RDAs describe the public record, retention period, and destruction method for each record type under an agency's authority. Upon destruction of a public record, an agency must submit a certificate of destruction to the Records Management Division.

In March 2013, the division developed an online application to catalog and maintain RDAs, and the Public Records Commission asked all state agencies to amend or retire RDAs that existed at that time, and create new ones for public records currently in use. The Department of Revenue had 49 RDAs to amend or retire as of March 2013. Since 2013, the department has revised or retired 25 of their existing RDAs and created one new RDA. The Records Management Division conducted a records assessment at the department's Jackson office on June 15, 2017.

Audit Results

1. **Audit Objective:** Did department management comply with the Public Records Commission's 2013 request to review all departmental RDAs?

   Conclusion: Department management did not comply with the commission's request to update all existing RDAs. Since March 2013, the department has not updated 24 of 49 existing RDAs (see **Finding 1**).

2. **Audit Objective:** Did department management ensure that the department's public records were covered by an RDA?

   Conclusion: Department management did not ensure that the department's public records were covered by an RDA. Specifically, the department did not create RDAs for public records related to the qualified headquarters facility tax credit or the job tax credit (see **Finding 1**).

3. **Audit Objective:** Did department management ensure compliance with the state's public record laws?

   Conclusion: Department management did not comply with public record laws. We found that management disposed of tax credit audit records that were not covered by an RDA (see **Finding 1**).

Methodology To Achieve Objectives

To achieve our objectives, we obtained an understanding of the state's process for creating and updating RDAs from the Records Management Division. We obtained and reviewed

- *Records Management Best Practices and Procedures*, issued by the Secretary of State;
- applicable public records statutes;
- the list of the department's RDAs; and
- the Records Management Division's June 2017 public records assessment at the department's Jackson office.

We interviewed the department's former and current Public Records Officers to discuss the department's efforts to review its RDAs to ensure that its public records have corresponding RDAs. From the list of the department's RDAs, we performed an analysis to determine if the RDAs were current.

Finding 1 – The department has not fully assessed its public records to determine if it should create, amend, or retire records disposition authorizations (RDA); as a result, the department did not create RDAs to address new public records and improperly disposed of tax audit records without an existing RDA

During our review of the Department of Revenue's process for managing its public records, we determined that, as of June 21, 2017, the department had not reviewed and updated 24 of 49 RDAs (49%). These 49 RDAs were created by the department and approved by the Public Records Commission from September 22, 1972, to December 25, 2012. We also found that the department did not create new RDAs to govern all public records in use and destroyed public records without an approved RDA.

Job Tax Credit and Qualified Headquarters Facility Tax Credit Documentation

In our review of the department's tax audit process for job tax credits and qualified headquarters facility tax credits, we requested the Audit Division's supporting documentation for the audit conclusions to ensure the conclusions were adequately documented and complied with applicable requirements. While tax audit staff maintained an electronic file for the tax audits we reviewed, for 11 of 54 tax audits (job tax credit and headquarters tax credit audits) tested (20%), audit staff did not maintain sufficient evidence in those electronic audit files for us to determine whether the audit conclusions were appropriate. See **Finding 2** on page 16 and **Finding 3** on page 22.

When we inquired about the audit documentation for job tax credits, the Audit Director stated that there was "no specific authority or guidance that requires an auditor to retain a copy of every document they review." Additionally, necessary audit supporting documentation may have been destroyed at audit management's encouragement during the Audit Division's transition from paper to electronic working papers as a way to "maintain reasonable file sizes."

We also inquired about headquarters tax credit audits, and division management was unaware of any RDA that covered these records.

Public Records Assessment Recommendations

According to the department's former and current Public Records Officers, they did not have a complete understanding of the department's business processes and the public records the department used or generated. Because the department had not updated many of its RDAs for decades, the department had new public records that were not governed by an RDA, while previously identified public records and the associated RDAs were obsolete.

In the June 2017 public records assessment of the department's Jackson office, the Department of State's Records Management Division found that office personnel were unaware that the records created and maintained in the Jackson office were governed by departmental RDAs. As a result, the department was only retaining records for four years before destroying them, rather than the currently recommended five-year retention period. We also found that the Jackson office did not follow proper records disposition protocols by submitting the required certificates of destruction upon destruction of the records. When we requested the certificates of destruction for the Jackson office, neither the department's Public Records Officers nor the Records Management Division could provide the certificates.

The assessment also recommended the following:

- The department should create new RDAs and update current RDAs to ensure proper retention and disposition of its electronic records, especially with the transition to new information systems.
- The department's Public Records Officer should routinely be in contact with divisional liaisons and should ensure that divisions know which RDAs apply to which records.
- The Public Records Officer should develop training for the department so that field offices are familiar with proper recordkeeping practices.

Given the problems identified during our fieldwork, we also reviewed the department's 2016 risk assessment and determined that management had not identified the risk that the department was not properly following the RDA process. Because management did not identify this risk, the department did not implement internal controls to adequately protect its public records.

Public records ensure a state agency's official business is fair and transparent. The department's leadership role is to clearly communicate to directors and staff of each division the importance of establishing and implementing processes that affect its public records. Failure to create, maintain, and retain public records through an RDA resulted in the department prematurely and unlawfully destroying public records and ultimately prevented management from providing evidence of proper internal controls over tax audit documentation.

Recommendation

The Commissioner should ensure that staff follow all established public records requirements, that all departmental public records have RDAs approved by the Public Records Commission, and that certificates of destruction are submitted to the Records Management Division upon public records' destruction. The Revenue Processing Manager should work with the Public Records Commission to ensure the commission approves all departmental RDAs.

The Commissioner should work with staff to assess all significant risks, including the risks noted in this finding, in the department's documented risk assessment. Management should also implement internal control processes to ensure compliance with applicable requirements; assign employees to be responsible for ongoing monitoring of the risks and any mitigating controls; and take corrective action if deficiencies occur. In addition, management should update the risk assessment when internal controls are added or altered.

Managements' Comments

Department of Revenue

We concur. The department has not completed its assessment of all public records, and employees are not sufficiently aware of the required records disposition protocols.

Of the RDAs referenced in the audit report as still pending:

- All have been reviewed.
- The department submitted 11 revised RDAs to the Records Management Division. For each of these RDAs, the Records Management Division recommended adding additional information and/or technical specifications. The department is working to further revise these RDAs accordingly.
- The department has revised an additional five RDAs, which will be submitted to the Records Management Division as soon as possible.
- The department has been working with the Records Management Division on an RDA for the new integrated tax system. The remaining nine RDAs will be retired either into the new tax system RDA after it is finalized or into another RDA that is undergoing revision.

The department will complete these pending RDAs and submit them for consideration to the Public Records Commission as soon as possible.

Most recently, the department has taken additional steps to improve its administration of RDAs by replacing its Records Custodian with a management level employee and scheduling record retention training for employees.

With respect to the qualified headquarters facility credit and job tax credit in particular, the department retained detailed tax audit working papers for all qualified headquarters facility credit and job tax credit audits that were examined in the report.

With respect to the qualified headquarters facility credit, auditors often reviewed records, including invoices, on site at taxpayer locations. In such instances, the auditors created detailed schedules of the information contained on the invoices. The schedules became part of the tax audit working papers file. The department did not obtain copies of the invoices in such instances because the detailed schedules constituted the documentation of the allowable credit.

In cases where the auditor obtained copies of invoices, the auditor scheduled these invoices as well. These schedules also became part of the tax audit working papers file. The department considered invoices that did not comprise part of the tax audit working papers files to come under RDA SW16, and disposed of those records in accordance with RDA SW16.

In the case of the job tax credit, certain employment-related information was sometimes reviewed at the taxpayer's location. Other times, copies of a document were obtained but not retained after the completion of the audit. In both instances, the substance of the reviewed documents and how they were used to verify qualification was described in the audit summary report or other documents included in the tax audit working papers file. When documents were not included in the tax audit working papers, the department considered such documents to come under RDA SW16, and disposed of those records in accordance with RDA SW16.

The department will continue to work with the Records Management Division to complete all pending RDAs. Additionally, the department will consult with the Records Management Division about creating a new RDA to address the retention period for invoices and other temporary department work papers.

Department of State

We concur with the Comptroller of the Treasury's Audit Finding # 1 for the Department of Revenue. The Division of Records Management is continuing to work with the Department of Revenue to improve their business practices regarding records. In calendar year 2017 Records Management and the Department of Revenue have worked together in the following areas:

1. The Records Management Division conducted a Records Basics training class for the agency divisional liaisons in January. The purpose of the class was to familiarize the division liaisons with public records law and increase communication with the agency records officer. Records Management worked with the agency records officer to revise their Records Disposition Authorizations (RDAs) and prepare for records assessments.
2. The Records Management Division conducted records assessments of regional offices and the central office between June and August. We provided feedback to agency on how records are being stored, retention periods, and staff knowledge of records requirements. Department of Revenue staff reviewed the recommendations.
3. The Department of Revenue formed a records committee in July to prioritize the revision of their RDAs and look at other issues raised during the assessments.

4. The Department of Revenue Assistant Commissioner and General Counsel met with Records Management Division in August to plan strategies to improve the agency records program.
5. The Department of Revenue named a new records officer in September. This person will be able to devote more time to agency records issues than their predecessors.
6. The Department of Revenue began meeting with divisional directors and records liaisons to review specific RDAs, records storage, paper to digital conversion, and other records management issues. These meetings began in September and are continuing. Records Management Division personnel are attending these meetings to assist in answering questions and planning best practices.
7. The Department of Revenue is planning a training class for agency personnel once the divisional meetings are completed. The meeting will be conducted by Records Management, with direction from Department of Revenue personnel based on the feedback from the divisional meetings. The planning for this training began in August.
8. The Department of Revenue is actively working with the Records Management Division to revise their RDAs. The goal is to have most ready for the next Public Records Commission meeting in 2018.

Records Management will cooperate with the Department of Revenue in assessing the risks outlined in the audit finding and implementing practices to prevent future occurrences. We appreciate the work of the Comptroller's Office. Records Management will continue to work with the Division of State Audit to improve the performance of state agencies in the maintenance and final disposition of their records.

