REVIEW OF RETAIL SALES

AND

USE TAX COLLECTION AND DISTRIBUTION PROCESSES

NOVEMBER 2011

Auditor of Public Accounts
COMMONWEALTH OF VIRGINIA

Review Summary -- Interim Report

The Commonwealth collects almost $5 billion in retail sales and use taxes annually and distributes approximately $1 billion of these revenues to localities as a one percent local option tax. The Code of Virginia requires the Virginia Department of Taxation (Taxation) to collect all retail sales and use tax revenues in the Commonwealth and determine proper local allocations. For years, Virginia localities have experienced inaccuracies in their local retail sales and use tax distributions, and progressively, Taxation and localities have worked together to improve the accuracy of local distributions.

We performed this review pursuant to Section 30-133.2 of the Code of Virginia, which requires the Auditor of Public Accounts to perform a review of the collection and distribution of the Retail Sales and Use Tax with an important focus on the collection and distribution of local retail sales and use taxes.

This interim report provides background information on the collection and distribution process and discusses current practices employed by Taxation and localities to ensure accurate local distributions. We make the following observations based on this interim phase of our review.

- Retail sales and use tax collection and distribution is an evolving process that requires active participation by Taxation, localities, and taxpayers to ensure accurate distributions. Communication and coordination between the entities is critical to ensure the process is effective in minimizing distribution errors.

- In recent years, Taxation has implemented a number of internal controls and procedures to address and help reduce both business and agency errors in the business registration process, as well as the tax collection and distribution processes. Based on available data, both the number and dollar amount of adjustments required to correct erroneous local distributions has steadily decreased over the last three fiscal years. In fiscal year 2011, adjustments to correct erroneous distributions totaled $8.6 million, which is less than 1 percent of total local distributions of over $1 billion.

- Sales tax distribution errors do not impact all localities equally; therefore, any recommendations for improvements must undergo an evaluation of the cost effectiveness of the change.

We recognize that any recommendations for improvement must consider their potential impact on businesses. Suggested improvements that could result in increased costs for businesses or complicate the business registration process may not be cost effective solutions.

We identified several areas for further evaluation in the next phase of our review, focusing on the business registration process, and communication and coordination of information between Taxation and localities. Our evaluation in the next phase will also include recommendations for benchmarks to assess the effectiveness of Taxation’s local retail sales and use tax collection and distribution process.

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Section 1: Virginia Sales and Use Taxes

Description of Sales and Use Taxes

Virginia levies multiple sales and use taxes on businesses and individuals within the Commonwealth, as well as out-of-state entities engaging in business in the Commonwealth. Taxation collects most of the Commonwealth's sales and use taxes, including the state and local portions of the retail sales and use tax. Virginia's state and local retail sales and use tax encompasses three separate and mutually exclusive taxes: ***retail sales tax, use tax, and consumer's use tax.***

Consumers most frequently encounter ***retail sales tax,*** which the Commonwealth imposes on a dealer (i.e., the seller) for making retail sales in Virginia. Retail sales tax applies to the seller's gross receipts from retail sales of tangible personal property. Both individuals and businesses are subject to retail sales tax when making purchases of tangible personal property; however, only the dealer that sold the property is responsible for collecting the tax and remitting the funds to Taxation.

Retail Sales Tax

Definition: A tax imposed on gross receipts from retail sales of tangible personal property. Retail sales include sales to a consumer or to any person for any purpose other than resale. The tax also applies to the furnishing of transient accommodations and the lease or rental of tangible personal property as part of an established business. Nonprescription drugs and proprietary medicines have exemptions from state sales and use tax.

Collection: The dealer collects the tax from the customer by separately stating the amount of the tax and adding it to the sales price or charge. The tax on accommodations, leases, and rentals uses the lessor's gross proceeds from leases and rentals. The lessor separately states the amount of tax and adds it to the charge made to the lessee, which is the amount collected.

Tax Rate: Generally, the Retail Sales Tax rate is 5 percent. The rate on food purchased for home consumption is 2.5 percent. Effective January 1, 2011, Virginia also imposes a $0.50 fee on each retail purchase of prepaid wireless calling service.

In addition, Virginia imposes a ***use tax***, upon purchasers who use, consume, or store tangible personal property in Virginia, which they purchased outside Virginia or from an out-of-state source. The primary purpose of this tax is to prevent the sales tax from placing Virginia merchants at a competitive disadvantage with out-of-state retailers. An out-of-state dealer is only required to register and collect Virginia's retail sales and use tax if it has nexus, defined as a physical presence, in Virginia. An out-of-state dealer with nexus in Virginia must register with Taxation and pay use tax on items sold to Virginia residents. For example, an internet or catalog retailer headquartered out-of-state has a warehouse in Virginia; this warehouse constitutes nexus, and therefore, the retailer must collect use tax from Virginia customers. Some out-of-state dealers without nexus voluntarily collect the Virginia retail sales and use tax and remit the funds to Taxation.

Use Tax

Definition: A tax imposed on the storage, use, or consumption of tangible personal property within Virginia for items purchased from dealers outside of Virginia. Nonprescription drugs and proprietary medicines have exemptions from the use tax.

Collection: Every entity outside Virginia that engages in business as a dealer and has nexus in Virginia must collect and remit the tax on sales to Virginia customers. Those dealers without nexus that make sales to Virginia customers may voluntarily register, collect, and remit the use tax.

Tax Rate: The Use Tax rate is 5 percent. The rate on food purchased for human consumption is 2.5 percent.

Finally, Virginia imposes the ***consumer's use tax*** on businesses and individuals that make purchases in excess of $100 and do not pay the Virginia retail sales and use tax at the time of purchase. Consumers may make such purchases through out-of-state mail order, telephone, internet, or television shopping services. Furthermore, the consumer's use tax applies to purchases made tax-free outside of Virginia and brought back for use within the Commonwealth. In these instances, the business or individual that made the purchase has responsibility for paying the use tax to Taxation.

If the business or individual does not pay any sales tax on the item purchased, he owes the full five percent sales and use tax to the Commonwealth. Alternatively, if a business or individual purchases tangible personal property out-of-state and pays that state's tax, but the purchaser uses, consumes, or stores the tangible personal property in Virginia, the purchaser can claim a credit for taxes paid in another state. The amount of the credit is equal to the tax paid by the purchaser to another state or political subdivision, but cannot exceed the Virginia rate of five percent. For example, if a business purchases an item outside Virginia and pays retail sales tax of three percent, the business owes consumer's use tax of two percent to the Commonwealth.

Consumer's Use Tax

Definition: A tax applicable to both businesses and individuals, the Consumer's Use Tax applies to the use, consumption, or storage of tangible personal property in Virginia when the purchaser did not pay Virginia sales or use tax at the time of purchase. Exceptions: 1) not applicable for magazine or newspaper subscriptions, and 2) not applicable if the total amount of purchases during the year was from out-of-state mail order catalogs, internet retailers, or cable shopping retailers and totaled $100 or less for the entire year. Nonprescription drugs and proprietary medicines have an exemption from state sales and use tax.

Collection:
- Businesses must file a Consumer's Use Tax return to report the cost price of tangible personal property arising from all taxable transactions on which the dealer did not collect the Virginia sales or use tax.
- Individuals who did not pay the sales tax on a purchase of tangible personal property must file and pay the Consumer's Use Tax. Individuals may elect to have the Consumer's Use Tax deducted from their overpayment on their Individual Income Tax return, they can pay the tax on their income tax returns, or they can file a separate form.

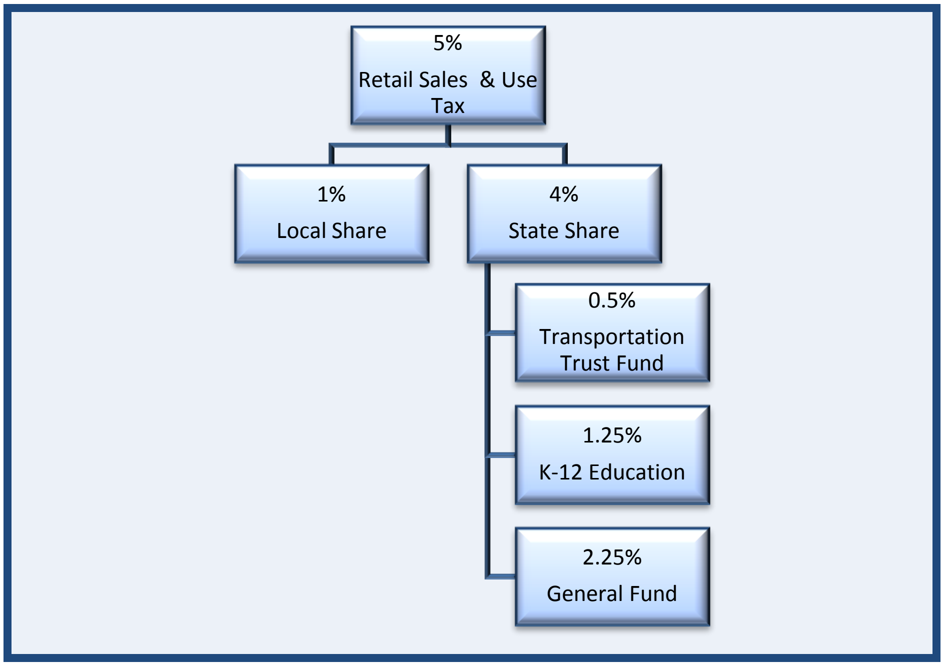
Tax Rate: The Consumer's Use Tax rate is 5 percent. The rate on food purchased for home consumption is 2.5 percent.

Taxation collects additional sales taxes, such as aircraft sales and use tax, motor vehicle wholesale fuel sales tax, and watercraft sales and use tax. Other state agencies also collect additional sales taxes, such the motor vehicle sales and use tax (collected by the Department of Motor Vehicles). These taxes do not, however, include a local portion, and the distribution of these taxes does not fall into the scope of this review, nor are they included in any tables or figures in this report.

How Sales and Use Taxes are Allocated

Virginia imposes the same five percent tax rate for retail sales and use tax and consumer's use tax. The allocation of this tax is set forth in the Code of Virginia. Of the five percent, the Commonwealth retains four percent, and Taxation distributes one percent to the locality where the consumer purchased or used the tangible personal property. The Code of Virginia permits localities to levy this one percent "local option" tax, which all Virginia localities currently impose. The Commonwealth also distributes a portion of the state's four percent share back to localities for public education. There is an allocation of the remaining portion between the Transportation Trust Fund and the General Fund. Figure 1, below, illustrates the distribution of retail sales and use tax, including the state and local portions as well as the additional allocations of the state share. Additionally, Appendix B provides detail of local retail sales and use tax distributions by locality for fiscal year 2011.

