



Wicomico County, Maryland

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Consultation Report – Income Tax Revenue

The County Council and County Executive of Wicomico County, Maryland:

The Office of the Internal Auditor (IA), per Council direction, has undertaken a limited consultation study for County income tax revenue. A report is submitted herewith. The purpose of the study was to gain a high-level understanding of income tax revenue as it relates to Wicomico County.

Scope and Objectives

The objectives and scope of the consultation were to

1. Gain a high-level understanding of how Wicomico County receives income tax revenue
2. Review trend analysis for employment
3. Review regression analysis from the Finance Department for income tax revenue estimation

Income Tax Payments

The following points appear in a recent Government Finance Officers Association (GFOA) presentation:¹

State law requires local income tax collection and distribution by the Maryland Comptroller no less than quarterly. The Comptroller accomplishes the task through a series of projected quarterly distributions of withholding and estimated taxes. Withholding and estimated tax payments are, in and of themselves, an estimate requiring reconciling distributions from the Comptroller after tax returns have been filed. Maryland collects income taxes on a calendar-year basis and recognizes the revenue on a fiscal-year basis:

- Maryland fiscal year is July 1 to June 30
- Wicomico County fiscal year is July 1 to June 30
- Income taxes are estimated and withheld on a calendar-year basis
- Income tax reporting and reconciliation (tax returns) for the calendar year are due April 15 of the following year
- Reconciliation (tax returns) create adjustments (refunds and balances due)
- Extended tax returns are due October 15 of the following year – although tax payments are due April 15, extended tax returns create adjustments

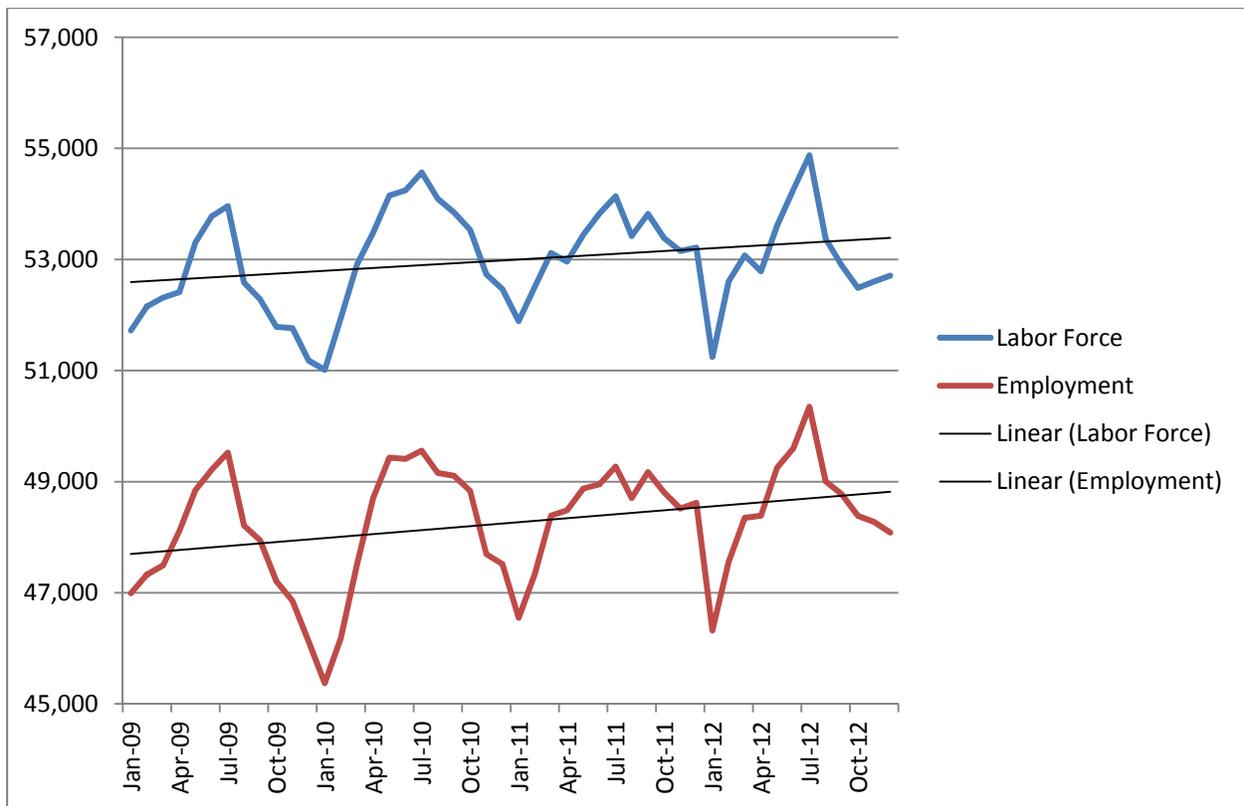
¹ Freyman, George and Wacks, Raymond. *It's All About November: How the Local Income Tax Distribution Works* [PDF document version of PowerPoint slides] (June 1, 2012). Supplied by the Wicomico County Finance Director

In addition, County resident workers employed in adjacent Maryland Counties, pay Wicomico County income tax. Conversely, Wicomico County workers who live in adjacent Maryland Counties pay County income tax to their Counties of residence².

Because of the way it is collected and received, revenue from a calendar tax year is recognized over three fiscal years. Government must use a modified accrual basis of revenue recognition³. That means that revenue must be earned, measurable, and available.⁴ It becomes apparent that the process of collection and distribution of County income tax requires constant estimation and adjustment.