QUALIFIED HEADQUARTERS FACILITY TAX CREDITS

To encourage companies to locate and expand their corporate headquarters in Tennessee, the state offers a sales and use tax credit, known as the qualified headquarters facility tax credit. According to Section 67-6-224, *Tennessee Code Annotated*, a qualified headquarters facility is a facility in the state that houses the international, national, or regional headquarters of a taxpayer. To qualify, headquarters employees must be located and employed, and primary headquarters-related functions and services must be performed, in Tennessee. Pursuant to Section 67-6-224(a), *Tennessee Code Annotated,* to be eligible for the headquarters tax credit, a company must make a minimum capital investment of $10,000,000; create 100 new full-time jobs within an investment period of no more than 6 years; and occupy the headquarters facility for 10 years after the investment period. The company can satisfy its capital investment requirement through the purchase of a building or buildings, whether newly constructed, expanded, or remodeled. The qualifying company receives a tax credit based on its paid sales and use taxes on *qualified tangible personal property,* such as building materials, machinery, equipment, furniture, and fixtures purchased or leased for the headquarters facility, when the sales and use taxes are paid during the *investment period* (one year prior through one year after constructing, expanding, or remodeling the facility).[2] Pursuant to Section 67-4-224, the company receives credit for the 6.5% sales and use taxes paid on qualified personal tangible property.

Section 67-6-224, *Tennessee Code Annotated*, requires the Department of Revenue to review and approve the headquarters tax credits. Companies seeking the credit must submit to the department an application and business plan describing, at a minimum, the capital investment to be made, the number of full-time jobs to be created, and a description of the jobs.

Qualified Headquarters Facility Tax Credit Audit Procedures

Once the department receives a company's application and business plan, the department's Audit Division staff review the materials to ensure the company is eligible to receive the headquarters tax credit. If approved, the department sends the company a letter tentatively approving it to take the credit for sales and use tax paid on items purchased or leased on qualified tangible personal property during the investment period.

A company may request to modify the terms of its tax credit (for example, the method for calculating the credit or the procedures used to resolve disputes related to the credit) by asking to enter into a management compliance agreement with the department. The Commissioner of the department has the sole discretion to approve the company's request for this agreement.

The Audit Division provides companies wishing to make claims for the credit with an Excel template and a "Do/Do Not Qualify" list. The template includes information such as invoice numbers, vendor names, descriptions of materials purchased, invoice amounts, Tennessee state taxes paid, and Tennessee state tax credits requested. The company requesting the credit completes the Excel template and submits it, along with copies of the invoices, to the Audit Division. When a company submits the spreadsheet with its claim for the headquarters tax credit, Audit Division staff then review the claim to ensure the taxpayer is eligible to receive the credit. Depending on the number of invoices the company submits, audit staff may not perform a complete review of all invoices that the company submits to earn the tax credit. Rather, they sample the invoice population and then project the sample outcome, which means there is always a risk that the company will get a credit it has not earned. The tax auditor reviews the documentation through either a desk or field review, as described below:

1. Desk Review – A tax auditor requests all documentation from the company remotely and reviews the documentation at his or her assigned workspace. The tax auditor verifies that the items listed on the invoice meet the definition of qualified tangible personal property.
2. Field Review – At least one tax auditor (and often many auditors) moves into the taxpayer's location and performs an on-site walkthrough at the headquarters facility to verify the items on the invoices are located at the facility and meet the definition of qualified tangible personal property.

[2] "Qualified tangible personal property" and "investment period" are defined in Section 67-6-224(b), *Tennessee Code Annotated.*

If the tax auditor reviews all invoices that support the claim, the tax auditor determines the credit amount based on the invoice items that meet the definition of qualified tangible personal property. If the tax auditor reviews a sample of invoices, the division's Data Support team uses a statistical software program to project the sampled amounts to the total credit to determine if the credit amount is reasonable.

Once the invoices are reviewed and the qualified tangible personal property amount has been determined, the tax auditor sends a memo with a proposed credit approval to the tax auditor's supervisor; manager; and eventually to the Assistant Commissioner over Audit Operations, who approves and sends the memo to the Audit Processing Unit. The Audit Processing Unit enters the credit into the Tennessee Revenue, Registration, and Reporting system and sends an approval notification to the company. The company may then begin to use the credit as a reduction for future sales and use tax returns.

Post-Investment Period

Once a company has completed its investment period, the Audit Division requests documentation to show the company has met the jobs and capital investment requirements. If the division determines that the company did not meet the requirements during the investment period, the division assesses a taxable liability on the company for any credits used. The division can also assess a tax liability on the company for any credits used if the company does not occupy the headquarters facility for 10 years after the end of the investment period. While many companies have met the job and capital investment requirements for the headquarters tax credit during their investment period, none have reached the 10-year occupancy period. The first company is set to meet this 10-year occupancy requirement on June 30, 2018.

Audit Results

1. Audit Objective: Did the department approve companies' applications and business plans for the qualified headquarters facility tax credit and issue approval letters in accordance with Section 67-6-224, *Tennessee Code Annotated*?

Conclusion: Based on testwork performed, the department approved companies' applications and business plans for the headquarters tax credit and issued approval letters in accordance with Section 67-6-224, *Tennessee Code Annotated*.

2. Audit Objective: Did the department verify that companies' claims for the headquarters tax credit were supported by invoices for qualified tangible personal property?

Conclusion: Based on testwork performed, the department approved $5,990,576 in headquarters tax credits during the audit period; however, because the department's process did not include making copies of supporting invoices and because the department could not provide evidence of sufficient supervisory review of qualifying invoices, we could not determine that 1,606,355 of the total credits were properly approved. Specifically, the department could not provide evidence of the supervisory review to support three approved headquarters tax credits for three taxpayers. Also, while the department provided invoices for the remaining seven companies, in some cases we still could not determine that the companies had fully earned the tax credits (see **Finding 2**).

3. **Audit Objective:** Did the department record the approved headquarters tax credit in the department's tax system?

Conclusion: Based on testwork performed, the department appropriately recorded each company's approved headquarters tax credit in the Tennessee Registration, Revenue, and Reporting system.

Methodology To Achieve Objectives

To meet the objectives, we interviewed the Assistant Commissioner over Audit Operations, the Assistant Director of the Audit Division, and the Tax Audit Manager to gain an understanding of the division's procedures for approving headquarters tax credits.

To test our objectives, we obtained a list and tested all 22 qualified headquarters facility tax credit audits, involving 10 companies, for which the department approved $5,990,576 in applicable tax credits during the period December 1, 2014, through April 7, 2017. We obtained and reviewed the companies' applications and business plans, tentative approval letters, approval claim spreadsheets, sampling memoranda, and management compliance agreements for each tax credit, if applicable. We also requested from the department the companies' invoices that the department had audited in order to approve the companies' tax credits. If the department reviewed a sample of invoices to approve the company's tax credit, we reviewed the same sampled invoices during our testwork.

For the approved company credits, we determined whether the company had an approved business plan and application on file; whether the approved credits were sufficiently supported by invoices; whether invoiced items met the definition of qualified tangible personal property; and whether the department had recorded the tax credits in the department's tax system.

From the list, we identified that as of July 24, 2017, 2 of the 10 companies have met their 6-year investment period requirement, while the remaining 8 companies are still within their capital investment period.

Finding 2 – The department's Audit Division did not provide sufficient evidence to support the approved tax credits and, in some cases, approved tax credits that did not meet the definition of qualified tangible personal property

Invoice Documentation Not Retained To Support the Claim For Tax Credit

Based on our review of all 22 qualified headquarters facility tax credits that the Department of Revenue approved during the audit period, we found that for 3 credits (14%), totaling approximately $1,605,143 for 3 companies, the Audit Division could not provide evidence of sufficient supervisory review of the companies' qualifying invoices to support the tax auditors' decisions to approve the tax credits. The Assistant to the Assistant Commissioner of Audit Operations stated that tax auditors adequately reviewed and approved the invoices supporting the credits but did not retain the invoices to support the companies' eligibility. According to management, the tax auditors were not required to keep the supporting invoices, and, in some cases, management may have actually destroyed the invoices. Because the invoices serve as supporting evidence of the department's approval of tax credits—and as such are official public records—the department violated the state's public records requirements. As noted in **Finding 1** on page 8, management is responsible for creating and submitting for approval records disposition authorizations (RDA) that describe the retention period for applicable public records, including supporting documentation used to reach audit conclusions.

According to management, they believed that they were not required to maintain the invoices as evidence of tax credit approvals because the invoices were viewed as temporary records and could be destroyed immediately upon determining the records held no fiscal, legal, or historic value. Also for the same reason, the department's Audit Division management had not formalized the policies and procedures governing the tax credit approval and documentation process. We expected that the division management had either developed tax audit policies and procedures governing the documentation of tax audit reviews, including the applicable RDAs for these public records, or adopted other best practices to use as guidance for the reviews and documentation requirements. One such best practice is the Institute of Internal Auditors' *International Standards For the Professional Practice of Internal Auditing* (IIA Standards). IIA Standards, Section 2330, "Documenting Information," states,

> Internal auditors must document sufficient, reliable, relevant, and useful information to support the engagement results and conclusions.
>
> The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.
>
> The chief audit executive must develop policies governing the custody and retention of consulting engagement records, as well as their release to internal and external parties. These policies must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

For the remaining 19 of the 22 approved headquarters tax credits (86%), the Audit Division retained some level of documentation; however, we noted that for 4 credits representing 2 companies, tax auditors accepted invoices that included the companies' purchase of items that did not meet the definition of qualified tangible personal property. Specifically, for the approved credits, the division did not ensure the companies' approved tax credits were based on purchases of items that qualified as tangible personal property. Tax auditors accepted company invoices that included services for shop drawings, sawing, and drilling, none of which meet the definition of qualified tangible personal property. We also found that invoices lacked sufficient details to determine whether items met the definition of qualified tangible personal property (for example, invoices that were not itemized but included terms such as drawings, engineering, installing, or manufacturing, which are not tangible personal property). The department approved $382,498 for these four credits; however, the department should have disallowed $1,212 from the approved credit amount because the items did not meet the definition of qualified tangible personal property.

According to Audit Division management, supporting documentation for the approved claims met the definition of qualified tangible personal property. Division management asserted that tax auditors reviewed additional documentation necessary to determine whether an item met the definition of qualified tangible personal property; however, this additional documentation was not retained and therefore was not available for our review. Since division management was not able to provide us with documentation to support its claims, we were not able to determine whether the items qualified as tangible personal property.

As noted in IIA Standards, Section 2330, "Documenting Information," auditors must document reliable, sufficient, and relevant information to support their audit conclusions.