Figure 1 - Retail Sales and Use Tax Allocation



Virginia imposes a two and one-half percent tax rate for retail sales of food purchased for home consumption. This includes most staple grocery food items and cold prepared foods packaged for home consumption. Of the two and one-half percent, the Commonwealth retains one and one-half percent, and Taxation distributes one percent to the locality where the consumer purchased or used the food. The Commonwealth also distributes one percent of the state's one and one-half percent share back to localities for public education, while the remaining state portion goes to the Transportation Trust Fund. Figure 2 illustrates the distribution of the food sales tax, including the state and local portions as well as the additional allocations of the state share.

Figure 2 - Food Sales Tax Allocation

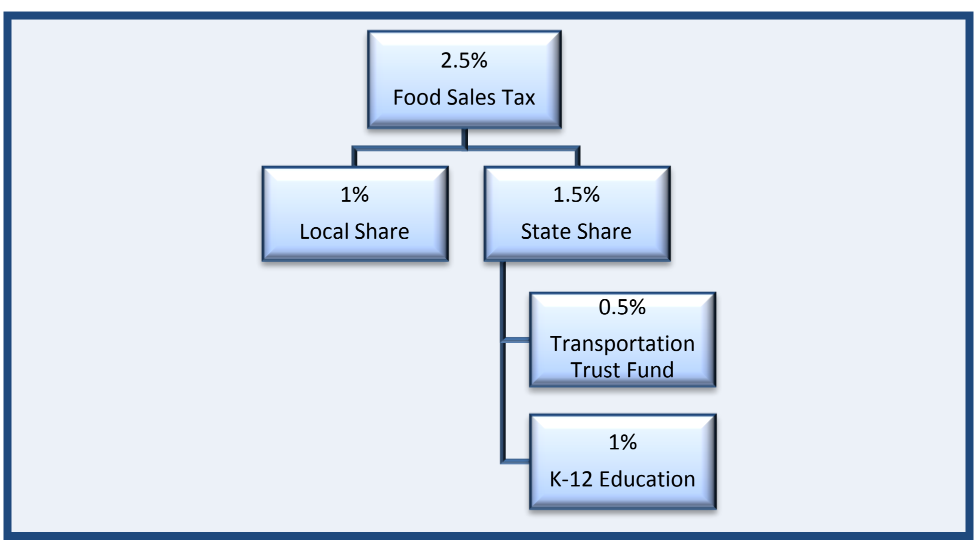


Table 1 shows actual state and local retail sales and use tax collections for fiscal years 2009 - 2011, including detail of collections from state and local revenue sources. The "local option" represents the one percent local tax added to the state's four percent tax. The "K-12 Education" represents a portion of the 2004 one-half percent increase in state sales and use tax, which the Commonwealth collects as local revenues under the Public Education Standards of Quality/Local Real Estate Property Tax Relief Fund.

Table 1 - State and Local Retail Sales and Use Tax Collections

(in millions)

	State		Local		
Fiscal Year	General Fund	Transportation Trust Fund	K-12 Education (2004 Increase)	Local Option	Total State and Local
2011	$ 3,012.4	$ 477.3	$204.0	$ 1,010.2	$ 4,703.9
2010	$ 3,082.5	$ 490.7	$209.4	$ 979.6	$ 4,762.2
2009	$ 2,904.1	$ 499.4	$213.4	$ 1,010.9	$ 4,627.8

Source: Commonwealth Accounting and Reporting System

Virginia also imposes a vending machine sales tax on dealers with vending machines through which they sell tangible personal property. Virginia calculates this tax on the cost price (manufactured cost) of tangible personal property sold through the vending machines. The vending machine sales tax rate is six percent of wholesale purchases, which includes a five percent state share and one percent local share, and its distribution is similar to the proportions as retail sales tax. We have included the vending machine sales tax in the amounts in Table 1. In fiscal year 2011, vending machine sales taxes comprised less than one-tenth of a percent of the Commonwealth's total retail sales and use tax collections.

Statutory Requirements

The Code of Virginia establishes the requirements related to the collection and distribution of sales and use taxes. These requirements are set out in various sections, and we have listed the more significant requirements which are relevant to this review in Appendix A.

Additionally, the Appropriation Act allows Taxation to retain a portion of local retail sales and use taxes collected as a fee for the administrative costs related to the collection and distribution process. On a biennial basis, Taxation estimates the amount of administrative costs necessary to accurately collect and distribute local sales and use taxes, and Taxation withholds these administrative fees from the amount distributed to localities. In fiscal year 2011, Taxation estimated these fees at $6.36 million. At year-end, the State Comptroller transfers the administrative fees from Taxation to the General Fund of the Commonwealth in accordance the Appropriation Act.

Section 2: Sales and Use Tax Collection and Distribution Processes

How Businesses Register

State Level

Virginia requires a new business to register with several state agencies before beginning operations. Every new business in Virginia must register with Taxation for all taxes that may apply to the operation of the business. Depending on the business entity type, a business may also need to register with the State Corporation Commission by filing forms specific to the entity type. A business liable for Virginia unemployment tax also must register with the Virginia Employment Commission.

Taxation's Form R-1, Business Registration Application (Application), allows a business to register for all applicable business taxes, such as sales and use tax, employer withholding tax, and corporate income tax. When a business submits its Application to Taxation and indicates that it will collect sales tax or remit use tax, the business also must provide identifying information regarding each of its business sites. Taxation later uses the information gathered during registration to properly allocate retail sales and use taxes to localities during the collection and distribution processes.

Information Provided to Taxation When a Business Registers

- *Business name*
- *Business locality (FIPS) code*
- *Business physical street address*
- *Tax types the business will collect*
- *Date the business became liable for collecting each tax type*

A business can mail its Application to Taxation, or it can complete the registration process electronically through Taxation's website. As of July 1, 2011, local Commissioners of the Revenue can assist businesses with Taxation's online registration process. Taxation records all information provided by a new business into its Integrated Revenue Management System (IRMS). If a business indicates on its Application that it will collect sales tax or remit use tax, Taxation sends the business a Certificate of Registration for sales tax. This certificate is the business's permit to collect sales tax and to issue and receive exemption certificates.

Taxation also assigns each business a Virginia account number, which the business must include on all of its returns. For businesses that remit sales and use taxes, Taxation uses the Virginia account number along with locality Federal Information Processing Standards (FIPS) codes to determine the appropriate distribution of sales and use taxes to a locality each month. If a business changes localities or adds additional locations in other localities, the business must notify Taxation of these changes to allow Taxation to update its records, or a business can update its registration information through Taxation's online system.

Local Level

At the local level, the business registration process varies depending on the locality. There are differences in what information localities collect as part of the registration process as well as applicable local fees or taxes. A locality can help ensure accurate local retail sales and use tax allocations by using the business information collected during the local registration process to identify erroneous distributions.

Localities that require business licenses also collect information about the business, such as its name, location, Federal Identification Number, Virginia account number, and estimated yearly gross receipts through the initial license application.

Many localities in the Commonwealth impose a Business, Professional, and Occupational License (BPOL) tax, which the locality may base on gross receipts or the Virginia taxable income of the business. Some localities also may charge an annual fee to issue the business license. However, a locality has the option of taxing some classifications of business and not taxing others, and not all localities in the Commonwealth impose the BPOL tax, so in such instances, the locality cannot collect business information through the license application. In some localities, a town may impose the BPOL tax while the county does not, so the entities work together to gather business information.

Many localities that do not impose the BPOL tax require that businesses complete a registration form or file with the Clerk of the Court to notify the locality of existence and provide business information, which enables the locality to properly assess other business taxes. Still, some localities do not impose such requirements and use only a process of discovery to identify any new businesses. This process of discovery may include such resources as information from Taxation, newspapers, radio and television advertisements, vehicle signs, business cards, Profit or Loss from Business schedules (Schedule C), Chamber of Commerce listings of new businesses, and word-of-mouth.

How Businesses and Individuals Remit Sales and Use Taxes to Taxation

Every dealer in the Commonwealth or entity engaging in business within the Commonwealth as a dealer must remit sales and use taxes to Taxation. Additionally, every individual liable for use taxes must remit consumer's use taxes to Taxation. The following sections provide detail on the procedures for businesses and individuals to remit these taxes.

Retail Sales and Use Tax

A Virginia business collects retail sales tax (including food tax) from the consumer when they make a sale, and the business later remits these funds to Taxation. Likewise, when an out-of-state business with nexus in Virginia sells tangible personal property to Virginia residents, the business collects use tax from the consumer and later remits these funds to Taxation.

Taxation places all newly registered accounts on a monthly filing status for their first year of reporting. After that time, if the business's average monthly liability is below $100, Taxation automatically changes the business's filing frequency from monthly to quarterly and notifies the business of this change.

Generally, dealers must file retail sales and use tax return that shows the amount due for general sales and use taxes, qualifying food sales and use taxes, and the local portion. Returns also include information such as any exemptions or penalties and interest due. Monthly filers must remit their retail sales and use tax return on or before the 20th of each month. Quarterly filers must remit their retail sales and use tax return on or before the 20th of the month following the close of each quarterly period. Quarterly periods end March 31, June 30, September 30, and December 31.

A dealer must pay the amount of retail sales and use taxes due, either by check or electronic funds transfer (EFT), when filing the return. If a dealer fails to file or pay the full amount of the tax when due, Taxation adds a penalty of six percent of the tax due for each month or any part of a month that the dealer does not file the return or does not pay the tax. The maximum penalty is 30 percent; the minimum penalty is $10.

Consumer's Use Tax

When a business purchases tangible personal property for use, consumption, or storage in Virginia, but does not pay the Virginia sales or use tax at the time of purchase, the business must pay consumer's use taxes to Taxation. A business that collects retail sales and use taxes can remit consumer's use tax on its monthly retail sales and use tax return. Otherwise, the business remits a separate consumer's use tax return on or before the 20th day of the month following the period in which the use tax liability was incurred.

When individuals purchase goods, other than magazines or newspaper subscriptions, from a business that does not collect the Virginia sales and use tax, they may be liable for consumer's use tax. If the purchases were from sources such as the Internet, mail order catalogs, and cable television shopping channels and exceed $100, an individual must report these purchases and pay consumer's use tax on the total amount of all untaxed purchases from all sources during the calendar year. Individuals also are liable for consumer's use tax when they purchase goods tax-free while outside Virginia.

Individuals file consumer's use tax on an annual basis. If filing based on the calendar year, an individual must file the return as soon as possible after January 1, but not later than May 1. If an individual files on a basis other than a calendar year, he must file the return by the 15th day of the 4th month after the close of his taxable year. When filing a separate return, the individual must pay the tax due at the time he files, either via check or money order. Alternatively, an individual can report this tax as part of his Virginia income tax return, and payment can be made via check, EFT, debit/credit card, or overpayment deduction.

Types of Filers

There are multiple types of retail sales and use tax filers, and the filer type determines how the entity remits taxes to Taxation. Table 2 shows the different types of filers, the various returns that filers use to remit these taxes to Taxation, the filing frequency, the filing methods, and the methods of payment. Below the table, we provide a description of each filer and the accompanying method to remit retail sales and use taxes.

