

CITY OF PHILADELPHIA PENNSYLVANIA

OFFICE OF THE CONTROLLER

Promoting honest, efficient, and fully accountable government

TAX DISCOVERY: SALES TAX CROSS-CHECKING

**REVIEW OF PHILADELPHIA'S
SALES TAX EVADERS**

DECEMBER 2010



City Controller
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Tax Discovery: Sales Tax Cross-Checking

Reviewing potential businesses evading sales tax

EXECUTIVE SUMMARY

December 2010

Why the Controller's Office Conducted the Review

Under the current fiscal year 2011, the City of Philadelphia is relying on \$242 million in sales tax revenues to help balance the budget and fund essential services. The City's eight percent sales tax is collected by the state, which keeps six percent, and then the remaining two percent is remitted back to the City.

As part of the City Controller's on-going efforts to generate new revenues for the City, the Controller's Office conducted a tax discovery initiative to review businesses operating within the City of Philadelphia but not collecting the required state sales tax, resulting in the City not receiving maximum revenues possible.

What the Controller's Office Found

- After reviewing a sample of 100 Philadelphia businesses not licensed for a sales tax but most likely required to collect the state's sales tax, almost 80 percent were in operation but did not submit any sales tax to the state.
- Of the total entities found to be in business, 57 had City tax filings in either fiscal years 2009 or 2010 and the other 20 were observed to be in operation through on-site inspections.
- On-site purchases at eight of the sampled businesses revealed two businesses that would provide only hand-written sales receipts when requested by the Controller's investigators; one of these receipts was on a napkin.
- The City is owed an estimated \$2 million from delinquent sales tax filers that are currently on the state's tax records.

What the Controller's Office Recommends

The Controller's Office has made recommendations located at the end of the report for both the Pennsylvania Revenue Department and the Philadelphia Department of Revenue to address these possible sales tax evaders.

Background:

The Commonwealth of Pennsylvania imposes a six percent sales tax on the retail sale, consumption, rental or use of tangible property within the state. Every person and business involved with making tax sales must be licensed with the Pennsylvania Department of Revenue and must report and remit these taxes within a specific time period. In 1992, the City of Philadelphia implemented, with state approval, a one percent sales tax putting the City’s rate at seven percent. Then, in October 2009, again with legislative approval, the City increased the rate to its current eight percent.

The state collects the entire tax rate for all businesses and as the case in Philadelphia, it keeps its six percent share and remits the two percent back to the City’s coffers. The City relies on these revenues to balance its budget and fund essential services. In the current FY2011 budget, Philadelphia is relying on \$242 million in sales tax revenues and any amount less results in the City having to make up for the shortfall. When businesses evade paying their fair share of sales taxes or become delinquent, the City must either cut or eliminate services, or raise other taxes; either option penalizes all Philadelphians.

Almost 1,000 Philadelphia businesses owed the state \$13 million in delinquent sales taxes, according to its December 2010 sales tax lien list. Of this total amount, it is estimated that the City is owed almost \$2 million if the previous one percent sales tax rate is applied, due to many of these businesses delinquent under the City’s previous lower rate. The top 10 delinquent Philadelphia businesses and amounts owed the state include the following:

1. Lees Industries Inc.	\$3,115,770
2. LS Services Inc.	\$1,224,831
3. Philly Car Share Inc.	\$258,287
4. Cary’s Oyster House LLC	\$249,189
5. Abbe’s Place Inc.	\$214,842
6. Philadelphia Hilton Inn	\$201,854
7. University Collision Center Inc.	\$201,809
8. Craig Drake Mfg. Inc.	\$187,279
9. Northeast Fence & Iron Works	\$146,425
10. Patidar Incorporated	\$144,576

These entities have sales tax liens and are subject to public record.