By not establishing a sufficient system of internal controls and providing appropriate leadership and direction in the development and maintenance of supporting documentation, department management increased the risk of inappropriate and inefficient business practices. When management does not either obtain and/or retain actual qualifying invoices or have supervisors perform a sufficient review of the tax auditor's analysis of those qualifying invoices, management increases the risk that the Audit Division will inappropriately approve companies to receive tax credits for which they are not eligible. In addition, when a company receives improper tax credits, the state loses revenue, which affects its ability to fund necessary programs that benefit the state's citizens.

Recommendation

The department's Commissioner and the Assistant Commissioner of Audit Operations should either obtain and/or retain the actual qualifying invoices or ensure that there is a supervisory or secondary review of the supporting documentation used to verify that tax auditors appropriately approved the credit. As part of the policies and procedures governing the tax credit approval and documentation process, the Commissioner should require that the supervisory or secondary review is sufficiently documented. The Commissioner should also ensure tax auditors only approve tax credits for purchases that meet the definition of qualified tangible personal property.

Management's Comment

We concur. As explained below and in our response to Finding 1, the department did not always retain company invoices after all reviews were completed. Additionally, a small amount of credit was granted on invoices that should have resulted instead in a full refund of the tax.

The department always ensured that multiple levels of review occurred prior to approving all tax credits and that all invoices were available throughout the entire review process. The department agrees that it should formalize its existing procedures related to a supervisor's role in reviewing headquarters credit claims and that it should develop a department RDA specific to temporary records. The majority of the referenced invoices were reviewed on site at the taxpayer's location, but all invoices were available for review and retained throughout the review process and are still obtainable today from the taxpayers.

In the instance in which the department disposed of copies of invoices after the credit was reviewed and approved, the department believed that the invoices were properly disposed of consistent with RDA SW16.

The department agrees that it allowed approximately $600 of headquarters credit on services. However, it should be noted that the taxpayer erroneously paid sales tax in the first place and would have been entitled to a full refund of the tax, which would have exceeded the amount of the credit. There was no financial loss to the state.

JOB TAX CREDITS

Background

Job tax credits are tax credits made available to companies that invest in Tennessee and create jobs from that investment. Job tax credits are authorized by Section 67-4-2109, *Tennessee Code Annotated*, and the credits are claimed against the franchise and excise taxes owed by corporations, limited partnerships, limited liability companies, and business trusts chartered or doing business in Tennessee. In order to qualify for the job tax credit, companies must

- file a business plan with the Department of Revenue that describes the investment to be made, the number of jobs the investment will create, the expected dates the jobs will be filled, and the effective date of the plan;
- make a required capital investment in real property, tangible personal property, or computer software owned or leased in the state, totaling at least $500,000, valued in accordance with generally accepted accounting principles; and
- create at least 25 full-time jobs with access to health care insurance within 3 years of the business plan's effective date.

Once a company submits a business plan to the department, the Audit Division reviews the plan and provides the company with a tentative approval, allowing the company to begin claiming the job tax credit on its tax returns once it meets the above requirements. If these requirements are met, a qualifying company is allowed a job tax credit of $4,500 per job created during the investment period. The company can use the credit to offset its franchise and excise tax, up to 50% of the combined franchise and excise tax liability shown on its tax return, before any credit is applied. Any unused credit may be carried forward to any tax period until the credit is exhausted, but not to exceed 15 years. Section 67-4-2109(b)(1)(E), *Tennessee Code Annotated,* authorizes the department to audit companies that have claimed a job tax credit.

Prior Audit Follow-up

In the department's October 2013 performance audit report, we found that department management and tax auditors did not adequately document their tax audit efforts related to the job tax credits and ultimately could not provide evidence that the companies audited complied with state law. Specifically, we noted that Audit Division management

- did not create a consistent method to achieve the audit objectives identified in the revenue audit program;
- did not include key job tax credit law requirements, such as capital investment and health care requirements, in the tax credit audit program;
- improperly approved companies' business plans that were submitted late; and
- did not properly segregate duties within the business plan approval process.

Management concurred with the finding and implemented the following corrective actions:

- replaced the checklist-style revenue audit program with the audit summary report, which requires tax auditors to document in narrative form the audit methodologies and conclusions for each job tax credit requirement;
- provided training for tax auditors;
- created a new *Advanced Franchise and Excise Tax – Job Tax Credit Manual* (effective January 1, 2015), which describes the audit procedures and documentation the auditor should retain during the audit; and
- developed a job tax credit checklist to ensure that tax auditors determine whether the taxpayer has complied with all requirements of the job tax credit act.

In an effort to ensure tax auditors maintain audit evidence, the department implemented electronic working papers so that auditors can maintain scanned audit evidence to support their audit conclusions.

Current Job Tax Credit Audit Procedures

Types of Review

Once a company claims a job tax credit on its tax return, the Audit Division performs one of the following types of review:

1. Field Audit – This type of audit is the most thorough review. At least one tax auditor (and often many auditors) moves into the taxpayer's workspace to collect documentation and conduct the audit. During the field audit, the tax auditor reviews detailed company documentation to determine whether the company was eligible for the initial job tax credit and/or the carry-forward credits for the period under audit. The department then provides the taxpayer with an audit report describing any findings or job tax credit disallowances.
2. Office Audit – This type of audit is smaller in scope than a field audit, and it is limited to smaller or less risky taxpayers and to a single type of tax return. The tax auditor requests all documentation from the taxpayer for each job tax credit requirement and performs the review from their official workstation. The department typically does not provide the taxpayer with an audit report unless the auditor finds job tax credit disallowances.
3. Initial Review – This review is brief and does not include examination of evidence or other documentation to verify eligibility; rather, tax auditors perform this review to determine if they should conduct a more thorough examination.[3] Tax auditors perform basic reasonableness checks, such as determining if the taxpayer's payroll expenses and total capital assets increased after the investment period as described in the business plan.

Tax Audit Process

The tax auditor documents the completion of a job tax credit audit through the job tax credit checklist and the audit summary report. The checklist provides the tax auditor with a list of tasks that should be completed during the audit, and the audit summary report provides a narrative of the tax auditor's methodologies and conclusions. The tax auditor is responsible for saving the audit summary report and the job tax credit checklist, along with all audit documentation, to the department's shared drive. For field audits, after the tax auditor completes the audit, including the checklist, a supervisor reviews the working papers and completes a checklist titled "Review Prior to Exit Conference" to document the review. For office audits, after the tax auditor completes the audit, including the checklist, a supervisor reviews the working papers.

To determine if management's corrective actions were effective, we examined the job tax credit audit procedures during the current audit.

[3] For example, if a taxpayer claimed to increase the number of full-time jobs but the payroll costs did not change, a tax auditor should conduct a more thorough review.

Current Audit Results

1. **Audit Objective:** Has the department ensured tax auditors perform the procedures implemented to correct the issues noted in the prior audit finding?

   Conclusion: Based on our testwork, the tax auditors used electronic working papers to maintain audit evidence. The working papers included audit summary reports with descriptions of the audit work performed for each audit completed during the audit period. The audit summary reports included job tax credit checklists providing audit evidence that the tax auditors audited all job tax credit requirements. Although the electronic working papers included audit evidence, the tax auditors did not always obtain or retain sufficient audit evidence to support the audit reports' conclusions, and tax auditors did not follow policies and procedures outlined in the *Advanced Franchise and Excise Tax – Job Tax Credit Manual* (see **Finding 3**). Supervisors documented their reviews of the job tax credit audits with their signature on the audit summary reports.

2. **Audit Objective:** Did management ensure the duties of receiving, approving, and tracking the job tax credit business plans were segregated?

   Conclusion: Based on discussions with department staff, management properly segregated the duties of receiving, approving, and tracking the business plans.

Methodology To Achieve Objectives

To meet our objective, we interviewed the Assistant Commissioner, the Audit Director, the Tax Audit Manager, and the Assistant Director of Internal Audit and Consulting Services to obtain an understanding of the job tax credit audit process and procedures management implemented to address the prior audit finding. We also obtained and reviewed the department's newly implemented detailed audit summary report, the *Advanced Franchise and Excise Tax – Job Tax Credit Manual*, the job tax credit checklist, and other relevant documentation.

To determine whether the job tax credit procedures were implemented and corrected the prior audit finding issues, we obtained a list of the 20 field audits and 12 office audits completed during the period December 1, 2014, through January 31, 2017, and reviewed the respective audit working papers for audit evidence supporting the tax auditors' conclusions. We also examined the working papers to determine if supervisors documented their reviews of the audit work. We discussed the business plan approval process with department staff to determine if management segregated the duties of receiving, approving, and tracking the job tax credit business plans.

<u>Finding 3 - As noted in the prior audit, department management did not adequately document the tax audits related to the job tax credits and ultimately could not provide evidence that the audited companies complied with state law</u>

As noted in the background of this section, management implemented corrective action to correct problems noted in the prior audit. The corrective action resolved some of the specific problems; however, our current testwork identified additional documentation errors after the corrective action plan was implemented.

<u>Job Tax Credit Audits</u>

For 4 of 20 job tax credit field audits tested (20%) and for 4 of 12 office audits tested (33%), the Department of Revenue's tax auditors did not always collect or maintain sufficient audit evidence as part of their working papers to support their conclusions concerning the job creation and health care requirements. For 1 field audit tested, we found evidence that the revenue tax auditor obtained documentation from the taxpayer, but we could not find evidence that the auditor examined the documentation to determine if it was adequate to support the audit conclusions. For the remaining 3 field audits and all 4 office audits, management could not provide us with the working papers or additional documentation either (1) because they could not locate the working papers or (2) because the working papers had already been shredded, violating the state's public records requirements (see **Finding 1** on page 8 for more information).

We also noted that the tax auditors did not adhere to the department's new policies and procedures governing required audit documentation. Based on testwork performed on the 8 field audits and 11 office audits that began after January 1, 2015, we noted that for 7 of 8 field audits tested (88%) and all 11 office audits tested, the revenue tax auditors did not create all documentation required by the department's *Advanced Franchise and Excise Tax – Job Tax Credit Manual*, which the department implemented to correct the prior audit finding. Specifically, we found that the tax auditors did not create the net new jobs calculations spreadsheet, which documents the tax auditor's review of the number of jobs the taxpayer created and whether the taxpayer provided employees with health care. We also noted that the audit files did not include the job tax credit checklists and did not document the tax auditors' methodologies used to test for eligibility criteria as required in the audit summary report. The *Advanced Franchise and Excise Tax – Job Tax Credit Manual,* instructs tax auditors to

> [r]etain, as part of the audit workpapers, copies of all applicable taxpayer records, including lists of purchases made during the investment period that are part of the required capital investment, employees/position lists, GAAP [generally accepted accounting procedures] depreciation schedules, Premium & Wage Reports (SUTA), and any federal forms relied on. If the taxpayer will not allow you to keep a copy of these records, a redacted copy should be requested and if a taxpayer refuses an explanation should be included on the job tax credit checklist.