Table 2 - Remitting Retail Sales and Use Taxes

Filer Type	Tax Return	Filing Frequency	Filing Method	Payment Method
Single or Combined	ST-9	Monthly or Quarterly	Paper or Electronic	Check or EFT
Consolidated	ST-9CO	Monthly or Quarterly	Paper or Electronic	Check or EFT
Non-Fixed	ST-9CO	Monthly or Quarterly	Paper or Electronic	Check or EFT
Direct Pay	ST-6	Monthly or Quarterly	Paper	Check
Out-of-State	ST-8	Monthly or Quarterly	Paper or Electronic	Check or EFT
Consumer Use: Business	ST-7	Monthly when Applicable	Paper	Check
Consumer Use: Individual	CU-7; Schedule ADJ with Form 760	Annually when Applicable	Paper or Electronic	Check, Money Order, EFT, or Overpayment Deduction
Vending Machine	VM-2	Monthly or Quarterly	Paper	Check

Single or **Combined Filers** – A business with only one location is a single filer, while a combined location filer has multiple business locations in a single locality. Both types of filers remit retail sales and use taxes using the ST-9, Retail Sales and Use Tax Return. Since these businesses operate in only one locality, the business does not need to allocate its sales taxes to a specific locality on the return because a single locality receives the entire local portion remitted. Taxation collects the locality information when the business registers for its sales and use tax Certificate of Registration.

Consolidated Filers - A consolidated filer has multiple business locations in multiple localities and must complete a Schedule of Local Taxes with its return each month to allocate sales and use taxes to the appropriate localities. Consolidated filers use the ST-9CO package to file retail sales and use tax returns.

Non-Fixed Filers – A non-fixed filer travels from locality to locality to sell tangible personal property (e.g., traveling artists, antique dealers). Non-fixed filers use the ST-9CO package with the Schedule of Local Taxes.

Direct Pay Filers – As explained under *Statutory Requirements*, a business with a direct payment permit can purchase items without paying sales tax, but once the business determines the use of the item and how much of that is subject to tax, the permit holder must report and pay the applicable sales and use tax directly to Taxation themselves. Direct pay filers use the ST-6, Direct Pay Permit Sales and Use Tax Return, which includes a Schedule of Local Taxes.

Out-of-State Filers – A dealer that sells tangible personal property to Virginia residents and businesses from locations outside of Virginia and ships these purchases into Virginia remits use taxes on the ST-8, Out-of-State Dealer's Use Tax Return, which includes a Schedule of Local Taxes.

Consumer Use Business and Individual Filers – As explained under *Descriptions of Sales and Use Taxes*, the consumer is liable for use tax when the retail sales and use tax was not paid at the time of purchase.

> When a business does not collect sales and use taxes but makes purchases that create consumer's use tax liability, the business must report the use tax on a ST-7, Consumer's Use Tax Return for Businesses.
>
> Individuals remit consumer's use taxes to Taxation using the CU-7, Consumer's Use Tax return for Individuals. Alternatively, individuals can report and pay this tax annually when they file their Virginia Income Tax Return.

Vending Machine Filers – A dealer reports sales made through vending machines using the VM-2, Vending Machine Dealer's Sales Tax Return, which includes a Schedule of Local Taxes.

For a single or combined filer, Taxation records the business location, based on FIPS code, in its financial system, IRMS, upon receipt of the business's Application. When Taxation processes the monthly or quarterly sales and use tax return for that business, the business account number on the return matches to the business account number stored in IRMS, and the location information associated with that business in IRMS identifies the appropriate locality for receipt of the local taxes reported by the business. If the business is a consolidated filer, the business's return includes a schedule of local taxes, which indicates the gross sales and taxable local sales attributed to each locality, identified by its FIPS code. Taxation processes this information through IRMS, and IRMS assigns the appropriate amount of local tax to each locality.

Out-of-state dealers that hold certificates of registration and collect use tax must also, to the extent reasonably practicable, use a schedule of local taxes to break down their shipments into Virginia by cities and counties to show the destination locality of the items; however, the Code of Virginia permits an out-of-state dealer that is unable to accurately assign a shipment to a particular city or county to remit the local use tax without making such assignment. In this instance, the dealer may identify the use taxes as "unassigned."

How Taxation Processes and Distributes Retail Sales and Use Taxes

As discussed in the previous section, Taxation processes various types of returns in both paper and electronic formats. Taxation receives paper tax returns through a separate post office box at its tax processing center. Taxation employees open these returns, verify that they include all information necessary to process the return, and research incomplete returns before processing. The employees then prepare the returns for scanning or data entry depending on the type and size of the return. For scanned returns, Taxation's scanning system either electronically captures data from the return using data capture software, or an employee keys data into one of Taxation's systems from a scanned image of the return. For returns that Taxation cannot scan, an employee manually enters data into one of Taxation's systems. System interfaces transfer scanned or manually entered data into IRMS.

Taxation processes electronic returns using its Web Upload and iFile applications. A business uses either Web Upload or iFile based on the type and number of returns it must file. For example, Web Upload allows a taxpayer to file on behalf of multiple companies and to file schedules for multiple locations, whereas iFile enables quick filing for only one company and requires the business to key each location on a separate schedule. Businesses access these applications through Taxation's website. Both the Web Upload and iFile applications interface with IRMS, so they transmit data directly from the application to IRMS.

Information from the businesses' retail sales and use tax returns determines the amount of local sales and use tax distribution to each locality. Taxation calculates the amount to distribute based on the amount of sales and use tax reported by businesses or individuals for each locality. The distribution also includes the locality's proportionate share of use taxes reported for unassigned localities, minus the administration fee retained by Taxation.

Monthly, Taxation distributes the local portion of sales and use taxes based on payments and returns processed between the 6th of the previous month and the 5th of the current month (e.g. January 6th - February 5th). When Taxation receives sales and use tax payments, IRMS initially records all sales and use taxes in the General Fund. Once Taxation processes sales tax payments and returns, IRMS generates an automated entry to move the amount due to localities to a separate fund. After Taxation allocates all of the revenues where businesses appropriately identified the locality for distribution, Taxation allocates unassigned revenues in proportion to a locality's assigned revenues. Additionally, each month Taxation withholds one-twelfth of the administrative fees, per the Appropriation Act, from the amount distributed to localities.

After IRMS runs the distribution batch, it generates a transmittal listing and Commonwealth Accounting and Reporting System (CARS) entry that identifies the amount due to each locality. After Taxation reconciles this information, the Department of Accounts processes electronic payments to the localities based on the entry made to CARS by Taxation.

How Taxation Corrects Distribution Errors

Taxation and localities work together to identify and correct local sales and use tax distribution errors. Localities identify distribution errors using various methods, such as comparing local records to Taxation-provided reports. Taxation provides a Locality Transfer Request Form that localities can use to report errors in local retail sales and use tax distributions. This form standardizes all requests for transfers of sales and use tax distributions and helps to ensure accuracy of future distributions. The requesting locality must provide all available information on the business name, including trade names and the complete physical location. The requesting locality also must list the tax account number or Federal Employer Identification Number (FEIN), the tax period(s) in which the locality believes the business incorrectly reported sales, and the FIPS codes for both the originating and receiving localities. Taxation also asks the locality to identify whether the error is due to a change of address (and to provide the date that the change occurred), or if the error is a correction of the registration record (i.e. the business registered using the wrong locality code).

Taxation and localities work together to identify and correct local sales and use tax distribution errors.

The requesting locality mails the transfer request form to the affected locality via certified mail, and the receiving locality has 60 days from the certified mail date to respond to the notification. The receiving locality fills out a second part of the form to indicate that they agree with the request to transfer funds, do not agree with the request and why, or that they have no response. If the receiving locality does not provide a response to the transfer request, Taxation proceeds with the sales tax transfer from the date of the certified receipt letter. If there is a disagreement between the localities, Taxation recommends that the appropriate officials from each locality meet to resolve the issue. The requesting locality must send a copy of the completed form with a copy of the certified mail receipt to Taxation.

Internally, Taxation also may identify errors in distributions through such means as audits, locality inquiries, or additional information provided by the business. When Taxation identifies an error, the agency's units work together to research and correct distributions. Taxation maintains all supporting documentation for agency- and locality-identified errors both in IRMS and hard-copy format. As allowed by the Code of Virginia, Taxation processes sales tax adjustments up to three years from the date of discovery. All adjustments occur over a six month period, as required by statute, unless noted otherwise.

Section 3: Collection and Distribution Issues and Responsive Actions

Since the inception of retail sales and use taxes, Virginia localities have experienced issues receiving accurate local distributions. Both businesses and Taxation can be responsible for errors in the retail sales and use tax process that result in inaccurate local distributions. In this section, we will analyze distribution errors over the last several years and discuss issues that hinder accurate distributions, as well as procedures that Taxation and localities have implemented to address these issues.

Analysis of Distribution Errors

Distribution errors include any inaccuracy in the amount of local retail sales and use tax that a locality receives. When Taxation identifies or is notified of distribution errors, Taxation records adjustments in IRMS to correct the error and transfer amounts between localities or adjust the distribution to a single locality. As part of our review, we requested information on the number and amount of adjustments over the last three fiscal years and show this information in the table below. While localities and Taxation collectively work to identify misallocations, some errors undoubtedly will go undetected. However, Taxation has lowered both the number and dollar amount of local retail sales and use tax distributions errors over the past three fiscal years as shown below.

Table 3 - Rate of Error for Local Retail Sales and Use Tax Distributions
By Fiscal Year

	2009	2010	2011
Number of Returns	938,780	932,080	924,061
Number of Adjustments	937	643	342
Local Distribution Amount	$ 1,010,847,125	$ 979,588,558	$ 1,010,204,536
Amount of Adjustments	$ 17,705,666	$ 11,663,142	$ 8,655,713
Error Rate (Amount)	1.75%	1.19%	0.86%

Source: Taxation's Integrated Revenue Management System

Although Taxation tracks statistics on the number of adjustments made to local retail sales and use tax distributions, these statistics do not specifically identify the cause of an adjustment. To gain a better understanding of the adjustments that occurred during fiscal year 2011, we reviewed supporting documentation for approximately one third of all adjustments during the fiscal year. This documentation included transfer request forms submitted by localities as well as research and correspondence from Taxation employees to identify and correct inaccurate distributions. We reviewed adjustments initiated by both localities and Taxation.

In most cases, the errors in sales and use tax distributions were due to errors during the business registration and filing processes. In these instances, businesses often registered in the wrong locality, failed to properly register multiple locations in multiple localities, or failed to properly file consolidated returns to indicate the correct allocation of local taxes. Inaccurate registrations occurred primarily in localities with similar names (e.g. Fairfax County, City of Fairfax) and localities that share ZIP codes (e.g. City of Charlottesville and Albemarle County).

Localities initiated the majority of adjustments reviewed in our sample. Furthermore, the same localities often initiated multiple adjustments throughout the fiscal year. These localities may have a greater number of erroneous distributions for reasons such as their locality name, high volume of business activity, or neighboring localities with similar physical addresses; however, these localities also may have greater resources to devote to this function.