Along with the sales tax delinquents that are on the state’s records, the Controller’s Office knows there is a growing problem with the City’s underground economy of businesses that, along with evading other taxes and licenses, are operating without a required sales tax license. While it is necessary to collect the monies owed that the state and city already know about, it is just as important to uncover those entities trying to evade the tax system and to put them on the tax record books.

Why this Report Was Conducted

As part of the City Controller’s on-going efforts to generate new revenues and savings for the City, the Controller’s Office conducted a tax discovery initiative to review businesses

operating within the City of Philadelphia but not collecting and submitting the required state sales tax, resulting in the City not receiving its two percent portion of the tax.

To increase revenue collections for the cash-strapped City, it implemented a one percent sales tax increase in 1992 with state legislative approval. Then, in October 2009, again with legislative approval, the City increased the rate to the current eight percent. All businesses must submit the full tax amount to the state, and the state then remits the City's two percent share back to Philadelphia's coffers.

Conducting a "sales tax cross-checking" of Philadelphia businesses in operation in FY10 that did not submit a sales tax with the Pennsylvania Department of Revenue allows the Controller's Office to provide the state, along with the City, a list of businesses that could be evading the sales tax.

Implementing the Sales Tax Cross-Checking

Generating the List

The Controller's Office obtained a list containing businesses within Philadelphia that submitted a sales tax in FY2010. The Controller's Office then generated its own list of 144,014 businesses registered with the City of Philadelphia in the same fiscal year by reviewing Business Privilege License filings.

The Controller's list contained all businesses, including those that are not required to collect a sales tax because business records do not indicate whether or not a business is subject to submitting a sales tax to the state.

Businesses Subject to Sales Tax

To identify which of the 144,014 businesses that would be required to collect a sales tax, the Controller's Office sorted these businesses into categories by their respective Standard Industry Code (SIC), which categorizes a specific type of business. This allowed the Controller to exclude businesses, such as law firms, real estate, healthcare organizations, etc, which would not be subject to a sales tax.

The Controller's Office then took the largest and most likely business categories that should be collecting a sales tax and submitting it to the state. The following business categories became the focus on the Controller's review: grocery, auto-repair, bar/restaurant and retail. A random sample of 25 businesses was selected from each of the categories below:

- 2,445 = grocery
- 1,597 = auto-repair
- 6,040 = bar/restaurant
- 2,073 = retail

The Controller's staff cross matched the sampled businesses it generated against the list that it obtained to ensure that the randomly selected businesses were not included on both lists.

Businesses “Conducting Business”

To ensure that the businesses sampled under the Controller’s review were currently in operation or operating in FY10 and could be generating sales that should be submitted to the state, the Controller’s staff researched FY2010 City tax filings for all 100 businesses.

For those businesses that did not file any taxes with the City, the Controller’s Office conducted on-site observations to determine if these businesses were in operation. Also, the Controller’s Fraud & Special Investigations unit made purchases at selected groceries and restaurants included in the sample to determine if a business was charging for sales tax for taxable items.

Findings

After reviewing the 100 sampled businesses not licensed for a sales tax but most likely to collect the state’s sales tax, the Controller’s Office found that almost 80 percent were in operation but did not submit any sales tax in FY10. Of the total found to be in business, 57 had City tax filings in either fiscal years 2009 or 2010, and the other 20 were observed to be in operation through on-site visits.

The Controller’s Office cannot release the identity of possible tax evaders because under Pennsylvania and local law, almost all tax information is confidential except for official purposes. However, once the state determines that these businesses in fact owe for sales tax and the actual amounts owed, it will take further action to assess the tax accounts and collect the owed monies. This could also result in the state to file a lien on the individual and/or business, which at that time the information will become a public document.