The manual also states that

> A new document called JTC [job tax credit] Audit Checklist must be completed and included with your audit. . . . Any JTC workpapers you produce must be included with the audit. This includes the JTC Net New Jobs Calculation spreadsheet.

When asked, the Audit Director explained that the manual is a guideline for tax auditors and that tax auditors were not always required to include the above information.

The Audit Director stated that "there is no specific authority or guidance that requires an auditor to retain a copy of every document they review."

By not establishing a sufficient system of internal controls and providing appropriate leadership and direction in the development and maintenance of supporting documentation, department management increased the risk of inappropriate and inefficient business practices. By not retaining proper documentation to support the job tax credit audit conclusions, the Audit Division adversely impacts department management's oversight responsibilities to ensure both the adequacy of the audits performed and the competence of personnel performing the audits. In addition, when the department does not maintain documentation, it increases the risk that management will not be able to defend its audit results in the event of taxpayer appeals.

Recommendation

The Commissioner and the Audit Director should ensure that revenue tax auditors retain or create all supporting documentation necessary to support their approval of the job tax credits and conclusions on all audits performed. In addition, management should ensure the tax audits follow all applicable job tax credit audit policies and procedures outlined in the *Advanced Franchise and Excise Tax – Job Tax Credit Manual*.

Management's Comment

We concur. As stated in the report, the department implemented corrective action to address the issues identified in the prior audit. The department implemented a thorough and technically up-to-date summary narrative and standardized electronic work papers, which include detailed instructions, guidelines, and training materials. The department substantially improved the documentation and organization of supporting working papers, and supervisory reviews have been consistently documented.

However, this audit identified inconsistencies among tax auditors in the clarity of explanation and in the overall file quality. The department agrees that the documentation guidelines and training should be refined and reinforced. We also agree that additional file maintenance standards should be developed for office audits, where most of the issues were noted. The department will implement additional corrective action to address these issues.

VEHICLE SERVICES

Vehicle Services Inventory Process

Pursuant to Section 55-2-101, *Tennessee Code Annotated*, the Department of Revenue is responsible for all vehicle registrations in Tennessee. To ensure that Tennessee residents register their vehicles, the department coordinates with each county clerk's office in the state to sell vehicle plates and decals to the county's residents.

Since the prior audit, the department's Vehicle Services section implemented a new print-on-demand decal service. These decals are the standard decals residents receive when they acquire or annually renew their vehicle registration. When residents pay for their registration, the county clerks' offices print decals on-site using specialized printers and plain thermal paper. Vehicle Services notified all county clerks of the new service in May 2014, and according to management, all counties had implemented the service by May 2016.

Vehicle Services coordinates with the Tennessee Rehabilitative Initiative in Correction Board (TRICOR) to manufacture the inventory of license plates, specialized decals, and thermal paper used for print-on-demand decals. TRICOR physically maintains the license plates and thermal paper until Vehicle Services informs TRICOR to send the inventory to an applicable county.

TRICOR also manufactures specialized decals (such as handicap decals), which are shipped to the Department of General Services. General Services holds the specialized decals until Vehicle Services requests them to be sent to an applicable county for issuance to motorists.

County Clerks' Revenue Collections

Section 55-6-105(a)(7)(8), *Tennessee Code Annotated,* requires each county clerk's office to remit and report all monies collected from the sale of vehicle plates and decals and to account for all registration plates and decals assigned to the clerks. The Vehicle Services section ensures that all inventory the department purchases from TRICOR is accounted for.

Prior Audit Follow-up

A 1989 financial audit of the Department of Safety included a finding regarding the Department of Safety not properly reconciling the distribution of vehicle plates and decals with revenue received from county clerks. In July 2006, an executive order transferred the responsibility for all Tennessee vehicle registrations from the Department of Safety to the Department of Revenue. Since 1989, state officials have been unsuccessful in tracking the vehicle plates and decals inventory or reconciling the revenue from the sales of these items.

In the Department of Revenue's October 2013 performance audit report, we found that the department was unable to track the inventory of vehicle plates and decals received and sold by the counties or perform a reconciliation of motor vehicle registration revenue collections to license plate and decal issuance records. Management concurred with the prior audit finding, citing limitations with the department's 40-year-old legacy title and registration system, which it uses to account for vehicle plate and decal information. In April 2015, the department contracted with a software vendor, Business Information Solutions, to replace the legacy system with the Vehicle Title and Registration System (VTRS). According to management, the department implemented VTRS on July 1, 2017, and the new system will account for each class of inventory, allowing the department to reconcile revenue collections with decal and license plate inventory sold. Although we were unable to test the new system, since the department implemented VTRS shortly before our fieldwork ended, we did test the department's new processes for tracking license plate and decal inventory, as described below.

License Plate and Decal Inventory Processes

Although the department has not developed a process to track print-on-demand decals, it has implemented the following new processes to track license plate and decal inventory at each county clerk's office:

1. License Plates – As of April 2014, vendors who service the counties' title and registration system send the department electronic files that detail the counties' monthly inventory records of license plates. The department reconciles the counties' electronic inventory records with the department's legacy title and registration system. The department then inquires with the counties concerning any discrepancies noted during the reconciliations.
2. Specialized Decals – As of April 2016, all counties are using the same application, which sends the department a quarterly motor vehicle inventory report detailing the amount of pre-printed decals at each county for each month. The department compares the most current report, along with any inventory orders during the month, to the prior month's report.

Current Audit Results

1. Audit Objective: Did the department correct the prior audit finding by reconciling the distribution of vehicle license plates and decals sold to the revenue received from the county clerks?

Conclusion: Based on our review, we found that the department did not correct the prior audit finding by reconciling the distribution of vehicle license plates and decals sold to the revenue received from the county clerks (see **Finding 4**).

2. Audit Objective: Did the department track the number of license plates and decals sold and voided, or the total dollar value of these license plates and decals?

Conclusion: Based on our review, we found that the department did not track the number of license plates and decals sold and voided, or the total dollar value of these items (see **Finding 4**).

Methodology To Achieve Objectives

To meet our objectives, we interviewed the Assistant Commissioner of Revenue Operations, the Vehicle Services Director, the Information Systems Manager, and the Chief Financial Officer to gain an understanding of the processes implemented as a result of the prior audit finding. We obtained and reviewed license plate and specialized decal inventory reports; a spreadsheet showing discrepancies between license plate inventory in the department's legacy system and electronic files from the county clerks' vendor; and revenue collections from the sale of license plates and decals for fiscal years 2015 and 2016.

Finding 4 – As noted in prior audits, Vehicle Services management was unable to reconcile motor vehicle registration revenue collections to license plate and decal issuance records during most of the audit period

Risks Associated With Revenue Collection

The process of collecting vehicle plate and decal revenues is inherently risky because of the decentralized nature of the collection process. When one entity collects fees on behalf of another, there is always a risk that the collecting entity may fail to remit the collections. The Department of Revenue relies on the county clerks' offices to distribute vehicle registration plates and decals and remit the revenues to the department. To mitigate the risk of the county clerks failing to remit all revenue collections, the department must regularly perform a reconciliation of independently obtained or verified license plate and decal distribution amounts with revenues collected and remitted. In order to perform this reconciliation, the department must coordinate with parties outside of its Vehicle Services staff, including

- county clerks' offices that sell license plates and decals;
- the Tennessee Rehabilitative Initiative in Correction Board (TRICOR), which is responsible for making the plates, specialized decals, and print-on-demand thermal paper and for shipping the plates and print-on-demand thermal paper to the county clerks' offices; and
- the Department of General Services, which stores and ships specialized decals made by TRICOR to the county clerks' offices.

Without inventory procedures and the proper reconciliation controls in place for license plates, specialized decals, and print-on-demand decals, a county clerk could issue a vehicle registration, collect the fees, fail to enter the vehicle registration renewal into the system, and retain the fees that should be sent to the state. Also, without proper inventory records and distribution procedures for license plates, specialized decals, and print-on-demand decals, the department cannot provide accurate inventory records to the officials responsible for the reconciliation.

Results of Our Audit Work

Based on our audit work, we found that Vehicle Services management does not track the number of license plates and decals that were sold or voided, nor do they track the total dollar value of the items sold. Because the department was unable to provide us with this information, we were unable to determine if the county clerks remitted all revenue from the sale of license plates and decals to the state, and the department was unable to ensure it received the revenue it was due.

According to the department, it collected $265,008,666 and $251,074,036 in license plates and decals sold in fiscal years 2016 and 2015, respectively. We were unable to independently verify the revenue in Edison, the state's accounting system, because management grouped and reported motor vehicle collections with other taxes and fees. As described in the beginning of this section, management informed us that it implemented a new Vehicle Title and Registration System (VTRS) on July 1, 2017. According to management, the new system will account for each class of inventory, allowing the department to reconcile revenue collections with license plate and decal inventory sold. We will audit this process during the next performance audit.

According to Section 9-18-102(a), *Tennessee Code Annotated,*

> Each agency of state government and institution of higher education along with each county, municipal, and metropolitan government shall establish and maintain internal controls, which shall provide reasonable assurance that:
>
> (1) Obligations and costs are in compliance with applicable law;
>
> (2) Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
>
> (3) Revenues and expenditures are properly recorded and accounted for to permit the preparation of accurate and reliable financial and statistical reports and to maintain accountability over the assets.

Given the problems we identified during fieldwork, we also reviewed the department's 2016 risk assessment. We determined that management did not document the risks or mitigating controls associated with reconciling revenue collections to distributions of vehicle license plates and decals.

Recommendation

The Commissioner and the Director of Vehicle Services should ensure Vehicle Services staff reconcile revenues received from each county clerk to the amount of inventory distributions of vehicle plates and decals. The department should evaluate the effectiveness of the new Vehicle Title and Registration System in the reconciliation process and thoroughly review and resolve any differences. Management should immediately report any indication of fraud, waste, or abuse to the Office of the Comptroller of the Treasury. In addition, the Commissioner should ensure that the department's annual risk assessment is revised to include the risks and mitigating controls associated with reconciling revenue collections with distributions of vehicle license plates and decals.

