MICHIGAN

OFFICE OF THE AUDITOR GENERAL

FOLLOW-UP REPORT
ON

SEVERANCE AND MOTOR CARRIER FUEL TAX COLLECTIONS

DEPARTMENT OF TREASURY

October 2011

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

271-0220-07F

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

October 6, 2011

Mr. Andy Dillon
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Dillon:

This is our report on our follow-up of the material condition (Finding 1) and corresponding recommendation reported in the performance audit of Severance and Motor Carrier Fuel Tax Collections, Department of Treasury. That audit report was issued and distributed in June 2008. Additional copies are available on request or at <http://www.audgen.michigan.gov>.

Our follow-up disclosed that the Department had partially complied with the recommendation. However, a material condition still exists.

If you have any questions, please call me or Scott M. Strong, C.P.A., C.I.A., Deputy Auditor General.

Michigan Auditor General

AUDITOR GENERAL

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INTRODUCTION

This report contains the results of our follow-up of the material condition and corresponding recommendation and the agency's preliminary response as reported in our performance audit of the Severance and Motor Carrier Fuel Tax Collections, Department of Treasury (271-0220-07), which was issued and distributed in June 2008. That audit report included 1 material condition (Finding 1) and 1 other reportable condition.

PURPOSE OF FOLLOW-UP

The purpose of this follow-up was to determine whether the Department of Treasury has taken appropriate corrective measures in response to the material condition and corresponding recommendation.

BACKGROUND

The Severance Tax Act (Sections 205.301 - 205.317 of the *Michigan Compiled Laws*) requires each producer or a pipeline company, common carrier, or purchaser for and on behalf of a producer to submit a monthly tax return and remit the severance tax due. Companies or individuals who submit the severance tax compute the tax by applying the applicable tax rate to the gross cash market value of oil and gas produced from Michigan wells. The tax rates of 6.6% for oil, 5.0% for gas, and 4.0% for oil from marginal and stripper wells have not varied since the audit was issued in June 2008. The Department of Treasury collects a separate privilege fee, not to exceed 1.0% (for calendar year 2010, the privilege fee was 0.29%) of the gross cash market value of oil and gas produced, to cover the costs incurred by the Department of Environmental Quality for monitoring oil and gas production in Michigan.

The Department of Treasury collected the following amount of severance taxes and privilege fees (unaudited) for the fiscal years ended September 30:

	2008*	2009	2010
Severance tax revenues	$100,398,000	$57,599,000	$58,138,000
Oil and gas privilege fee	13,932,000	6,005,000	3,257,000
Total	$114,330,000	$63,604,000	$61,395,000

* The elevated level of fiscal year 2007-08 revenues was caused by higher production and per unit pricing of natural gas.

Note: This unaudited information was obtained from the Department of Treasury's severance tax, oil, and gas monthly reports.

The Department reported that there were approximately 111 severance taxpayers as of August 15, 2011, up from the 103 that was reported for the fiscal year ended September 30, 2007.

SCOPE

Our fieldwork was performed in July and August 2011. To determine the status of compliance with our audit recommendation, we interviewed agency staff from the Department. We tested 50 tax returns to determine if information from the returns was accurately entered into the Department's Severance Tax Processing System, if crude oil and natural gas per unit of measure values reported by taxpayers were reasonable, and if severance tax amounts were correctly calculated. We reviewed the monthly reconciliation process to ensure compliance with severance tax collection requirements.

FOLLOW-UP RESULTS

EFFECTIVENESS OF EFFORTS TO DETECT UNDERPAYMENT OR NONPAYMENT OF TAXES

RECOMMENDATION AND RESPONSE AS REPORTED IN JUNE 2008:

1. Severance Tax

RECOMMENDATION

We recommend that the Department develop a comprehensive tax administration process to help ensure taxpayer compliance with applicable severance tax statutes.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation and informed us that it is in the process of implementing a more comprehensive tax administration process that should be in place for the second quarter of fiscal year 2008-09. The Department informed us that it believes the data captured on the revised Severance Tax Return and processed in the replacement Severance Tax Processing System will meet the objectives conveyed by the Office of the Auditor General to the Department.

Further, the Department informed us that it had made revisions to the 2008 Severance Tax Returns and Schedules to collect Office of Geological Survey well permit numbers and purchaser(s) and share percentage on the production schedule(s) completed by taxpayers. The Department indicated that this information will be maintained in the replacement Severance Tax Processing System.

The Department informed us that it will also review the Severance Tax Act, which dates back to 1929, to determine whether statutory amendments would increase the Department's ability to detect underpayment or nonpayment of severance tax.

FOLLOW-UP CONCLUSION

We concluded that the Department had partially complied with this recommendation. We noted that the Department had made improvements to its tax administration process; however, it had not fully addressed the condition cited in our 2008 audit. A material condition still exists.

Specifically, our follow-up disclosed that in February 2009, the Department completed its implementation of the new Severance Tax Processing System database. Improvements in the database reduced the risk of clerical errors and increased the quality of compiled information. However, the Department had not implemented critical components of a comprehensive tax administration process that would help the Department ensure that the appropriate amount of severance tax was collected.

The Department indicated that the Severance Tax Act provides for a number of different taxpayers to pay tax on the severed gas and oil and allows certain persons to pay the tax on behalf of other taxpayers. Also, the Act does not require consistency in how, or at what point, companies should measure the gas and oil that was produced. Therefore, the Department informed us that it believes that amendments to the Act to address these concerns would enhance the Department's ability to detect underpayment or nonpayment of severance tax. However, the Department has not yet pursued these amendments.

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