Taxation has implemented additional controls in recent fiscal years, so one would anticipate a decrease in the number of adjustments affecting future tax periods.

Most of the Taxation-initiated adjustments were the result of an audit, where Taxation determined that a business had incorrectly registered or was incorrectly allocating its local sales and use taxes. In some instances, an audit resulted in a refund to the business, so Taxation processed adjustments to transfer sales and use tax funds from a locality account in accordance with the audit refund. Additionally, some Taxation-initiated adjustments occurred because businesses paying Use taxes provided additional information to Taxation, which allowed Taxation to properly allocate previously unassigned taxes.

During our review of adjustments, we also noted that approximately 90 percent of the adjustments in our sample affected tax periods prior to fiscal year 2011 even though Taxation processed the adjustment in fiscal year 2011. As we explain later in this section, Taxation has implemented additional controls in recent fiscal years, so one would anticipate a decrease in the number of adjustments affecting future tax periods. Even with these new processes, it could take a few years for Taxation and localities to fully identify and correct distribution errors made in periods prior to the implementation of these controls.

Issues Hindering Accurate Distributions

<u>*Business Registration Errors*</u>

As we discussed above, business registration errors appear to be the primary cause of inaccurate distributions to localities. When a business submits its Application or registers online with Taxation and indicates that it will collect retail sales and use taxes, it may incorrectly identify the locality to receive the local portion of the taxes, which automatically assigns all subsequent payments to the wrong locality. Many Virginia localities have mailing addresses and ZIP codes that cross over multiple jurisdictional boundaries. Additionally, some Virginia localities have similar names, such as Richmond City and Richmond County. A business may unintentionally register under the wrong locality simply because of confusion. This may be especially true for out-of-state businesses that are

Business registration errors appear to be the primary cause of inaccurate distributions to localities.

unfamiliar with Virginia locality boundaries and names.

Another error related to business registration can occur if a business moves to another locality and fails to notify Taxation of the change in address. In this case, Taxation will continue to assign distributions to the original locality. Similarly, if a consolidated filer opens a new store and fails to register the new store with Taxation, even though they collect and remit the tax, the improper registration of the new store, will result in the locality not receiving the proper allocation.

Even if a business has correctly registered with Taxation, a consolidated filer may erroneously report the allocations of local sales and use taxes on its monthly returns. If a business has multiple locations in multiple localities and does not correctly identify the amount of taxes attributable to each locality, localities will receive inaccurate distributions. This includes non-fixed filers who make sales from various locations (e.g. flea markets) and must provide every location in which they conduct business for each filing period. If these filers fail to properly document each location in which sales occur, they may not report each location as required by Taxation.

Unassigned Locality Account

Sometimes distribution errors occur when the business cannot assign use taxes to the correct locality. Every out-of-state business must include a schedule of local taxes with their retail sales and use tax return. This schedule allows the business to indicate the amount of gross sales and taxable local sales attributable to each locality. However, out-of-state dealers that cannot accurately assign a shipment to a particular city or county may remit the local use tax without making such assignment. In this instance, the dealer may identify the use taxes as "unassigned." An out-of-state dealer may be confused because of Virginia's jurisdictional boundaries, similar locality names, or local government structure, in which cities and counties are distinct political entities without any overlapping taxing authority.

> *Taxation distributed approximately $13.6 million in unassigned retail sales and use taxes during fiscal year 2011.*

According to IRMS data, Taxation distributed approximately $13.6 million in unassigned retail sales and use taxes during fiscal year 2011. This amount comprises approximately one percent of all distributed local retail sales and use taxes during the fiscal year. Taxation distributes unassigned tax revenues in proportion to the amount of assigned revenues that each locality receives. Any time a dealer remits tax revenues as unassigned, a locality misses out on its proper allocation of taxes.

Failure to Remit Taxes

When a business or individual does not remit retail sales and use taxes, including consumer's use tax, to Taxation, both the Commonwealth and the localities lose revenue. A business may fail to register with Taxation to collect and remit these taxes, or a business may fall behind in remitting its monthly or quarterly retail sales and use taxes. Businesses also may neglect to properly file consumer's use taxes for items purchased tax-free and used, stored, or consumed in Virginia.

Similarly, individuals who meet the requirements for filing consumer's use tax may neglect to remit these taxes annually. Often, businesses and individuals purchase items tax-free from internet retailers without nexus in Virginia. Unfortunately, federal law does not require these dealers to collect Virginia retail sales and use taxes from the purchaser, so Virginia must rely on the consumer to remit consumer's use tax on these items.

Human Error

Incorrect distributions sometimes occur because of human errors made by Taxation employees while processing the retail sales and use tax returns. When Taxation receives paper retail sales and use tax returns, employees must scan and enter the data into the system that controls the locality distribution process. During the manual capture of data, taxation staff may make mistakes that cause an incorrect distribution.

Although Taxation's systems include programmed prompts, edits, and systematic data processing rules to minimize human error, errors still may occur. During our review of fiscal year 2011 adjustments, our sample of all adjustments did not include any human data entry errors requiring adjustment. Consequently, this lack of adjustments resulting from human data entry errors may be an indication of the infrequency of such errors.

Taxation's Procedures to Ensure Accurate Collections and Distributions

To address some of the issues discussed above, Taxation has implemented a number of procedures and controls to help ensure accurate collection and distribution of these taxes. There are several units within Taxation involved in the error identification and resolution process, including the Registration Unit, the Error Resolution Unit, the Special Taxes and Services Unit, the Finance Unit, and Field Audit. Taxation also regularly communicates with localities to ensure proper distributions.

Taxation's auditors and collectors speak with local finance staff about audit leads and accounts of mutual interest, and Taxation communicates with local Commissioners of the Revenue and Directors of Finance about pending sales tax transfer requests. As needed, Taxation works with the Commissioners of the Revenue Tax Department Liaison Committee to address any local concerns regarding retail sales and use tax distributions, and Taxation's locality liaison provides information to localities on various tax-related subjects. Below, we describe Taxation's key controls and how they prevent or detect distribution errors.

Locality Verification

Taxation's Registration unit reviews new business registrations and changes to registrations to verify that the business identified the correct locality to receive local sales and use tax distributions based on the business's physical address. Taxation's financial system uses Trillium global locator software to identify or verify a business's location using the physical address that the business provides on its registration form. This software can also add the additional four digits to a five digit ZIP code and normalizes addresses to conform to the United States Postal Service.

Effective July 2010, the developer of the Trillium software enhanced the application to include geo-coding, which assigns latitude and longitude coordinates to a location. Using geo-coding allows Taxation to more accurately determine the correct FIPS code for a business. The developer of the Trillium updates the software every 60 to 90 days to incorporate any new data or changes.

Taxation's Registration unit also manually reviews consolidated returns every month to ensure accuracy of location information. The unit reviews a report that compares the consolidated return to the business registration information to confirm that the number of business locations within a locality on the return agrees to the information maintained in Taxation's financial system. The Registration unit follows up on any discrepancies.

Lastly, in January 2011 Taxation implemented a new online service, called FIPS Code Lookup, which allows a business to research the appropriate FIPS code for a specific address. In-state dealers can use this service to identify the proper FIPS code for their business locations, while out-of-state dealers can use the service to identify the appropriate FIPS code associated with the destination locality of items sold. Accurate FIPS codes help ensure that Taxation distributes local retail sales and use taxes to the appropriate locality.

Reports Provided to Localities

Taxation offers eight different reports to help localities identify errors in local retail sales and use tax distributions. Below, we provide a summary of these reports and how they may help a locality identify erroneous registrations and distributions.

> ***Registration Tax Type Activity by Locality Report*** *– This monthly report lists registration activity, such as additions, modifications, and deletions, by tax type. Localities can use this report to review any changes that local businesses made, such as name or FEIN changes.*
>
> ***Updated Business Registration Report*** *– This monthly report displays all active businesses registered within a locality for retail sales, consumer use, vending machine, withholding, corporate income, and communications taxes. Localities can use this report to identify new local businesses, or to verify that businesses registered with the locality also registered with Taxation.*
>
> ***Locality Distribution Detail Information Report*** *– This monthly report provides information on the distribution of the local retail sales, use, and vending tax money to a locality, along with the distribution of unassigned retail sales, use, and vending taxes to the locality. Localities can use this report to monitor the detail of their monthly distribution. Additionally, on a calendar year basis, localities can create their own local reports by combining monthly distribution reports into one spreadsheet and sorting by taxpayer name or account number. Localities can customize their local reports by sorting the combined distribution report by dollar amount and reviewing the negative numbers, which represent money taken away from*

a locality. For any funds taken away in the current report, the locality can verify that it actually received those funds in a prior distribution by checking that tax account for the same tax period. Furthermore, localities can review this report to verify that it receives a distribution from each business every month and identify any significant fluctuations. Finally, a locality can compare the local retail sales and use tax distribution for a specific business to the business license gross receipts reported by that business to the locality to identify any significant discrepancies.

Locality Transfer Report *– This monthly report provides information on the revenue transferred between localities. Taxation may transfer revenue between localities due to an audit adjustment covering several periods, or an adjustment due to incorrect distributions over a period of time. Taxation reports any adjustments to both the "transferred out" locality and the "transferred in" locality. Localities can use this report to ensure the report reflects any expected corrections and appropriately explains any funds moved out of the locality.*

Locality Sales Tax Information Report *– This monthly report also shows a locality's gross receipts for retail sales and vending machine taxes, but the report is not cumulative and only shows data for a specific month. Localities can use this report to compare Taxation's dealer identifying information to the local business license data to verify that all accounts registered with Taxation are in the locality and properly licensed there. Localities that impose a meal tax can use this report to compare the gross food sales amounts, as filed on the sales tax return, to the local monthly meals tax submissions.*

New Sales Tax Dealers Report *– This monthly report displays sales tax dealers that have opened, re-opened, or closed a location in particular locality during the month. Localities can use this report to verify that new businesses registered to that locality with Taxation actually are located in the locality. Similarly, if a locality knows that a new business opened in their locality during that month, they can review this report to verify the business properly registered with Taxation to remit local retail sales and use taxes to that locality.*

Gross Receipts for Localities Report - Cumulative *– This monthly report shows a locality's gross receipts for retail sales and vending machine taxes. This report is cumulative and captures the gross receipts for an entire taxable year. Localities can compare this report to local business license records to determine if the business paid the correct amount of business license (BPOL) tax to the locality.*

North American Industry Classification System (NAICS) Taxable Sales Detail Report *– This report displays detailed information by NAICS code for taxable sales for a specific locality. Localities can use this report to assist in local budget planning and to locate businesses that use an incorrect NAICS code. Taxation runs this report at the request of the locality.*

Taxation also allows localities to access certain reports for other localities within the Commonwealth. Specifically, localities can review the Registration Tax Type Activity by Locality for the Month Report, Updated Business Registration Report, and New Sales Tax Dealers Monthly Report for other localities. This allows a locality to determine whether a new business may have mistakenly registered under the FIPS code for a surrounding locality or a locality with a similar name.