Management's Comment

We concur. During most of the audit period, the department was unable to reconcile motor vehicle registration revenue collections to license plate and decal issuance records because of system constraints. On July 1, 2017, we implemented a new Motor Vehicle Title and Registration System (VTRS), which gives us the ability to reconcile these funds. While the timing of this audit and the system implementation did not allow for a review of VTRS, we fully anticipate that the next review will clear this repeat finding that has spanned 29 years.

EXCISE TAX APPORTIONMENTS TO LOCAL GOVERNMENTS

On June 10, 2011, Governor Bill Haslam signed into law Chapter 438 of the Public Acts of 2011, repealing Section 67-5-1101, *Tennessee Code Annotated,* which authorized counties and municipalities (local governments) to impose a tax on the value of the shares of stock of stockholders (intangible personal property) on non-depository financial, regulated investment, and cemetery institutions that do business in their jurisdictions. To replace the local governments' lost tax revenue, the public chapter created three sections, codified in Sections 67-4-2020 through 67-4-2022, *Tennessee Code Annotated,* that address the allocation and distribution (called an apportionment) of a portion of these institutions' excise taxes back to the local governments where these institutions do business.

Pursuant to Sections 67-4-2020 through 67-4-2022, the Department of Revenue is required to allocate and distribute to local governments 3% of net earnings reported by non-depository financial, regulated investment, and cemetery institutions, minus 7% of the real and tangible personal property taxes (based on value) these institutions paid for the second fiscal year preceding the year in which the distribution is made. According to statute, the first apportionments would be calculated using net earnings collected during the institutions' 2011 tax year, with the first distributions occurring in calendar year 2013 and continuing each year thereafter. The statutes require the department to annually report to the Comptroller of the Treasury the total apportionments made to the local governments.

Audit Results

1. Audit Objective: Did the department properly apportion excise tax revenue collected from non-depository financial, regulated investment,[4] and cemetery institutions

[4] According to Section 67-4-2008(a)(3), *Tennessee Code Annotated*, investment companies are generally exempt from franchise and excise tax. Since no excise tax was collected from these institutions, any revenue collected from regulated investment institutions was not required to be submitted back to the local governments in which these institutions operate.

to local governments in accordance with Sections 67-4-2020 through 67-4-2022, *Tennessee Code Annotated*?

Conclusion: During audit fieldwork, we noted that the department failed to timely apportion excise tax revenue collected from non-depository financial and cemetery institutions for 2011, 2012, and 2013. The department made these distributions in February 2017 (see **Observation 1**).

In addition, for the same years, the department did not report apportionment distributions made to each local government to the Comptroller of the Treasury as required (see **Observation 1**).

2. **Audit Objective:** Did the department use net earnings of non-depository financial, regulated investment,[4] and cemetery institutions' tax filings in the calculation of distributions made to local governments as required by Sections 67-4-2020 through 67-4-2022, *Tennessee Code Annotated*?

Conclusion: Based on our testwork, we noted that management used net earnings of non-depository financial and cemetery institutions in its calculation of distributions to local governments as required by state statute, with one minor exception.

Methodology To Achieve Objectives

To meet our objectives, we reviewed Sections 67-4-2020 through 67-4-2022, *Tennessee Code Annotated,* to gain an understanding of excise tax requirements. We interviewed department management and Comptroller of the Treasury staff. We also reviewed correspondence between department staff and the Commissioner; the non-depository financial, investment, and cemetery questionnaire templates; and the correspondence between department management and Comptroller staff. To determine the amount of excise allocations the department made to local governments, we reviewed apportionment summary reports detailing the allocations made in July 2016, February 2017, and March 2017.

To determine if net earnings within cemetery and non-depository financial institutions' 2011 through 2014 tax filings were used to calculate the apportionments to local governments, we obtained a population of all 37 cemetery and non-depository financial institutions whose 2011 through 2014 net earnings, along with other information used to calculate these apportionments, totaled $339,120,005 in net earnings. We then tested these 37 cemetery and non-depository financial institutions to determine if net earnings within these tax filings matched the net earnings the department used to calculate the apportionments made to local governments.

Observation 1 – <u>For three years, the department did not distribute funding to cities and counties in accordance with state law, which the department corrected in February 2017</u>

In September 2015, the General Counsel for the Office of the Comptroller of the Treasury requested from the Department of Revenue a list of excise tax distributions the department made to local governments in accordance with Section 67-4-2020(C), *Tennessee Code Annotated*. Upon researching this request, department management realized that they did not have procedures to calculate and apportion excise tax revenue to local governments. Once management became aware of their noncompliance, they began to develop and implement procedures to distribute the excise tax allocations to the local governments. According to the Chief Financial Officer, when implementing these procedures, the department experienced difficulties in identifying institutions that might qualify as "non-depository or regulated investment institutions." She stated that the statute did not clearly define these types of institutions. In an attempt to identify these institutions, the Chief Financial Officer contacted the Comptroller's Office's State Board of Equalization to determine the entities that paid real property taxes under the recently repealed legislation; however, only two local governments received the tax under the repealed legislation. In another attempt at identification, the department extracted a broad list of entities that paid the franchise and excise tax from the Revenue Integrated Tax System and sent the entities an informational questionnaire about the entities' net earnings and property taxes to complete and return.

As promulgated in Section 67-4-2020(1)(A),[5] *Tennessee Code Annotated*, the department should calculate distributions based on the institution's net earnings, property tax rates, receivables, and account balances in the second fiscal year preceding the year in which the distribution is made. Based on our review of the information management provided, as well as audit work we performed, we noted that the department did not make the excise tax allocations to local governments timely. The department paid the combined excise tax allocation to local governments for tax years 2011, 2012, and 2013, totaling $6,563,904.69, in February 2017. According to statute, management should have made these payments during calendar years 2013, 2014, and 2015, respectively. We also noted that distributions for the 2011 through 2013 tax years were calculated in part using certain 2014 tax year information. Specifically, the department used the following to calculate apportionments for the 2011 through 2013 tax years:

1. receivables and account balances for the 2014 tax year;
2. net earnings for the 2011 through 2013 tax years; and
3. property tax rates for the 2014 tax year **<u>or</u>** the 2011 through 2013 tax years, respectively.

[5] Section 67-4-2021(1)(A), *Tennessee Code Annotated,* only addresses allocation and distribution requirements for regulated investment institutions. Sections 67-4-2020(1)(A) and 67-4-2022(1)(A), *Tennessee Code Annotated,* have similar requirements for non-depositary financial and cemetery institutions, including the requirement that net earnings be calculated in the second fiscal year preceding the year in which the distribution is made.

Table 2
Apportionments Based on Tax Year

Calculation of Apportionments		**Apportionment Payments to Local Governments**	
Tax Year Statute Required Department to Use	**Tax Year the Department Used to Calculate**	**Tax Year Apportionment Should Have Been Paid**	**Tax Year Apportionment Was Paid**
2011	2011 or 2014	2013	2017
2012	2012 or 2014	2014	2017
2013	2013 or 2014	2015	2017
2014	2014	2016	2016

The department obtained verbal approval from the Department of Finance and Administration (F&A) to retroactively apportion in budget year 2017 those years that had not previously been apportioned as required. We discussed with F&A the department's use of the institutions' 2014 account balance, receivables, and property tax information to calculate the 2011 through 2013 tax year apportionments. F&A agreed that the method used was appropriate if it was the best information available to calculate the apportionment. Short of the department sending out another informational questionnaire to the entities to obtain the appropriate information for 2011 through 2013, we believe this method was reasonable.

Management's delay in distributing funds to local governments also resulted in management's inability to report annually to the Comptroller's Office the amount of excise tax allocations in accordance with the statutes. Management reported the excise tax allocations to the Comptroller's Office once the department made payments to the local governments in February 2017 for tax years 2011 through 2013. Management complied with state statute and reported the excise tax allocations paid to the local governments for tax years 2014 and 2015, in June 2016 and March 2017, respectively.

CONSOLIDATED NET WORTH ELECTIONS

Any corporation, limited partnership, limited liability company, or business trust chartered, organized, or doing business in Tennessee must register for and pay franchise and excise taxes. While the excise tax is based on net earnings or income for the tax year, the franchise tax is based on the greater of the taxpayer's net worth or the book value of real or tangible personal property owned or used in Tennessee. Pursuant to Section 67-4-2103, *Tennessee Code Annotated*, a taxpayer that is a member of an affiliated group (a group of two or more entities with more than 50% direct or indirect common ownership) or a financial institution affiliated group may elect to compute its net worth base[6] for franchise tax purposes on a consolidated basis by filing a Consolidated Net Worth Election Registration Application with the Department of Revenue. The

[6] A net worth base is an income or asset balance used to calculate a tax liability.

group must file its application for the period in which the election is to take effect on or before its franchise and excise tax return is due to the state. The department's Division of Taxpayer Services receives and enters the applications into the Revenue Integrated Tax System (RITS).

The department provides this option because the calculation of consolidated net worth provides a more complete picture of an afilliate group's overall net worth, which is important in computing the franchise tax base. Once owners of affiliated groups pursue the consolidated election, they are required to complete Schedule F2 – Consolidated Net Worth as part of their franchise and excise tax return. Schedule F2 includes the gross total consolidated net worth of the entire affiliated group, the apportionment ratio (which is used to apportion net worth), and the apportioned consolidated net worth tax base. The Audit Division audits for compliance when it conducts field and office audits. The election to compute net worth on a consolidated basis remains in effect for a minimum of five years and continues until the group revokes its election by filing a group registration revocation form as required by Section 67-4-2103(h), *Tennessee Code Annotated*.

Audit Results

Audit Objective: Did the department ensure that taxpayers who had submitted a Consolidated Net Worth Election Registration Application also completed Schedule F2 as part of their franchise and excise tax return, and that the taxpayers who completed Schedule F2 also submitted an application in accordance with Section 67-4-2103(g)(h), *Tennessee Code Annotated*?

Conclusion: Based on testwork performed, the department did not always ensure that taxpayers with an application on file completed Schedule F2 or that taxpayers who completed Schedule F2 submitted an application in accordance with Section 67-4-2103(g)(h), *Tennessee Code Annotated* (see **Observation 2**).

Methodology To Achieve Objective

To meet our objectives, we interviewed key personnel and reviewed Section 67-4-2103(g)(h), *Tennessee Code Annotated*, to gain an understanding of the consolidated net worth election. We obtained a list of 9,042 franchise and excise tax returns from RITS with tax period end dates occurring between December 1, 2014, and December 31, 2016, and a "yes" in the consolidated filer fields.[7] We selected a nonstatistical, random sample of 60 franchise and excise tax returns and reviewed the taxpayers' Consolidated Net Worth Election Registration Applications and Schedule F2 – Consolidated Net Worth in RITS to determine if the department ensured that the taxpayers with an application on file completed Schedule F2 and that the taxpayers who completed Schedule F2 had an application on file in accordance with Section 67-4-2103(g)(h), *Tennessee Code Annotated*.

