

**UNIVERSITY OF CALIFORNIA, DAVIS  
INTERNAL AUDIT SERVICES**

**Sales, Use and Unrelated Business Income Tax  
Internal Audit Services Project # 14-18**

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### Management Summary

Sales tax is collected on items sold to any consumer. While a variety of exceptions for the application of sales tax exist, the most important exemption related to any form of health care is that prescription drugs, and items inserted into the body, are tax exempt. In applying sales tax, the consumer is charged tax by the UC Davis Health System (UCDHS) as the seller and is then required to be remitted back to the State Board of Equalization (BOE). At the request of the UC Davis Health System Controller, Chief Financial Officer, and Chief Executive Officer, Internal Audit Services (IAS) included a review of internal controls over the collection and remittance of sales, use and unrelated business income tax (UBIT) in our FY 2014 Audit Plan. This request was triggered by a failure to properly remit sales tax to the Board of Equalization. Specifically, for all of 2012, Food and Nutrition Services (FNS) failed to remit over \$180,000 resulting in UC Davis paying over \$30,000 in penalties.

In addition to examining sales tax, unrelated business income tax (UBIT) was also included in the scope of this audit. UBIT consists of regularly occurring trade or business activities that are unrelated to the exempt purpose of UCDHS. UC Davis's exempt purpose of education and providing medical care makes this tax inapplicable to the vast majority of UCDHS activities.

In order to determine the accuracy of the collected and reported tax for UCDHS, while keeping the amount of data at a manageable level, only the last three years were reviewed. Within those three years, data was gathered from the Sacramento County sales tax account (1155110) to determine which departments engage in sales. This was supplemented by interviews with various UCDHS employees to determine who participates in taxable sales based on the items sold in each department. This approach helped widen the scope of departments examined in the audit and led to the identification of several departments failing to report sales tax. For a full summary of all the departments examined see Appendix A below.

Several instances of errors in the collection and remittance of sales tax were identified. Specifically, Dermatology, Optics, Facial Plastics, and Otolaryngology all failed to properly collect and remit sales tax for all of their sales. Pharmacy was also found to be inconsistent in recording and remitting the tax it collected. The most critical findings are the insufficient oversight of the sales tax process and that department's lack awareness of the resources available to them to determine the taxability of specific items.

For UBIT, it was determined that the annual UCOP survey required of each UC campus has consistently been filed. This means that no findings related to UBIT were found.

Our detailed observations, recommendations and corresponding management actions can be found within the body of this report.

**Observations****A. Sales tax failed to be consistently collected and remitted to the Board of Equalization**

The *University of California Sales & Use Tax Manual* requires that tax be collected on all taxable sales and then remitted to the state as required by law. It was found that sales tax was not always being collected and remitted as required. This resulted in UC Davis owing the Board of Equalization back taxes plus penalties for the tax that was not collected and remitted. The exact amount owed has not yet been determined.

During the review of various UCDHS departments (See *Appendix A* for a complete list), Dermatology, Optics, Facial Plastics, Otolaryngology and Pharmacy were all found to not be properly handling sales tax. While all these departments were properly collecting tax on some items and excluding prescription items, collection and remittance mistakes were still being made. With the exception of Pharmacy, all of these departments were not properly collecting sales tax on all of their products. Both Dermatology and Facial Plastics offer a variety of cosmetic products for sale that are non-prescription and available for anyone to purchase. All of these are taxable products according to *Board of Equalization Publication 27*, and therefore should have been taxed. Similarly, Optics failed to collect sales tax on non-prescription plano sunglasses as required by *Sales and Use Tax Regulation 1592* and Otolaryngology did not tax hearing aid accessories as dictated by *Regulation 1506, Annotation 360.0006*. All of these products should have been taxed and ultimately remitted to the Board of Equalization.

Pharmacy engages in prescription and non-prescription sales. While all of their non-prescription items are taxed correctly, the collected tax was not consistently documented, resulting in the failure of some tax to be remitted. During the investigation of this issue, the Assistant Chief Pharmacist adjusted department policy and re-coached his staff on how to record sales tax to ensure it is always properly recorded.