Research Unassigned Taxes

When a business files a return that requires a schedule of local taxes, such as the ST-9CO, but does not provide this schedule with its return, Taxation places the return on a work list for additional research and follow-up. Out-of-state dealer returns with missing or incomplete schedules, including taxes designated as "unassigned," may not go on the work list since the Code of Virginia permits an out-of-state dealer to remit the local use tax without making such assignment. However, Taxation may not waive an in-state dealer's missing or incomplete return from this work list. Additionally, Taxation's Special Taxes and Services (STS) unit reviews local sales taxes allocated to the Unassigned Account and corrects allocations when the correct locality is identifiable. This process helps to ensure that localities receive the proper amount of local retail sales and use tax distribution in accordance with actual activity.

Field Audit

Taxation's Field and Interstate Auditors perform audits to ensure that businesses are compliant with Virginia's tax laws. Field Audit performs business audits with a primary focus on sales and use taxes and corporate income taxes. Taxation has auditors in eight field audit units throughout the Commonwealth and in key locations outside of Virginia since many Virginia businesses have out-of-state corporate headquarters that maintain the businesses' records. In these instances, Taxation locates auditors near these corporate headquarters.

Field Audit selects audit candidates from various sources, such as taxpayer complaints and tips from localities, and audits larger businesses every three years. When Field Audit determines that a business owes retail sales and use taxes, Taxation collects the full five percent tax plus any applicable penalty and interest, and allocates the one percent local portion to the proper locality in accordance with Taxation's regular distribution procedures. Additionally, Field Audit may determine that a business has improperly registered or erroneously allocated sales and use taxes to the wrong locality. In such instances, Field Audit works with other units within Taxation to research and correct any previously inaccurate local distributions.

Although Taxation cannot guarantee that all businesses properly register and remit retail sales and use taxes, the Field Audit section is integral in helping to ensure more accurate and complete retail sales and use tax collections, as Field audits frequently detect distribution errors that Taxation subsequently adjusts.

Verify Receipt of Returns for Top Remitters

Taxation's Error Resolution unit maintains a list of the "Top Remitters," or those dealers that typically remit large amounts of retail sales and use taxes each month. Supervisory personnel in the Error Resolution unit review this list monthly to ensure that Taxation receives and processes these returns prior to local distributions. Since these dealers typically account for a significant portion of retail sales and use taxes each month, this review ensures that localities do not experience large deficits in their monthly distributions.

Pre- and Post-Distribution Reviews

Before Taxation distributes the local retail sales and use taxes each month, the agency's Special Taxes and Services unit and Revenue Accounting unit collectively review the IRMS' Pre-Distribution Report. The units compare the current month's report to the prior year's report for the same month and investigate any variances in excess of 20 percent and $50,000, both positive and negative. Taxation believes this review will detect any significant errors before Taxation distributes the funds to localities.

Additionally, the Revenue Accounting unit performs an annual review of its financial system, IRMS, to ensure that there was a distribution of all entries to the local sales tax account. This review ensures that any money received into the account from taxpayers underwent distribution to localities during the year.

Local Access to IRMS

Taxation provides every locality with inquiry access to the Advantage Revenue (AR) portion of its financial system, IRMS. This access allows localities to review business registration information and local distribution information to ensure accuracy. Localities not only can review prior distributions, but they can also view a current total for the locality's upcoming distribution. Using this information, a locality may be able to identify errors in past distributions or catch errors prior to the next month's distribution.

Localities' Procedures to Ensure Accurate Collections and Distributions

According to the Code of Virginia, a locality's head of finance is responsible for tax collection, including oversight of local retail sales and use tax distributions from the Commonwealth. Depending on the locality's executive structure, a Commissioner of the Revenue or Director of Finance performs this oversight, and these local officials employ varying degrees of procedures to identify and correct erroneous local retail sales and use tax distributions.

The impact of inaccurate local retail sales and use tax distributions varies widely across the Commonwealth. Larger counties adjacent to cities and localities with similar names may experience numerous errors during a year, while smaller localities with few local businesses may encounter few, if any, erroneous distributions. For example, Henrico County borders Richmond City, and the border between the two localities is heavily developed. Until 2009, 16 ZIP codes located entirely within Henrico County carried a Richmond, Virginia mailing address. Consequently, businesses registering for retail sales and use tax accounts often mistakenly used the Richmond City FIPS code to register businesses physically located in Henrico County.

Henrico worked with the United States Postal Services to have these ZIP codes changed, and they now have a Henrico address; however, years before this change, Henrico began to implement procedures to identify errors in local retail sales and use tax distributions. Today, Henrico still experiences erroneous distributions, but the County works diligently to identify and correct any misallocations. The following section outlines some of the procedures that Henrico uses to ensure accurate distributions.

Henrico County Best Practices

Henrico County works to prevent errors beginning with the first stages of business operation. When Henrico issues its businesses licenses to new businesses, the County makes available a Virginia sales and use tax registration packet pre-printed with Henrico's locality code.

Henrico County has an audit function, which includes a sales tax audit program. Henrico's auditors regularly review Taxation's reports discussed earlier as well as the following additional reports:

> ***Top Dealers Report*** – Henrico uses this report to verify that the county's top dealers file consistently. Every two years, Henrico compares a business's gross sales reported to Taxation to the gross receipts reported on the Henrico business license.
>
> ***Unassigned Report*** – Henrico reviews Taxation's list of unassigned taxes to determine whether any of these funds might belong to Henrico based on a Henrico business license.
>
> ***Metro Distribution Report*** – This report shows distributions in the metro Richmond area. Henrico reviews the report for reasonableness and verifies fairly consistent distribution percentages, or verifies justification for inconsistent percentages.
>
> ***Richmond International Raceway Report*** – Henrico reviews this report to ensure taxes due to Henrico from the Richmond Raceway do not go to Martinsville, Virginia, the home of the Martinsville Speedway.
>
> ***New Dealers Reports for Other Localities*** – Henrico reviews new dealer reports for other localities, such as Richmond and Chesterfield, to identify any dealers located in Henrico that incorrectly registered in a neighboring locality.

In addition to these reviews, Henrico performs annual or ongoing reviews of reports for the taxes remitted by certain business types within the County, either because of the large potential retail sales and use tax revenues, or because they are higher risk. Such businesses include shopping malls, leasing companies, hotels, contractors, and businesses in boundary areas. Furthermore, Henrico has field inspectors canvassing the community to verify all businesses file their appropriate tax returns, such as business license and business personal property. During these reviews, the field inspectors check retailers' business registrations to verify that they have registered using the proper locality code.

Henrico also monitors use taxes within the county, specifically businesses like contractors and leasing companies, which typically have large amounts of use taxes. A contractor is generally the "final user" of an item; and has the use taxes liability for their purchases. Consequently, on large construction projects, Henrico expects to see large amounts of use taxes reported by contractors. County officials are aware when these construction projects take place within the locality, and officials use Taxation's reports to verify that the contractors properly report use taxes. Out-of-state companies engaged in leasing must collect use tax on the gross receipts from their lease. Henrico captures this information on its business personal property returns, which, when compared to Taxation's records, allows the County to verify that the leasing company properly reports use taxes.

With regard to use taxes due from out-of-state retailers for items sold to Henrico residents online on through mail-order catalogs, the County elicits cooperation from businesses to verify use tax collections. For retailers willing to cooperate, Henrico runs their customer database through a postal software package to determine accuracy of the retailer's use tax allocations.

When Henrico identifies errors in distributions, including errors in business registration, it submits a Locality Transfer Request form to Taxation. Additionally, the County regularly compares a business's sales reported to Taxation to the county's business license records and notifies Taxation of any large variances.

Survey of Localities

Unfortunately, not all localities can devote staff and resources to this issue. Some localities perform similar procedures to Henrico, but on a smaller scale, while other localities do not have the time or resources available to identify and research errors in local retail sales and use tax distributions.

> *Unfortunately, not all localities can devote staff and resources to identify and research errors in local retail sales and use tax distributions.*

To gain an understanding of the procedures used by other localities in the Commonwealth, we surveyed a sample of 50 Virginia localities, both counties and cities. We judgmentally selected localities to include both larger and smaller localities since we suspected that this would provide a varying degree of local procedures. We requested information from the Commissioner of the Revenue or Director of Finance in each locality, and we received responses from 29 localities, for a 58 percent response rate. We included the survey questions as well as a summary of the responses, below.

Question 1: Does your locality have any processes/resources you use to identify errors in local retail sales and use tax distributions, or to identify businesses that are not remitting retail sales and use taxes (non-paying entities)? If so, please describe.

Of those localities that responded, 83 percent have procedures in place to identify errors in local retail sales and use tax distributions. Localities without such procedures were smaller localities with limited staff. Of the localities with procedures in place to identify erroneous distributions, all incorporate Taxation's reports, such as the New Sales Tax Dealers Monthly Report, into their reviews. Some localities indicated that they have staff dedicated to reviewing reports provided by Taxation and researching and correcting distribution errors. Other localities indicated that they review Taxation's reports, but they can only dedicate minimal resources to this review.

Question 2: What, if any, issues has your locality identified with regard to local retail sales and use tax collections and/or distributions from the Department of Taxation?

Surveyed localities most commonly identified inaccurate business registrations as the cause of erroneous distributions. Approximately 66 percent of surveyed localities responded that they often find inaccuracies in businesses' FIPS code when performing monthly reviews of Taxation's reports. Registration issues included businesses registered under FIPS codes for neighboring localities, failure to register additional FIPS codes when opening new locations in other jurisdictions, and not changing the FIPS code when the entity moves to another locality. This information was consistent with our review of distributions errors where we found that localities identified inaccurate business registrations on their transfer request forms as the cause of most distribution errors.

Other issues identified by localities were less common but equally significant in terms of their impact on a locality's local retail sales and use tax distribution. Some localities identify businesses that aren't paying any retail sales and use taxes or businesses that under report their retail sales and use taxes. Because localities do not have any statutory authority to collect these taxes, the locality provides this information to Taxation. The locality then must rely on Taxation's audit and collection staff to guarantee proper follow-up and collection of these funds. However, even with these procedures, Taxation cannot guarantee payment from a business.

One of the larger localities in our survey noted that, on multiple occasions, data entry errors by Taxation resulted in erroneous distributions that were significantly less than the actual amounts due to the locality. Because this locality performs regular reviews of Taxation's reports and these errors were significant, it was able to identify the mistakes and correct the distributions. However, if a locality does not have the resources to perform these reviews, or if the mistakes are less obvious, a locality could lose revenue as a result of data entry errors. During our review of fiscal year 2011 adjustments, we did not find supporting documentation that indicated any of the adjustments resulted from human keying error. These errors may be infrequent but could have a significant impact on a locality.

Question 3: How does your locality work with the Department of Taxation to ensure non-paying entities are properly charged? Is there any information that your locality regularly provides to the Department of Taxation to ensure accurate local sales and use tax distributions or to ensure that non-paying entities are identified?