[7] The Revenue Integrated Tax System contains two fields where the taxpayers either reported that they are a consolidated filer or submitted a Consolidated Net Worth Election Registration Application.

Observation 2 – The department did not ensure that taxpayers complied with consolidated net worth election requirements in *Tennessee Code Annotated*

Based on testwork performed, we found that for 13 of 60 franchise and excise tax returns tested (22%), the Department of Revenue did not ensure that the taxpayer complied with consolidated net worth election requirements. Specifically, we noted the following:

- For 5 tax returns tested, management did not ensure that the taxpayers who completed Schedule F2 as part of their tax return had a Consolidated Net Worth Election Registration Application on file. According to the Audit Director, the department could not provide us with the applications, and it is possible the taxpayers may have completed Schedule F2 in error. According to Section 67-4-2103(g), *Tennessee Code Annotated,*

  > A taxpayer electing to compute its net worth on a consolidated basis shall make such election by filing a group registration form with the department and providing such information as may be reasonably required by the commissioner on or before the due date of the tax return for the period for which such election is to take effect.

- For 8 tax returns tested, management did not ensure that the taxpayers with an application on file completed Schedule F2. The Assistant Commissioner stated that these consolidated net worth elections have been in place for over 5 years, and once a taxpayer makes the election, it is bound for 5 years but not beyond. According to Section 67-4-2103(h), *Tennessee Code Annotated,*

  > Once a taxpayer elects to compute its net worth on a consolidated basis, such election shall remain in effect for a minimum of five (5) tax years and thereafter until revoked.

  The department does not require taxpayers who do not complete Schedule F2 beyond 5 years to complete a group registration revocation form. According to Section 67-4-2103(h), *Tennessee Code Annotated*,

  > The affiliated group may revoke such election after the minimum period by filing a group registration revocation form with the department and providing such information as the commissioner may reasonably require on or before the due date of the tax return for the period during which such election is to be revoked.

  According to the Audit Director, the department accepts the taxpayer's tax return as its revocation after 5 years. We noted, however, that the franchise and excise tax return does not include an option for the taxpayer to revoke the election, and the department could not provide a group registration revocation form for the 8 taxpayers we tested.

TAX AUDIT PROCESS AND TAX LIABILITY ASSESSMENTS

Tax Audit Process

In order to ensure taxpayers pay the correct amount of state tax, the Department of Revenue audits taxpayers. Tax audits may either result in a refund to the taxpayer, the taxpayer owing money to the department, or no change to the taxpayer's account with the department. In order to ensure the proper amount of taxes have been collected, tax auditors must maintain sufficient evidence to support their audit results, in the form of working papers and associated tax information recorded into the Revenue Integrated Tax System (RITS).

To properly obtain and retain sufficient evidence, tax auditors must comply with the applicable standards promulgated in the department's procedural bulletins, which are the Audit Division's written procedures governing the audit of one, multiple, or all taxes. The department provides newly hired tax auditors with audit manuals and training materials, including procedural bulletins. The Tax Audit Supervisor and the Tax Audit Manager review audits to ensure auditors comply with the procedural bulletins.

Some procedural bulletins require tax auditors to include additional documentation in the audit working papers. For example, Procedural Bulletin 15, "Recording Audit Adjustment Reasons," requires the auditor to include working paper documentation showing the underlying reasons for an audit adjustment in RITS for each audited tax type (for example, sales and use tax; franchise and excise tax; or business tax). If the auditor enters audit adjustments, the audit either resulted in a refund to the taxpayer or the taxpayer owing the department a tax liability.

Tax Liability Assessments

A tax liability assessment represents the amount of additional tax the audit reveals the taxpayer owes. Pursuant to Section 67-1-1501(c), *Tennessee Code Annotated*, the department may assess a tax liability within the applicable statute of limitations. Tax auditors document these tax assessments on the audit summary report, which serves as an audit narrative that supports the tax liability assessment. In the audit summary report, the tax auditor documents the period covered during the audit, the tax type impacted by the assessment, and work performed to test the tax filing. The tax auditor also includes any previous tax liabilities the taxpayer owes, commonly referred to as a debit memo. When recording the tax assessment in RITS, the tax liabilities become a bulk debit, which is the tax liability assessed from an audit plus any previous tax liabilities the taxpayer owes.

Recording Bulk Debits

The Audit Division has established the following procedures for recording a bulk debit in RITS:

1. The Tax Audit Supervisors review the tax assessment for accuracy and determine if it includes previous tax liabilities. The supervisors then send a notice of proposed assessment, which includes the updated tax liability, to an Audit Technician.
2. The Audit Technician enters the assessment into RITS and then emails the notice of proposed assessment to the division's Audit Processing Unit.
3. The Audit Processing Unit reviews the assessment in RITS to ensure it matches the notice of proposed assessment and then posts the assessment into RITS, thus creating the bulk debit.

On March 6, 2017, the department began to convert some tax records (including sales and use, tobacco, liquor by the drink, and professional privilege taxes) from RITS to a modernized tax system known as the Tennessee Revenue, Registration, and Reporting (TR3) system. Once converted, these tax records could only be viewed in TR3. Tax records not converted during this initial rollout are available in RITS until subsequent rollouts occur. Since TR3's initial rollout occurred during our fieldwork, we did not attempt to determine if the tax liability assessment and bulk debit processes will change once TR3 is fully implemented.

Audit Results

1. Audit Objective: Did tax auditors prepare tax audit working papers in accordance with procedural bulletins?

Conclusion: Based on testwork performed, tax auditors did prepare working papers in accordance with procedural bulletins.

2. Audit Objective: Did management have adequate procedures to record bulk debits in RITS?

Conclusion: Based on our review, management had adequate procedures to record bulk debits in RITS.

Methodology To Achieve Objectives

To meet our objectives and gain an understanding of procedural bulletins and the tax liability assessment processes, we interviewed the Assistant Commissioner over Audit Operations and the Tax Auditor 4 in the Processing Unit, and we obtained and reviewed procedural bulletins, audit summary report templates, notices of proposed assessment, and examples of documents created during the department's audit process.

We also obtained a population of 7,105 audits of tax returns filed from December 1, 2014, through January 31, 2017, totaling $62,875,401, that resulted in a tax liability owed to the department. We then tested 60 audits, totaling $11,439,236, by

- identifying 10 audits, totaling $10,950,751, with a tax liability exceeding $500,000; and
- selecting a nonstatistical random sample of 50 audits, totaling $488,485.

We tested these 60 audits to determine if the tax auditors prepared audit working papers in accordance with the appropriate procedural bulletin and if management appropriately recorded bulk debits in RITS.

For our testwork, we reviewed audit working papers to determine if tax auditors followed the applicable procedural bulletins, and we reviewed the finished audit reports to see if tax auditors adequately documented the procedures performed.

We also reviewed audit working papers to determine if tax auditors recorded the previous bulk debit amount listed in the taxpayer's account prior to the audit and if tax auditors included this amount when calculating the new total tax liability amount. We then traced the new tax liability amount to either RITS or TR3.

STATE VENDOR'S SALES TAX ACCOUNT REGISTRATION

Entities that provide goods and services in Tennessee must register with the Department of Revenue to collect and remit the sales and use taxes levied by the Retailers' Sales Tax Act, to comply with Title 67, Chapter 6, *Tennessee Code Annotated*. For entities wanting to contract with the state to provide goods and services, Section 12-3-306, *Tennessee Code Annotated*, requires the Commissioner of the Department of Revenue and the Chief Procurement Officer to devise procedures to ensure that entities seeking to do business in the state register with the department to collect and remit the sales and use tax before the state executes contracts with these entities.

Prior Audit Follow-up

In the 2013 performance report, we reported that the department failed to devise procedures in accordance with Section 12-3-306, *Tennessee Code Annotated*. After we notified the department of the noncompliance on April 30, 2013, the Commissioner approved a memo containing proposed procedures to ensure compliance; the Procurement Commission approved these procedures on August 22, 2013.

The prior finding noted that, according to the *Procurement Procedures Manual* of the Central Procurement Office, the Purchasing Division may delegate a limited purchase authority (called a Delegated Purchase Authority) to other state agencies to enter into contracts valued at $50,000 or below without obtaining approval from the Central Procurement Office. From a list of vendor payments associated with Delegated Purchase Authority contracts, we identified 117 vendors that exhibited a significant business presence in Tennessee. Of the 117 vendors, 45 vendors should have been registered with the department; however, the department could not determine whether 7 vendors should have been registered.

Current Audit Results

1. Audit Objective: Did the department follow up as needed with the unregistered businesses identified in the prior audit?

Conclusion: Based on our audit work, the department followed up as needed with the unregistered businesses identified in the prior audit.

2. **Audit Objective:** Did the department ensure that statewide vendors awarded contracts by state agencies under a Delegated Purchase Authority were registered with the department as required by Section 12-3-306, *Tennessee Code Annotated*?

Conclusion: Based on our audit work, we found that the department improved its process to ensure that statewide vendors contracted under a Delegated Purchase Authority were registered with the department as required by Section 12-3-306, *Tennessee Code Annotated*. However, we tested all vendors that the state had awarded contracts under the Delegated Purchase Authority process for the period December 1, 2014, through March 14, 2017, and found there were still errors (see **Observation 3**).

Methodology To Achieve Objectives

To meet our objectives, we reviewed applicable Tennessee law, interviewed key personnel, and reviewed the department's policies and procedures to gain an understanding of the department's controls over the Retailers' Sales Tax registration.

To determine whether the department followed up with the unregistered businesses identified in the prior audit, we reviewed the Audit Division's inquiry letters to the 52 vendors noted in the prior audit. If the division could not provide an inquiry letter, when necessary, we verified the vendor's registration with the department's Revenue Integrated Tax System or, if applicable, the Tennessee Revenue, Registration, and Reporting system.