The primary causes of these sales tax problems are the insufficient oversight and monitoring over the collection and remittance process, and the lack of adequate guidance to departments on how to locate existing information on collecting and remitting sales tax. Simply identifying the departments engaging in taxable sales was difficult and many departments are unclear why certain products are taxed and others are not.

### Recommendations

1. To ensure that taxes are always properly collected and remitted in the future, a more effective oversight process to ensure sales tax is properly collected and remitted for existing as well as new products needs to be developed.
2. The resources from UCOP, the BOE and Accounting and Financial Services regarding the applicability of sales tax needs to be more clearly communicated to the appropriate departments. This is especially true for the UCOP and BOE resources that provide instruction on what items are taxable and what items are exempt.
3. Taxes that were not properly collected need to be determined and appropriately remitted.

### Management Corrective Actions

1. The Health System Controller will work with the Campus Controller and Director of Tax Reporting and Compliance to:
  - a. Develop an oversight procedure for identifying departments that generate taxable sales.
  - b. Develop further oversight procedures within the departments generating taxable sales to ensure sales tax is properly collected and remitted. This will include a process for vetting all new products to determine if they should be subject to sales tax.

These actions will be implemented by 1/15/2015.

2. The Health System Controller will work with the Campus Controller and Director of Tax Reporting and Compliance to develop a process for clearly communicating to departments all relevant regulations regarding sales tax collection and remittance. This communication process will include training and making appropriate reference materials available. These actions will be implemented by 1/15/2015.
3. The Health System Controller will help facilitate repayment of back taxes by ensuring that each department owing back taxes is in communication with Accounting and Financial Services to determine the exact amount owed. Additionally, the Health System Legal Affairs office will be consulted to determine how far back each department needs to go to calculate back taxes. This will be implemented by 1/15/2015.

#### **B. No Unrelated Business Income Tax issues found**

*Policy BFB-A-61* addresses the unrelated business income tax (UBIT) requirements for the University of California. It requires that each campus files a Nonfinancial Questionnaire on UBIT with the Office of the President annually. The UCDHS and the main Davis campus had no new taxable unrelated business activity in the past several years.

## APPENDIX A

## Departments Reviewed for Sales Tax Collection and Remittance Compliance

Department	Collection or Remittance Issue	Explanation
Dermatology	Collection and Remittance	Dermatology sells non-prescription cosmetics and skin care products to anyone who wishes to purchase them. These items are subject to sales tax and therefore need to be collected and remitted to the Board of Equalization.
Facial Plastics	Collection and Remittance	Plastic Surgery sells non-prescription cosmetics and skin care products to anyone who wishes to purchase them. These items are subject to sales tax and therefore need to be collected and remitted to the Board of Equalization.
Pharmacy	Remittance	Pharmacy has properly collected sales tax on all its taxable sales. However, the collected tax has been inconsistently recorded, resulting in some tax not being properly remitted to the state.
Gift shop	None	All taxable items were charged sales tax and remitted to the state.
Bookstore	None	All taxable items were charged sales tax and remitted to the state.
Med Illustration	None	Med Illustration appears to be reported correctly, but no one in the department or accounting claims to be recording the sales tax. Since the tax is properly being accounting this issue was not pursued.
Otolaryngology	Collection and Remittance	Otolaryngology has correctly not collected sales tax on the sale of hearing aids. However, they have failed to collect and remit sales tax on hearing aid accessory sales as required by the Board of Equalization.

<b>Department</b>	<b>Collection or Remittance Issue</b>	<b>Explanation</b>
Internal Medicine	None	No taxable sales.
Food & Nutrition Services	None	Failed remittance in 2012 triggered this audit of sales tax. At the time the audit was conducted, all problems had been resolved and tax was being properly collected and remitted.
OBGYN	None	No taxable sales.
Pain Management	None	No taxable sales.
Optics	Collection and Remittance	Most of the department sales were taxed and remitted properly. However, non-prescription plano sunglasses sales were not taxed and should have been. Only when the sale is accompanied by a prescription can plano sunglasses be tax exempt.
PCNs	None	No taxable sales.