Two surveyed localities – both smaller to mid-sized counties – indicated they regularly meet with or provide information to Taxation's field auditors in their localities. The remaining localities stated that they only provide information to Taxation on request or when the locality identifies issues. Thirteen localities had specific employee contacts within Taxation with whom they directly communicate on any questions or issues identified regarding their local retail sales and use tax distribution. Other than the Locality Transfer Request Forms, localities informally provide Taxation with information through telephone or email communication. Overall, localities indicated that they have good working relationships with Taxation to address these issues; however, the lack of a formal reporting process for issues other than transfers sometimes hinders their ability to determine whether Taxation properly addresses issues brought to their attention.

Question 4: What steps does your locality take, both internally and with the Department of Taxation, to correct errors in sales and use tax distributions?

When localities identify errors in local retail sales and use tax distributions, they submit a Locality Transfer Request form to notify Taxation of these errors. Generally, the surveyed localities indicated that they are pleased with this process and that Taxation properly corrects erroneous distributions. Multiple localities indicated they also directly contact the businesses when the locality identifies a registration error. This direct contact ensures that both the business and Taxation are aware of the error and can make the appropriate corrections. In addition to the Locality Transfer Request form, localities indicated they contact Taxation directly via telephone or email with any additional information on errors that do not involve a transfer between localities.

Question 5: Do you have any suggestions on information or assistance from the Department of Taxation to ensure accurate collections and/or distributions of sales and use tax?

Surveyed localities offered various suggestions for ways that Taxation might improve its local retail sales and use tax collection and distribution process. In many cases, these suggestions included ways that Taxation could better aid the localities in their research and error reporting procedures. We discuss some of the most prevalent and critical suggestions below.

Since localities most frequently identify errors in business registration, surveyed localities suggested a more accurate and thorough review process for Taxation's business registration. Early detection of FIPS code errors would prevent unnecessary time and expense to correct these errors at both the local and state levels. Recently, Taxation implemented additional controls during the registration process, including enhanced locality verification procedures. As new businesses register with Taxation under these enhanced controls, Taxation and localities may notice fewer registration errors.

Since many of the surveyed localities use Taxation's monthly reports to identify erroneous distributions, localities offered some suggestions on report changes, such as additional data fields that provide enhanced business information and lessen a locality's research to identify errors. Any changes to reports would be contingent on Taxation's ability to modify current reports and on the information Taxation currently collects and stores from businesses. Requests for additional data that Taxation does not already collect would require a complete revision of the registration and return process and may not be efficient.

Although Taxation standardized the process for requesting transfers, localities often expressed concern for the lack of a standardized process to report discrepancies and track the status of outstanding cases. Sometimes localities identify an issue or discrepancy that may not require a transfer of funds, such as a non-paying entity or an unexplainable variance between monthly distributions. In these instances, the locality contacts Taxation via telephone or email to report and discuss this information. Localities do not, however, have any type of formal method to communicate these issues, nor do they have a formal method to receive or view status updates. Standardizing this process would make it easier for a locality to both report and follow-up on identified discrepancies.

Section 4: Evaluation of Possibilities for Process Improvement

Both Taxation and localities have implemented procedures to reduce or minimize retail sales tax distribution errors as discussed in the previous section. Although the error rates in distributions are relatively low and have been decreasing, some distribution errors continue to occur and the revenue impact for some localities can be significant. We believe there are still opportunities to improve the process and possibly further reduce distribution errors, but any improvements will involve cooperation and coordination between Taxation and the localities.

In evaluating the process and making recommendations for improvement, the Commonwealth must consider the potential impact on businesses. Suggested improvements that would result in increased costs for businesses or complicate the business registration process may not be cost effective solutions and could deter new businesses from locating in the Commonwealth. Additionally, the Commonwealth must stress that sales tax distribution errors will not impact all localities equally and therefore any improvements undergo an evaluation of the cost effectiveness of the change. We have identified the following areas for further evaluation in the next phase of our review.

Improvements to the Business Registration Process

We found that business registration errors and inaccurate business returns constitute the majority of retail sales tax distribution errors. Minimizing these types of errors would prevent unnecessary time and expense spent on correcting the errors at both the local and state levels. We list below areas of consideration in the business registration and filing processes that we will further evaluate in the next phase of our review. As we evaluate these items in the next phase, we will identify areas where Taxation, in coordination with localities, might improve its processes and recommend benchmarks to measure progress.

What actions could Taxation and localities implement to improve the accuracy of information that businesses provide regarding FIPS codes and alternate business locations during the business registration and filing processes? Furthermore, can we correlate errors to specific types of filers, such as consolidated and out-of-state, and identify specific filer needs that Taxation could address to prevent errors during registration and return filing?

How have Taxation's recently-implemented and strengthened controls affected the error rate for the distribution of local retail sales and use taxes? This error rate has steadily decreased over the past three fiscal years, and we expect to see additional reductions in erroneous distributions and accompanying adjustments as a result of recent controls.

Could Taxation analyze distribution error information periodically to identify particular localities or trends, and use that information to provide targeted assistance (e.g. additional training or reports?)

Could Taxation reduce the number of FIPS code errors by requiring all businesses to register electronically? Currently businesses can register either electronically or in paper form.

Would the use of penalties or incentives improve the accuracy of the information collected in the business registration process? Taxation addressed these issues in a 2009 report to the Virginia General Assembly. Taxation evaluated a number of penalty and incentive options to encourage proper registration and local sales tax allocation, but decided not to take any actions because of the unfavorable effects that these penalties and incentives might have on businesses and localities.

Improve Communication and Coordination between Taxation and Localities

Taxation and localities share responsibility for an accurate distribution process, and any improvements to this process will require attention and action by both entities. Inadequate communication between Taxation and the localities can affect how well the process for local retail sales and use tax distributions works. Taxation and localities should work to improve communication to ensure both that Taxation addresses the localities' concerns, but also that the localities' acknowledge Taxation's efforts.

As discussed previously, Taxation offers several different reports that help localities identify errors in local retail sales and use tax distributions. Taxation relies heavily on the localities to review Taxation's reports, compare them to local records, and notify Taxation of any discrepancies. Taxation also provides every locality with access to their financial system to review business registration information and local distribution information for accuracy. While the majority of localities we surveyed indicated they use Taxation's reports at the local level, questions remain about some localities' diligence in reviewing Taxation's information or the timeliness of these reviews. This lack of usage could result from a number of factors including a lack of resources at the locality, ineffective reports, or a lack of training on how to use the information.

Taxation's Internal Audit recently reviewed report usage and found that many localities do not appear to use the information in a timely manner. Internal Audit looked at two reports that they determined most informative for localities, which reflect registration tax type activity and all business registrations in the locality for a month. Internal Audit found that more than half (70 of 135) of all localities had not accessed these reports six weeks after Taxation made them available for review. This finding is somewhat contradictory to the results of our locality survey which indicated that the majority of localities use these reports; however, we did not evaluate timeliness in our survey, which could account for the discrepancy. Furthermore, it is possible some localities use alternate methods of researching discrepancies that do not involve these reports.

Our contact with local Commissioners of the Revenue and Directors of Finance also indicated opportunities for improving communication between localities and Taxation. For example, three localities surveyed, all of which indicated they regularly use Taxation's reports, requested access to an unassigned retail sales and use tax report; however, Taxation indicates it currently provides this report to localities for their use. Localities also suggested Taxation perform specific procedures or implement controls to ensure accurate distributions, yet our review found that Taxation's local retail sales and use tax collection and distribution process already includes such controls and procedures. Based on these miscommunications, it appears there are some opportunities to improve the exchange of information between Taxation and the localities.

As already discussed, both Taxation and localities must work together to ensure accurate local retail sales and use tax collections and distributions. We list below areas related to communication and coordination between the two parties that we identified for further evaluation in the next phase of our review. As we evaluate these items in the next phase, we will identify areas where Taxation might improve its processes and recommend benchmarks to measure progress.

Are there enhancements to Taxation's reports that would improve the effectiveness of the reports so localities would use them more? Are there new reports that Taxation could develop or are there old reports that are not effective?

For localities that do not regularly use the reports, are there reasons why they are not using them? For localities that are using the report, how timely are their reviews?

Has Taxation provided adequate training to localities on how to access the information (reports and IRMS) and how to use and analyze the information? Should Taxation provide this type of training on a periodic basis, especially in the event of turnover at the locality? What are the best ways for Taxation to provide this training?

How does Taxation make localities aware of the agency's continuing efforts to ensure accurate distributions, and does Taxation notify localities when the agency implements additional procedures or controls to further this effort? Are there improvements that Taxation could make in these communications?

Should Taxation formalize the process for reporting non-transfer related issues to include standard employee contacts at Taxation and a way for localities to monitor the status of an issue? Localities often contact Taxation about potential issues or discrepancies other than transfers of funds between localities, but this is a very informal process. Standardizing this process would make it easier for a locality both to report and follow-up on identified discrepancies or issues.

Section 5: Project Background

Reason for this Review

Since the inception of the Commonwealth's retail sales and use tax, Virginia localities have experienced inaccuracies in local retail sales and use tax distributions. Errors made by both the taxpayers and Taxation affect a locality's retail sales and use tax revenues and could have significant impacts on local operations. The Code of Virginia permits localities to impose a one percent local retail sales and use tax; however, statue prohibits localities from directly collecting these funds. Localities rely on taxpayers and Taxation to ensure accuracy in retail sales and use tax registration, processing, and allocation; yet, Taxation is limited in its ability to eliminate all distribution errors.

We performed this review as required by Section 30-133.2 of the Code of Virginia. This Section was modified as a result of Chapter 614 of the 2011 Acts of Assembly, which can be found in Appendix C. Section 30-133.2 of the Code of Virginia requires the Auditor of Public Accounts to perform an annual review of the collection and distribution of retail sales and use taxes with an important focus on the collection and distribution of local retail sales and use taxes. This review will be a multiple year review and must include, but not be limited, to the following.

- A review of the Department of Taxation's policies and procedures for the collection and distribution of the local retail sales and use tax pursuant to Chapter 6 of Title 58.1 of the Code of Virginia.
- A review of procedures employed by local officials to identify entities that have not paid retail sales and use taxes and how the Department of Taxation could coordinate and assist or work with local officials to collect and accurately distribute these collections;
- An evaluation of the audits performed by the Department of Taxation on retail sales and use tax collection and distribution;
- An evaluation of the Department of Taxation's procedures for identifying the proper county or city for distributions of local retail sales and use taxes;
- A review of the Department of Taxation's coordination and work with local officials to determine what information both groups can share and how they coordinate activities to enhance the collections and accuracy of distribution of local retail sales and use taxes; and
- Recommendations to improve and enhance the Department of Taxation's and the local officials' policies and procedures for the collection and distribution of retail sales and use taxes.

Beginning with the Commonwealth's fiscal year ending June 30, 2013, and thereafter, in furtherance of the review, the Auditor of Public Accounts shall recommend annual benchmarks for evaluating the effectiveness of Taxation's local retail sales and use tax collection and distribution process.