Lastly, to determine whether the department ensured that statewide vendors contracted under a Delegated Purchase Authority were registered with the department, we obtained a list of payments from Edison, the state's accounting system, that were issued to 55 vendors that contracted with the state under a Delegated Purchase Authority. These payments were issued for the period December 1, 2014, through March 14, 2017. To determine whether vendors from this list were properly registered with the department to collect and remit the sales and use tax, we queried the department's tax systems to verify associated sales and use tax accounts. We also made inquiries with relevant personnel, researched Tennessee law, performed vendor research, and reviewed invoice documentation in Edison to determine whether the vendor was exempt from registration.

Observation 3 – Since the prior audit, the department took corrective action and reduced the number of unregistered state contractors to 5%

During our work to follow up on the prior audit finding, we identified that of the 55 vendors awarded contracts under a Delegated Purchase Authority for the period December 1, 2014, through March 14, 2017, management did not ensure 3 vendors (5%) had registered an account as required by Section 12-3-306, *Tennessee Code Annotated*, even though these vendors conducted business in Tennessee. Therefore, the state contracted with these vendors for services even though the Department of Revenue had no evidence that the contractor/vendor had charged, collected, and properly remitted the required sales and use tax to the department.

According to Section 12-3-306,

> A state governmental entity shall not contract to acquire goods or services, and no person may contract to supply goods or services to a state governmental entity, unless, prior to, or contemporaneous with, entering into the contract, the person contracting to supply goods or services and its affiliates register with the department of revenue to collect and remit the sales and use tax levied by the Retailers' Sales Tax Act.

We recommend that the department perform regular checks to verify that state contactors receiving payments through a Delegated Purchase Authority have a valid sales and use tax account or clearly document that the contractor is exempt from registering.

INFORMATION SYSTEMS

The Department of Revenue relies on various information systems, databases, and applications to capture and maintain information that supports departmental activities. Strategic Technology Solutions (STS) within the Department of Finance and Administration is responsible for maintaining the department's computer systems and applications, including but not limited to

- the Active Directory, which verifies user credentials and defines their access rights;
- the Revenue Integrated Tax System, which registers taxpayers for filing and paying Tennessee's taxes; and
- the Legacy Title and Registration System, which accounts for vehicle plate and decal information.

Audit Results

Audit Objective: Did management follow state information systems policies and industry best practices?

Conclusion: Based on the procedures performed, we determined that management did not always follow state information systems policies in one area (see **Finding 5**).

Methodology To Achieve Objective

To achieve our objective, we interviewed management and obtained relevant documentation to gain an understanding of the department's systems' control activities and assessed management's adherence to state information systems policies and industry best practices.

<u>Finding 5 – The Department of Revenue and the Department of Finance and Administration's Strategic Technology Solutions did not provide adequate internal controls in one area</u>

The departments did not design and monitor internal controls in one specific area. Ineffective internal controls increase the risk of fraud, errors, or data loss. The details of this finding are confidential pursuant to Section 10-7-504(i), *Tennessee Code Annotated*. We provided the departments with detailed information regarding the specific condition we identified, as well as our recommendation for improvement.

<u>Recommendation</u>

Management should ensure that this condition is remedied by the prompt development and consistent implementation of internal controls. Management should implement effective controls to ensure compliance with applicable requirements; assign staff to be responsible for ongoing monitoring of the risks and mitigating controls; and take action if deficiencies occur.

<u>Managements' Comments</u>

<u>Department of Revenue</u>

We concur. Policies and procedures that address the situation are being developed and implemented. Employees responsible for the implementation of these policies and procedures have been identified and informed of the importance of compliance.

<u>Department of Finance and Administration</u>

We concur. STS is working with the Department of Revenue and the other Executive Branch agencies that fall under Enterprise IT Transformation to develop standard procedures to address the identified control weakness.

INTERNAL AUDIT REVIEW OF TIMELY DEPOSITS

In 2017, the Department of Revenue's Internal Audit and Consulting Services section conducted a review of the regional offices' compliance with the Department of Finance and Administration's (F&A) Policy 25, "Deposit Practices." The policy requires departments that have accumulated over $500 to deposit the funds within 24 hours; amounts of $100 to $500 may be deposited within 5 working days. In June 2017, the Chief Compliance Officer provided the Comptroller's Office with the results of Internal Audit and Consulting Services' internal review.

Audit Results

Audit Objective: Did management take the necessary action to address the department's noncompliance with F&A Policy 25?

Conclusion: Based on our review of Internal Audit and Consulting Services' memo, we determined that management took the necessary action to address the department's noncompliance with F&A Policy 25. However, additional action is required as discussed in **Observation 4**.

Methodology To Achieve Objective

To achieve our objective, we reviewed the Internal Audit and Consulting Services section's memo describing the results of the review conducted at the department's regional offices to determine if the offices complied with F&A Policy 25. In addition, we discussed the results with department management.

Observation 4 – The department risks noncompliance with timely deposits of tax collections

The results of the internal review conducted by the department's Internal Audit and Consulting Services section revealed the following issues:

- checks received at the regional offices were not deposited within 24 hours as required by Department of Finance and Administration (F&A) policy because the regional offices had to mail the checks to the Nashville office, which took approximately 7 to 22 days;
- the regional offices could not deposit the checks electronically because the offices could not scan a clear image of the checks to allow for remote deposits; and
- the revenue from checks collected by the regional offices was approximately less than 1% of all revenue collections.

The department submitted a policy exception request to F&A on July 17, 2017; however, as of August 7, 2017, the department had not received a response. With the implementation of the department's new tax information system, the Tennessee Revenue, Registration, and Reporting (TR3) system, the regional offices will be able to deposit checks electronically when received and thus be able to fully comply with F&A Policy 25. According to management, TR3's first phase was implemented in March 2017, and 76% of the checks received at the regional offices are now remotely deposited within 24 hours. The department anticipates full implementation of TR3 by 2020. We will verify management's Policy 25 compliance rate during the next performance audit.

With the small percentage of deposits affected and the implementation of TR3, the department accepts the risk relating to noncompliance, and we accept the department's decision as reasonable.

APPENDICES

APPENDIX 1
Business Unit Codes

34701	Administration Division
34702	Collection Services Division
34713	Taxpayer and Vehicle Services Division
34714	Audit Division
34716	Processing Division
34717	Vehicle Services
34718	Anti-Theft Unit
34720	Sales Tax Disaster Relief
34721	Tax Refund Interest Expense
34722	Strategic Technology Solutions
34723	Tennessee Revenue, Registration, and Reporting System
34724	Insurance Verification
34799	Revenue Taxes

APPENDIX 2
Department of Revenue — Collected Revenue
Fiscal Years 2014 Through 2016

CLASS OF TAX	2014	2015	2016
Sales &Use	$ 7,254,033,640.92	$ 7,678,148,394.04	$ 8,228,183,371.80
Franchise & Excise	1,853,449,014.98	2,191,529,404.09	2,312,023,105.50
Business	130,343,442.17	148,917,817.59	154,341,324.05
Gasoline	619,704,525.85	627,139,941.59	657,787,156.91
Motor Fuel	162,309,036.49	166,053,615.62	172,615,572.84
Petroleum Special	63,382,277.13	64,411,928.56	67,205,203.21
Motor Vehicle Registration	253,692,081.07	260,330,198.85	274,813,056.57
Motor Vehicle Title	11,765,985.49	11,962,721.45	21,828,123.78
Income	239,218,761.66	302,195,521.88	323,951,987.37
Inheritance, Gift, & Estate	107,341,131.85	84,210,923.64	62,470,971.11
Tobacco	261,100,645.08	263,565,761.38	263,738,924.05
Alcoholic Beverage	55,507,944.78	57,925,700.87	62,086,387.04
Beer	17,572,377.89	17,908,638.02	18,177,549.60
Mixed Drink (LBD)	76,050,103.77	85,379,826.04	95,542,914.97
Privilege	304,873,666.13	352,391,640.57	379,328,853.61
Gas & Oil Severance	1,554,554.54	1,433,050.66	642,367.37
TVA	332,326,039.44	345,506,521.28	349,080,971.22
Miscellaneous Taxes	26,754,178.81	26,335,479.61	26,406,579.92
TOTAL	**$ 11,770,979,408.05**	**$ 12,685,347,085.74**	**$ 13,470,224,420.92**

Source: Department of Revenue (unaudited).

Appendix 3
Tax Definitions and Descriptions

Tax	*Tennessee Code Annotated*	Definition/Description
Alcoholic Beverage Tax	57-3-302	$1.21 per gallon on wine and $4.40 per gallon on spirits.
Automotive Rental Surcharge Tax	67-4-1901	3% surcharge or tax on charges for rental of private passenger motor vehicles for a period of 31 days or less.
Bail Bond Tax	67-4-803	$12 per bail bond.
Beer Excise Tax	57-5-201 57-5-205 57-5-102	Registration fees imposed on beer wholesalers ($20) and manufacturers ($40); a privilege tax of $4.29 per 31-gallon barrel of beer manufactured or sold in the state.
Business Tax	67-4-701 67-4-703 67-4-705 67-4-707-709 67-4-714-724	Tax administered by the Department of Revenue and imposed principally by local units of government on certain businesses, vocations, and operations carried on within the state.
Coin-operated Amusement Machine Tax	67-4-2205 67-4-2204	$10 per bona fide coin-operated amusement machine offered for commercial use and play by the public. Also, an annual master license tax is levied on machine owners ranging from $500 to $2,000 depending on the number of machines owned and offered for use.
Franchise Tax	67-4-2106 67-4-2105 67-4-2119	$0.25 on each $100 of stock surplus or undivided profits of entities for the privilege of doing business within the state. The tax applies to business entities that enjoy some form of limited liability protection. The minimum tax is $100.
Excise Tax	67-4-2007 67-4-2006	6.5% of net earnings of all business conducted for a profit in this state. The tax applies to business entities that enjoy some form of limited liability protection. Current year losses may be carried forward as many as 15 years in computing net earnings subject to tax.
Gross Receipts Tax	67-4-402; 67-4-405; 67-4-406; 67-4-410; 39-17-1316 16 USC 831(1) 67-4-3101	Taxes levied principally on the gross receipts of certain types of businesses operating in the state. The main sources are taxes on the following portions of gross receipts: 1.9% on soft-drink bottlers, 3% on gross receipts over $5,000 of intrastate, water and electric power distribution companies, 1.5% on manufactured or natural gas intrastate distributors, 15% on mixing bars and clubs, 5% of covered electric current sales of non-TVA entities, and in lieu of tax payment by the Tennessee Valley Authority (TVA); and a $10 per year firearms dealer permit fee.
Income Tax	67-2-102	5% on incomes from dividends on stocks or interest on certain bonds.
Inheritance, Estate and Gift Tax	67-8-303 67-8-204 67-8-106 67-8-101	Inheritance and estate taxes are imposed on estates that exceed the maximum single exemption. The exemption varies depending on the year in which the decedent died. For decedents dying in 2016 and thereafter, no tax is imposed. The gift tax was repealed for any transfer by gift occurring on or after January 1, 2012.
Liquor by the Drink Tax	57-4-301(c)	The liquor-by-the-drink tax is a gross receipts tax imposed on retailers licensed to sell alcoholic beverages for consumption on the premises. It is 15% of gross receipts. This tax is paid to the Department of Revenue.