The following table represents the results from the Controllers City tax filing research and on-site observations:

Category	Filed FY10 City Taxes	Observed to be in Business	Total Found to be Business	Total Not in Business	% in Business
Auto Repair (25)	11	7	18	7	72%
Restaurant (25)	15	4	19	6	76%
Retail (25)	19	0	19	6	76%
Grocery (25)	12	9	21	4	84%
Total	57	20	77	33	77%

The Controller’s Office compiled the businesses found to be in operation and selected 10 to conduct purchase inspections to determine if these businesses were charging for sales tax for taxable items. Of these 10, one indicated that it did not serve food, only alcohol and another business was found to be recently put up for sale. The inspected businesses were not informed of the Controller’s initiative.

The Controller’s Fraud & Special Investigations unit purchased items such as bottled soft drinks and dish detergent soap as well as prepared food such as noodles and hot soup, all

of which are taxable items in Pennsylvania, according the Department of Revenue’s Retailers Information Guide. Receipts were requested from each business for each sale.

To determine if a business was applying the appropriate sales tax to the purchase, the Controller’s Office relied on the receipts provided at the point of sale. Seven of the eight businesses provided some form of a receipt. Of these seven, five provided a “normal” receipt printed through a cash register, and two provided hand-written receipts because it was the only form they would provide when the Controller’s staff requested it. One of these receipts was hand-written on a napkin.

Only two of the seven receipts indicated that a sales tax was included in the purchase. The other receipts, both printed and hand-written, contained only the item and its purchase price. A café restaurant provided a receipt for a bottled soft drink and registered into their system as “1 Misc. Non Tax”.

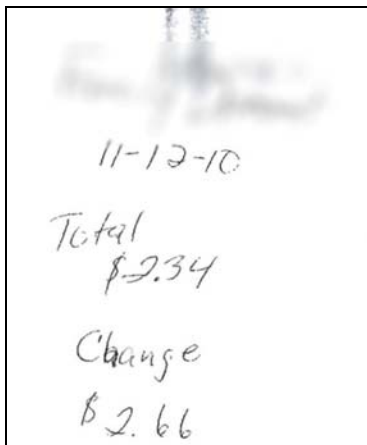
One corner grocery store refused to provide any form of a sales receipt for the purchases made by the Controller’s staff. Below are images of some of the receipts that were provided by businesses inspected by the Controller’s Fraud & Special Investigations unit:



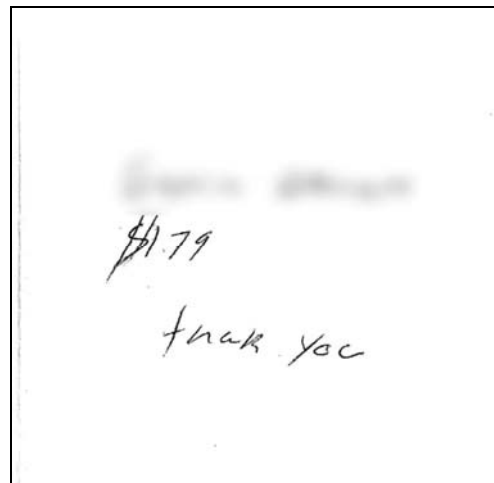
This receipt shows the appropriate sales tax included in the purchase



The taxable item purchased was entered into the business’ cash register as “Non Tax”



This hand-written receipt was written on a small piece of paper



This receipt was hand-written on a napkin.

Recommendations:

After conducting the sales tax cross-checking review of Philadelphia's businesses, the Controller has made the following recommendations:

State Revenue Department

- coordinate efforts with the City's Revenue Department to review businesses that are not in compliance with the state's required sales tax and take necessary steps to enforce actions.
- establish a state-wide sales tax cross-checking initiative that every county must comply annually to reduce non-filers.
- pursue enforcement to collect owed monies as well as file liens against entities from the controller's report that are found to be not compliant with the state's sales tax law.
- apply all fees and fines and any other legal action against entities found to be violating the state law.

City Revenue Department

- conduct an annual cross-checking of businesses operating in Philadelphia to the list of businesses that file for sales tax with the state.
- review the businesses included in the Controller's sales tax cross-checking report for city taxes that may not be filed.