Objectives

In accordance with statute, we divided this review into three phases with the following objectives for each phase.

Phase 1 – fiscal year ending June 30, 2011

- Gain an understanding of Taxation's policies and procedures for the collection and distribution of the local retail sales and use tax;
- Evaluate the audits performed by Taxation on retail sales and use tax collection and distribution;
- Evaluate Taxation's procedures for identifying the proper county or city for distributions of local retail sales and use taxes; and
- Gain an understanding of procedures employed by local officials to identify entities that have not paid retail sales and use taxes and how Taxation could coordinate and assist or work with local officials to collect and accurately distribute these collections.

Phase 2 – fiscal year ending June 30, 2012

- Review Taxation's coordination and work with local officials to determine what information both groups can share and how they coordinate activities to enhance the collections and accuracy of distribution of local retail sales and use taxes;
- Provide recommendations to improve and enhance the Department of Taxation's and the local officials' policies and procedures for the collection and distribution of retail sales and use taxes; and
- Determine annual benchmarks for evaluating the effectiveness of the Department of Taxation's local retail sales and use tax collection and distribution process.

Following Phase Two, our annual audit of Taxation will include an evaluation of Taxation's local retail sales and use tax collection and distribution process in relation to these benchmarks.

Scope

Virginia levies multiple sales and use taxes on businesses and individuals within the Commonwealth, as well as out-of-state entities engaging in business within the Commonwealth. Taxation collects most of the Commonwealth's sales and use taxes through three separate and mutually exclusive taxes: sales tax, use tax, and consumer's use tax. Each of these taxes includes a one percent local portion that Taxation distributes to the locality. Our review looks at the collection and distribution of these taxes with an important focus on the collection and distribution of local portions of these taxes.

Methodology

We interviewed Taxation staff and reviewed the agency's policies and procedures to gain an understanding of the registration, collection, processing, and distribution of retail sales and use taxes. We employed similar procedures to gain an understanding of the audit procedures performed by Taxation to include both field audits on taxpayers and internal audits performed to assess effectiveness of the agency's collection and distribution procedures. We reviewed Taxation's 2009 report to the Senate Finance and House Appropriations Committees titled *Incentive and Penalty Options to Encourage the Correct Allocation of the Local Retail Sales and Use Tax*, which outlines potential incentives for taxpayers who accurately report the local retail sales and use tax by locality, as well as penalties for those who erroneously report the tax. We also reviewed the 2011 Internal Audit report on Taxation's Sales Tax Distribution process, which the Internal Audit Department performed to determine the adequacy of key controls and compliance with established policies and procedures.

We met with and surveyed local officials, including local Commissioners of the Revenue, to determine what procedures localities have in place to identify and correct errors in local retail sales and use tax distributions. Additionally, we analyzed financial information from Taxation's systems for overall retail sales and use collections as well as adjustments to local distributions. We also reviewed supporting documentation for a sample of fiscal year 2011 adjustments made to local retail sales and use taxes to gain an understanding of the general causes for the adjustments and to identity any trends.

Summary of Results from Interim Review

This interim report provides background information on the retail sales and use tax collection and distribution process and discusses current practices employed by Taxation and localities to ensure accurate local distributions. We make the following observations based on this interim phase of our review.

- Retail sales and use tax collection and distribution is an evolving process that requires active participation by Taxation, localities, and taxpayers to ensure accurate distributions. Communication and coordination between the entities is critical to ensure the process is effective in minimizing distribution errors.

- In recent years, Taxation has implemented a number of internal controls and procedures to address and help reduce both business and agency errors in the business registration process as well as the tax collection and distribution processes. Based on available data, both the number and dollar amount of adjustments required to correct erroneous local distributions has steadily decreased over the last three fiscal years. In fiscal year 2011, adjustments to correct erroneous distributions totaled $8.6 million, which is less than one percent of total local distributions of over $1 billion.

- Sales tax distribution errors do not impact all localities equally; therefore, any recommendations for improvements must undergo an evaluation of the cost effectiveness of the change.

We recognize that any recommendations for improvement must consider their potential impact on businesses. Suggested improvements that could result in increased costs for businesses or complicate the business registration process may not be cost effective solutions.

We identified several areas for further evaluation in the next phase of our review, focusing on the business registration process, and communication and coordination of information between Taxation and localities.

Commonwealth of Virginia

Auditor of Public Accounts

Walter J. Kucharski
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

November 15, 2011

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission

We have reviewed Taxation's procedures for the collection and distribution of retail sales and use taxes with an important focus on the collection and distribution of local retail sales and use taxes and are pleased to submit our interim report entitled **Review of Retail Sales and Use Tax Collection and Distribution Processes.** We conducted this review 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.

Exit Conference and Report Distribution

We provided a copy of this interim report to Taxation management on November 28, 2011 and they provided a response which we have included in the section titled "Agency Response." We also provided copies of this report to the Commissioners of the Revenue Association and they did not provide a response to this report.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

LCW/clj

Appendix A: Statutory Requirements Governing Retail Sales and Use Taxes

The Code of Virginia establishes the requirements related to the collection and distribution of sales and use taxes. These requirements are set out in various sections, and we have listed the more significant requirements which are relevant to this review below:

Sections 58.1-603 and 58.1-604 of the Code of Virginia provide statutory authority for the Commonwealth to impose retail sales and use tax at a rate of four percent, and Section 58.1-611.1 of the Code of Virginia provides authority for the Commonwealth to impose a tax on food purchased for human consumption at a rate of one and one-half percent.

Sections 58.1-605 and 58.1-606 of the Code of Virginia give cities and counties the option to impose local retail sales and use taxes at a rate of one percent to provide revenue for the general fund of the locality; every city and county in the Commonwealth imposes the optional one percent local retail sales and use tax, often called the "local option." Localities may not directly collect the one percent retail sales and use tax. The Tax Commissioner must collect and distribute any local sales and use tax. Taxation makes distributions of the local sales and use taxes using location of sale or use. Section 58.1-606 of the Code of Virginia also permits an out-of-state dealer that is unable to accurately assign a shipment to a particular city or county to remit the local use tax without making such assignment. In this instance, the dealer may identify the use taxes as "unassigned."

Section 58.1-614 of the Code of Virginia provides statutory authority for the Commonwealth to impose a vending machine sales tax of five percent. This section of the Code of Virginia also requires dealers making sales of tangible personal property through vending machines to report and remit to Taxation the one percent local sales and use tax, for a total tax of 6 percent.

Section 58.1-638 of the Code of Virginia outlines the allocation of the state portion of retail sales and use taxes. Pursuant to this section, all retail sales and use tax revenues generated by the one-half percent sales and use tax increase must go to the Transportation Trust Fund. (This is the .5 percent going to the Transportation Trust Fund as shown in Figure 1.)

> Additionally, one-half of the net revenue from the one-half percent increase in the rate of the state sales and use tax effective August 1, 2004, pursuant to enactments of the 2004 Special Session I of the General Assembly, must be transferred to the Public Education Standards of Quality/Local Real Estate Property Tax Relief Fund. Additionally, this section requires that the Commonwealth distribute one percent of the state sales and use tax revenue among the counties and cities of the Commonwealth on the basis of school age population. (This is the 1.25 percent of the state share going to K -12 Education as shown in Figure 1.) The remaining state portion of the tax goes to the General Fund.

Section 58.1-605 of the Code of Virginia outlines the procedures to correct inaccurate local retail sales and use tax distributions. As required by statute, when Taxation or localities identify errors in distributions, Taxation corrects the error over a six-month period of time, during which Taxation pays one-sixth of the total adjustment each month, in addition to the locality's current monthly distribution. In addition, statute permits localities to recover amounts erroneously not paid and not previously refunded during the three years preceding discovery of the error.

Chapter 6 of Title 58.1 of the Code of Virginia also provides statutory authority for retail sales and use tax exemptions. Some businesses, such as non-profit organizations, can qualify for an exemption from paying retail sales and use tax on purchased items. To qualify for an exemption, the organization must meet specific criteria, apply to the Tax Commissioner, and receive approval in the form of an exemption certificate. Specific exemptions, such as the purchase of non-prescription drugs, apply without the need of an exemption certificate. In many cases, for a dealer to sell, lease, or rent tangible personal property without charging retail sales tax, the dealer must obtain a certificate of exemption from the buyer. A dealer who makes a sale without charging retail sales tax must retain a copy of the exemption certificate on file to substantiate that the sale was tax exempt under the law.

Section 58.1-612 of the Code of Virginia outlines the complete definition of a dealer along with criteria to determine whether a dealer has sufficient activity within the Commonwealth to require registration for collecting Virginia retail sales and use taxes.

Section 58.1-613 of the Code of Virginia requires every person who desires to engage in or conduct business as a dealer in the Commonwealth to file with the Tax Commissioner for a certificate of registration for each place of business in the Commonwealth. Legislation passed during the 2011 General Assembly Session and effective July 1, 2011 modified this section of the Code of Virginia to allow dealers the option to register their business for sales and use taxes with the assistance of the Local Commissioners of the Revenue if the local Commissioner elects to provide these services. The business must be present in the local Commissioner's office, and the Commissioner may guide the business through Taxation's online registration process. We discuss the registration process in more detail under the Section 2 of this report.

Section 58.1-624 of the Code of Virginia outlines the criteria surrounding direct payment permits. Instead of paying taxes to a dealer, a direct payment permit holder pays sales and use taxes due on purchases of tangible personal property directly to the Tax Commissioner. The Tax Commissioner can issue direct payment permits to a manufacturer, mine operator, or public service corporation because it is often difficult at the time of purchase for the entity to determine how it will use the property and whether there will be a tax due on that purchase. The Tax Commissioner must receive and approve an application from a business before issuing a direct payment permit. The permit is valid until the holder surrenders or the Tax Commissioner cancels the permit. A business with a direct payment permit can purchase items without paying sales tax, but once it determines the use of the item and how much of that is subject to tax, the permit holder must report and pay the applicable sales and use tax directly to Taxation themselves.