Mixed Drink Tax	57-4-301	A license tax of $150 to $2,000 for the privilege of selling alcoholic beverages for consumption on premises plus a $300 application fee and a 15% gross receipts tax on sales.
Oil and Tire Taxes	67-4-1603 68-211-1006	Tire - A pre-disposal fee of $1.35 per tire is imposed on businesses making retail sales of new tires in this state. Exemptions include used tires, recaps, retreads, and tires for vehicles that are propelled solely by human muscular power, such as bicycles. Also exempt are tires sold "for resale" that are property supported by a sales tax resale certificate. Motor Oil (Used Oil Collection) - A $0.02 per quart fee is applied at the wholesale level on sales of motor oil in packaged form. Exemptions include motor oils or similar lubricants that are subsequently exported from Tennessee. Oil sold by a distributor to be used for the purpose of industrial machinery is also exempt.
Privilege Tax	16-15-5007; 36-3-610; 36-6-413; 39-13-101-102; 39-13-111; 39-13-709; 16-22-109; 55-10-419; 67-4-602; 40-24-107; 67-4-409; 67-4-1701-1703; 36-6-413, 67-4-411, 67-4-602, 40-24-107, 67-4-1603, 67-4-1701, 67-4-1703, 67-4-1901, 68-211-1006, 67-4-803, 67-4-804; 55-10-403, 67-4-3203	Various taxes on litigation in the courts; domestic protection civil penalties ($50); sex offender tax (maximum $3,000); drug treatment offenders ($75); blood alcohol testing fee ($250 per conviction); an additional $250 fee per conviction, or granting of pretrial diversion, for violation of any drug law; a $40 ignition interlock fee upon conviction of driving under the influence of alcohol or drugs; a $13.75 fee upon forfeiture of a cash bond or other surety entered as a result of a municipal traffic citation; a maximum fine of $200 for persons convicted of either assault, aggravated assault, or domestic assault; and a maximum fine of $5,000 for assault and $15,000 for aggravated assault on a law enforcement officer. Realty transfer tax (37 cents per $100 of consideration or property value), mortgage recordation tax (11.5 cents per $100 of principal indebtedness), occupational tax ($400 on certain occupations), $2,500 tax per player per regular season game in the state ($7,500 per year cap on certain professional sports team players) on all National Basketball Association (NBA) and National Hockey League (NHL) players on a team roster for more than 10 days. $15 marriage license fee, plus a $62.50 marriage license fee for couples not completing a premarital preparation course.
Sales and Use Tax	67-6-201, 67-6-202, 67-6-228 67-6-206, 67-6-216, 67-6-217, 67-6-219, 67-6-221, 67-6-226, 67-6-227, 67-6-202, 67-6-702	7.0% is the general rate that applies to the gross proceeds derived from the retail sale or use of tangible personal property and specific services for merchandise purchased from any vending machine. The sales tax rate for the retail sale of food and food ingredients for human consumption is 5%. Also, rates varying from 1% to 8.25% apply to other items and services including the following: 1.5% for energy fuels used by manufacturers and 1% for water used by manufacturers; 3.5% for manufactured homes; 4.5% for aviation fuel; 3.75% for sales of tangible personal property to common carriers for use totally outside Tennessee; 7.5% for interstate telecommunication services sold to businesses; 8.25% for video programming services (between $15 and $27.50) and satellite TV services. An additional tax of 2.75% is imposed on the amount for single article sales of personal property in excess of $1,600 but less than or equal to $3,200.

Coal Severance Tax	67-7-103 67-7-104	$0.75 per ton of severed coal in the state during FY 2012 and FY 2013, and $1.00 per ton during FY 2014 and thereafter.
Crude Oil and Natural Gas Severance Tax	60-1-301	3% of the sales price of severed oil and natural gas in the state.
Television and Telecommunications Tax	67-6-201	Sales tax is levied on communications by electric or electronic transmission of impulses and includes transmission by or through any media, such as wires, cables, microwaves, radio waves, light waves or any combination of those or similar media. The "television and telecommunications tax" is nothing more than the application of the state sales tax to sales of television programming and telecommunications services. The tax rates are found throughout the sales and use tax statute.
Tobacco Tax	67- 4-1004; 67-4-1005; 67-4-1015; 67-4-1020; 47-25-308; 47-25-309	$0.031 per cigarette or $0.62 per package of 20; $0.0005 per cigarette pack enforcement fee; 6.6% of wholesale price on other tobacco products; license fees of $100 to $200 per location for manufacturing distributors, tobacco manufacturer's warehouses, wholesale dealers and jobbers and tobacco distributors; a $25 fee for replacing a lost or destroyed license; proceeds from the sale of confiscated goods; and penalties of $100 to $5,000 for violations of the Unfair Cigarette Sales Law.
Gasoline Tax	67-3-201; 60-4-102	$0.20 on each gallon of gasoline sold, stored, or distributed in the state.
Motor Fuel Tax	67-3-202; 67-3-1404; 67-3-1309; 67-3-1113; 67-3-1102; 67-3-1106	$0.17 on each gallon of diesel fuel and all fuel other than gasoline, except dyed fuel under IRS rules for motor vehicles, trains, and aircraft; a prepaid annual agricultural diesel tax ranging from $56 to $159, based on registered gross weight; $0.13 on each gallon of compressed natural gas used for motor vehicles on public highways; $0.14 on each gallon of liquefied gas used for motor vehicles on public highways; and an annual vehicle tax on liquefied gas users ranging from $70 to $114, based on registered gross vehicle weight.
Gasoline Inspection Tax (Special Petroleum Products and Export Tax)	67-3-203; 67-3-204; 68-215-110; 67-3-205	$0.01 for each gallon of gasoline and most other volatile fuels sold, used, or stored; an additional $0.004 per gallon for the environmental assurance fee; and an export fee of 1/20 of one cent on fuels subject to the special petroleum products tax.
Motor Vehicle Title Fees	55-6-101	$5.50 certificate of title fee and other fees received for the issuance of motor vehicle titles and noting of liens.
Unauthorized Substance Tax	67-4-2803 67-4-2805 - 2807	Tax on merchants, peddlers, or privileges on various controlled substances or controlled substance analogues upon which the tax has not been paid as evidenced by a stamp available from the Tennessee Department of Revenue. Unauthorized substances include marijuana, cocaine, crack, methamphetamine, etc., as well as untaxed liquors and spirits and "low value street drugs." The tax rate varies by the type and quantity of unauthorized substance or controlled substance analogues.

Insurance Company Premium Tax	56-2-305, 56-4-101, 56-4-216, 56-4-205 through 208, 56-4-218, 56-5-111, 56-6-112, 56-6-121, 56-6-1207, 56-6-1403, 56-13-103, 56-13-114, 56-32-124, 56-51-152, 50-6-115	Life, accident, and health companies are taxed at a rate of 1.75% on gross premiums received; health maintenance organizations and prepaid limited health service organizations are taxed 6% of the gross amount of all dollars collected from an enrollee or on an enrollee's behalf. All other companies, except captive insurance companies, workers' compensation insurance companies, and surplus lines insurance companies, pay a tax rate of 2.5% on gross premiums paid by or for policyholders residing in state or on property located in state. Companies writing fire insurance and lines of business having fire coverage as a part of the risk rate pay a .75% tax on that portion of the premium applicable to fire risk. The minimum aggregate tax on insurance companies is $150. Captive insurance companies are taxed at various rates on premiums collected and reinsurance assumed. The minimum aggregate tax on captive insurance companies is $5,000 and the maximum is $100,000. Cell insurance companies with ten or more cells are subject to a $5,000 minimum tax and maximum tax of $10,000, plus an additional $5,000 for each cell over 10 cells. The premiums charged for surplus lines insurance are subject to a gross premium tax of 5%. Companies writing workers' compensation insurance are taxed 4.0% on gross premiums collected for workers' compensation insurance, plus a surcharge of 0.4% on gross premiums. Other revenues collected include retaliatory fees, captive insurance company certificate of authority and other filing fees, self-service storage and travel insurance supervising entity license fees, rate service advisory organization fees, workers' compensation extraterritorial coverage certifications, and fines and penalties.
Workers' Compensation Tax	50-6-401, 50-6-405, 50-4-206, 56-4-207	4% on gross premiums collected. Up to 50% of the gross premium tax is earmarked for the Second Injury Fund. In addition, a 0.4% surcharge on gross premiums is levied, which is earmarked for administration of the Tennessee Occupational Safety and Health Act.
Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) Gross Receipts Tax	68-11-830(d)(2)	A 5.5% monthly gross receipts tax on revenue generated from ICF/IID certified beds.
Fantasy Sports Tax		Six percent on all adjusted revenues of a fantasy sports contest offered by a fantasy sports operator to Tennessee consumers.

Source: 2017-2018 State of Tennessee Budget Document: Revenue Sources and Basis of Apportionment, https://www.tn.gov/revenue/section/taxes.

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APPENDIX 4
Tax Credits

Class of Tax	**Credit For Tax**	***Tennessee Code Annotated***
Franchise and Excise Tax	Industrial Machinery Credit (Basic)	67-4-2009(3)(A)(i)
Franchise and Excise Tax	Industrial Machinery Credit (Large Capital Investments)	67-4-2009(3)(I)
Franchise and Excise Tax	Job Tax Credit (Basic)	67-4-2109(b)(1)
Franchise and Excise Tax	Job Tax Credit (Additional Annual)	67-4-2109(b)(2)
Franchise and Excise Tax	Brownfield Property Credit	67-4-2009(8)
Franchise and Excise Tax	Green Energy Tax Credit	67-4-2109(m)(3)
Franchise and Excise Tax	Carbon Charge Credit	67-4-2109(m)(4)
Franchise and Excise Tax	Qualified Headquarters Relocation Credit	67-4-2109(g)
Sales and Use Tax	Qualified Headquarters Facility	67-6-224
Sales and Use Tax	Qualified Disaster Restoration Project	67-6-235