Appendix B: Local Retail Sales and Use Tax Distributions by Locality Fiscal Year 2011

County	Share of State Tax	Local Option	Total Amount
Accomack	$ 5,002,264	$ 3,595,027	$ 8,597,291
Albemarle	11,783,380	12,716,282	24,499,661
Alleghany	2,255,449	806,257	3,061,706
Amelia	1,372,065	600,330	1,972,395
Amherst	4,204,131	2,179,495	6,383,626
Appomattox	1,706,355	1,015,862	2,722,217
Arlington	15,475,335	36,783,488	52,258,824
Augusta	9,515,177	4,469,900	13,985,077
Bath	518,216	685,988	1,204,204
Bedford	7,653,088	4,243,246	11,896,335
Bland	677,977	238,534	916,511
Botetourt	4,456,526	2,064,672	6,521,198
Brunswick	1,852,690	676,310	2,529,001
Buchanan	2,571,615	1,592,246	4,163,861
Buckingham	1,705,012	984,420	2,689,432
Campbell	7,236,233	3,983,000	11,219,233
Caroline	3,904,747	1,577,305	5,482,051
Carroll	2,951,551	1,638,351	4,589,902
Charles City	706,170	501,378	1,207,549
Charlotte	1,551,293	574,779	2,126,071
Chesterfield	43,555,007	39,889,313	83,444,321
Clarke	1,671,449	862,358	2,533,807
Craig	618,906	144,401	763,307
Culpeper	6,042,053	5,815,324	11,857,377
Cumberland	1,264,663	361,063	1,625,726
Dickenson	1,817,113	795,453	2,612,567
Dinwiddie	3,875,211	1,175,439	5,050,649
Essex	1,206,263	1,708,725	2,914,987
Fairfax	136,827,903	157,013,166	293,841,069
Fauquier	10,359,627	6,752,973	17,112,601
Floyd	1,656,010	680,617	2,336,627
Fluvanna	2,766,282	1,063,998	3,830,280
Franklin	6,362,918	3,981,668	10,344,586
Frederick	10,895,297	9,663,616	20,558,913
Giles	2,093,674	1,425,624	3,519,299

County	Share of State Tax	Local Option	Total Amount
Gloucester	$ 5,086,172	$ 3,518,365	$ 8,604,538
Goochland	2,303,780	1,697,114	4,000,895
Grayson	1,778,180	403,047	2,181,227
Greene	2,444,746	1,386,955	3,831,701
Greensville	1,152,561	406,441	1,559,002
Halifax	4,866,669	3,107,177	7,973,846
Hanover	15,192,733	16,241,345	31,434,078
Henrico	40,055,705	57,288,935	97,344,639
Henry	6,372,987	3,816,374	10,189,361
Highland	245,683	98,011	343,694
Isle of Wight	5,094,899	2,193,044	7,287,943
James City	8,176,675	8,809,725	16,986,400
King and Queen	765,913	172,306	938,219
King George	3,216,029	1,337,155	4,553,184
King William	2,321,233	989,349	3,310,582
Lancaster	1,161,959	1,678,958	2,840,917
Lee	2,993,169	1,346,375	4,339,545
Loudoun	47,877,280	58,818,238	106,695,519
Louisa	3,967,845	2,658,671	6,626,516
Lunenburg	1,390,860	451,311	1,842,172
Madison	1,637,886	764,820	2,402,706
Mathews	1,055,899	412,630	1,468,529
Mecklenburg	3,531,523	3,517,231	7,048,754
Middlesex	1,028,377	848,635	1,877,012
Montgomery	9,209,751	10,077,227	19,286,978
Nelson	1,794,962	970,841	2,765,803
New Kent	2,339,357	970,701	3,310,058
Northampton	1,511,017	1,164,964	2,675,980
Northumberland	1,222,373	651,495	1,873,868
Nottoway	1,915,789	1,250,408	3,166,197
Orange	3,930,255	2,197,355	6,127,609
Page	2,609,206	1,636,347	4,245,552
Patrick	2,186,980	1,034,088	3,221,068
Pittsylvania	7,559,783	1,920,738	9,480,521
Powhatan	3,660,406	859,942	4,520,348

Appendix B: Continued

County	Share of State Tax	Local Option	Total Amount
Prince Edward	$ 2,402,456	$ 2,857,067	$ 5,259,523
Prince George	4,895,533	1,876,051	6,771,584
Prince William	56,378,847	49,703,631	106,082,478
Pulaski	3,720,149	3,209,037	6,929,186
Rappahannock	843,108	459,864	1,302,972
Richmond	940,442	1,152,398	2,092,840
Roanoke	13,503,831	9,789,448	23,293,280
Rockbridge	2,378,962	2,312,097	4,691,059
Rockingham	10,115,958	5,264,311	15,380,270
Russell	2,860,259	1,970,257	4,830,516
Scott	2,926,714	1,460,984	4,387,698
Shenandoah	4,749,869	3,735,107	8,484,975
Smyth	3,785,261	2,130,590	5,915,852

County	Share of State Tax	Local Option	Total Amount
Southampton	$ 2,268,203	$ 552,548	$ 2,820,751
Spotsylvania	20,204,395	14,384,834	34,589,229
Stafford	20,252,055	10,237,891	30,489,946
Surry	823,642	438,157	1,261,799
Sussex	1,008,911	774,404	1,783,315
Tazewell	4,577,354	5,891,301	10,468,655
Warren	4,667,303	3,625,916	8,293,219
Washington	5,829,934	7,122,312	12,952,246
Westmoreland	1,592,240	889,944	2,482,184
Wise	5,272,113	4,450,051	9,722,164
Wythe	3,403,312	3,550,665	6,953,977
York	10,665,724	9,069,899	19,735,623
Total Counties	**$709,836,868**	**$653,865,688**	**$1,363,702,556**

City	Share of State Tax	Local Option	Total Amount
Alexandria	$ 8,792,896	$ 23,556,294	$ 32,349,190
Bedford	605,481	883,100	1,488,581
Bristol	1,943,982	3,584,232	5,528,214
Buena Vista	711,541	392,187	1,103,727
Charlottesville	3,630,199	8,953,944	12,584,143
Chesapeake	34,308,337	32,112,912	66,421,249
Colonial Heights	2,294,383	6,738,871	9,033,254
Covington	549,766	1,189,620	1,739,386
Danville	5,703,736	7,757,733	13,461,468
Emporia	829,683	1,429,696	2,259,379
Fairfax	2,378,291	9,712,059	12,090,349
Falls Church	1,826,511	3,521,106	5,347,617
Franklin	1,088,120	1,606,848	2,694,968
Fredericksburg	2,290,355	10,317,540	12,607,895
Galax	879,357	1,995,847	2,875,204
Hampton	17,746,224	13,799,753	31,545,977
Harrisonburg	3,764,452	10,815,108	14,579,560
Hopewell	2,671,633	1,953,953	4,625,587
Lexington	386,648	790,560	1,177,208
Lynchburg	7,810,164	13,224,283	21,034,447

City	Share of State Tax	Local Option	Total Amount
Manassas	$ 5,217,069	$ 7,267,574	$ 12,484,643
Manassas Park	1,839,265	1,348,752	3,188,017
Martinsville	2,343,385	1,913,500	4,256,885
Newport News	26,804,269	21,215,614	48,019,883
Norfolk	26,069,906	28,323,599	54,393,505
Norton	645,757	1,883,923	2,529,679
Petersburg	3,454,328	3,692,227	7,146,555
Poquoson	1,793,619	512,185	2,305,804
Portsmouth	12,033,090	6,288,900	18,321,990
Radford	1,033,748	861,311	1,895,058
Richmond	23,367,394	25,838,704	49,206,098
Roanoke	10,540,869	18,242,414	28,783,283
Salem	2,928,728	5,702,252	8,630,980
Staunton	2,311,164	3,367,112	5,678,276
Suffolk	12,598,295	7,517,173	20,115,468
Virginia Beach	62,992,818	51,677,840	114,670,658
Waynesboro	2,587,725	4,448,920	7,036,645
Williamsburg	745,775	3,967,494	4,713,269
Winchester	3,162,328	7,933,708	11,096,036
Total Cities	**$302,681,289**	**$356,338,848**	**$659,020,137**

Source: Commonwealth Accounting and Reporting System

Appendix C: Chapter 614 of the 2011 Acts of Assembly

CHAPTER 614

An Act to amend the Code of Virginia by adding a section numbered 30-133.2, relating to the Auditor of Public Accounts reviewing the distribution of collections of retail sales and use taxes.

[S 1271]

Approved March 25, 2011

Be it enacted by the General Assembly of Virginia:

1. That the Code of Virginia is amended by adding a section numbered 30-133.2 as follows:

§ 30-133.2. Annual review of the collection and distribution of retail sales and use taxes.

As part of the annual audit of the Department of Taxation, the Auditor of Public Accounts shall perform a review of the collection and distribution of the Retail Sales and Use Tax (§ 58.1-600 et seq.), with an important focus being the collection and distribution of local retail sales and use taxes. In addition to all other responsibilities and duties required under law, the Auditor of Public Accounts shall, promptly upon completion of the annual review, issue a report to the Chairmen of the House Committee on Appropriations, the House Committee on Finance, the Senate Committee on Finance, and the Commissioner of the Department of Taxation. All actions or requests for tax information by the office of the Auditor of Public Accounts for the purpose of conducting the review shall be deemed to be performed in the line of duty for purposes of § 58.1-3.

2. That for the Commonwealth's fiscal years ending June 30, 2011, and June 30, 2012, the review to be performed by the Auditor of Public Accounts pursuant to the provisions of this act shall include but shall not be limited to the following:

a. A review of the Department of Taxation's policies and procedures for the collection and distribution of the local retail sales and use tax pursuant to Chapter 6 (§ 58.1-600 et seq.) of Title 58.1 of the Code of Virginia;

b. A review of procedures employed by local officials to identify entities that have not paid retail sales and use taxes and how the Department of Taxation could coordinate and assist or work with local officials to collect and accurately distribute these collections;

c. An evaluation of the audits performed by the Department of Taxation on retail sales and use tax collection and distribution;

d. An evaluation of the Department of Taxation's procedures for identifying the proper county or city for distributions of local retail sales and use taxes;

e. A review of the Department of Taxation's coordination and work with local officials to determine what information both groups can share and how they coordinate activities to enhance the collections and accuracy of distribution of local retail sales and use taxes; and

f. Recommendations to improve and enhance the Department of Taxation’s and the local officials' policies and procedures for the collection and distribution of retail sales and use taxes.

3. That beginning with the Commonwealth's fiscal year ending June 30, 2013, and thereafter, in furtherance of the review required pursuant to the provisions of this act, the Auditor of Public Accounts shall recommend annual benchmarks for evaluating the effectiveness of the Department of Taxation’s local retail sales and use tax collection and distribution process to the Chairmen of the House Committee on Appropriations, the House Committee on Finance, the Senate Committee on Finance, and the Commissioner of the Department of Taxation.

COMMONWEALTH of VIRGINIA

Department of Taxation

December 9, 2011

Mr. Walter J. Kucharski
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, Virginia 23219

Dear Mr. Kucharski:

The Department of Taxation appreciates the opportunity to review the draft of the Interim Review of the Collection and Distribution of the Retail Sales and Use Tax Process. We believe the report is thorough and very well done and provides an accurate description of sales and use taxes, including the process for collection and distribution. We also appreciate the report's acknowledgment that the Department has implemented a number of internal controls and procedures designed to reduce issues in the business registration and collection and distribution processes.

It is my understanding that since this report is an interim report and includes no recommendations, a corrective action plan is not necessary. Should you or your staff have any questions, please contact me at 804-786-3332. Again, thank you for the opportunity to review and comment.

Sincerely,

Craig M. Burns
Tax Commissioner

RESPONSIBLE OFFICIALS

Craig M. Burns
Tax Commissioner