Employment Trend Analysis

IA gathered employment data for Wicomico County from January 2009 through December 2012.⁵ Graphical representation including trend lines follows:



² Source: *Maryland 2012 State & Local Tax Forms & Instructions*, p11

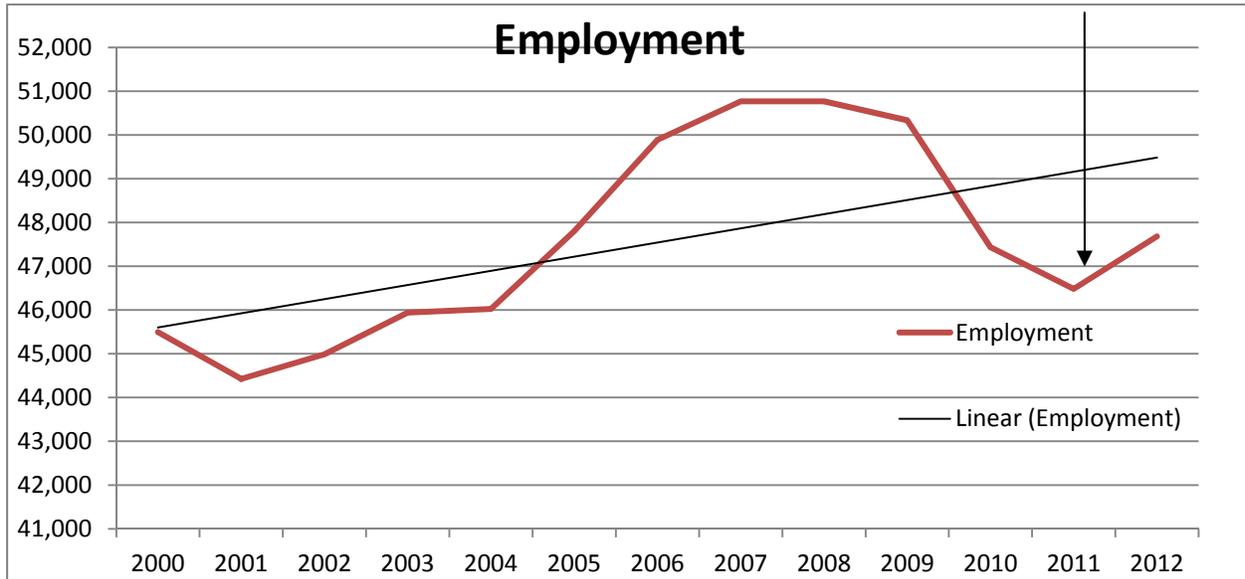
³ Gauthier, Stephen (2012) *Governmental Accounting, Auditing, and Financial Reporting (Blue Book) 75th ed.* (p124) Chicago, IL: GFOA of the US and Canada

⁴ "Available" is further defined as collectable within the current period or soon enough thereafter to be used to pay liabilities in the current period

⁵ Maryland Department of Labor, Licensing, and Regulation. (2013) *Civilian Labor Force, Employment, & Unemployment by Place of Residence – Wicomico County* [Data file] Available from <http://www.dllr.state.md.us/lmi/laus/wicomico.shtml>

A larger picture of trending (annually) from 2000 to 2012 follows:

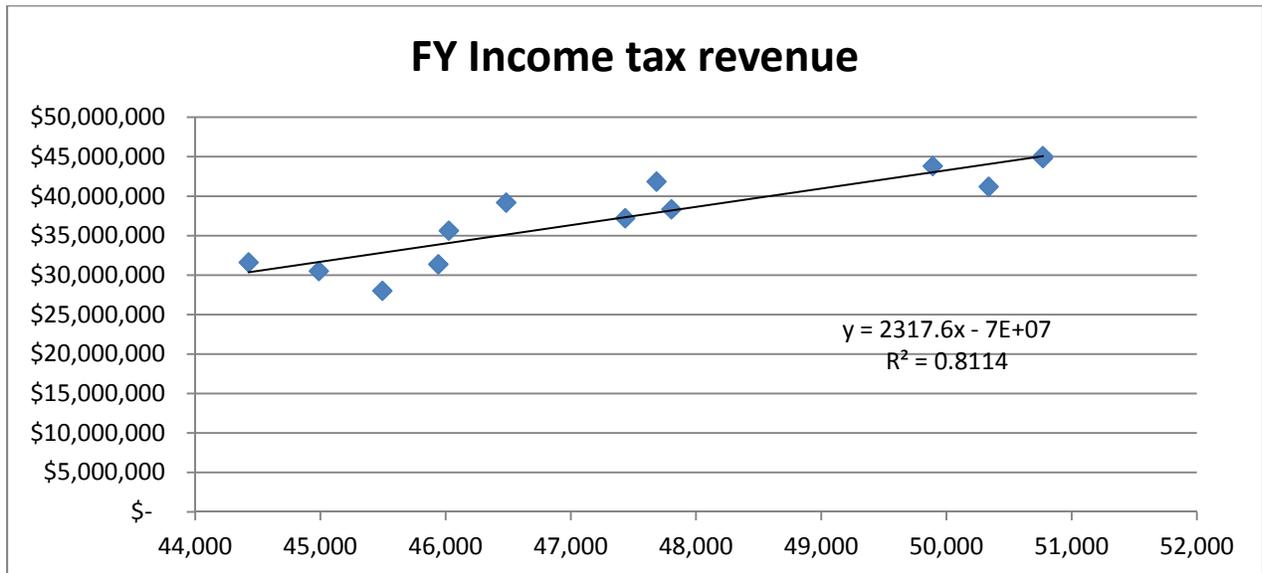
Employment level at
FY2012 forecast date



IA draws no conclusions from the data other than the fact that both employment and labor force seem to be trending positively over the period.

Regression Analysis

IA reviewed working papers supplied by the Finance Director used to perform the regression analysis for revenue estimation. The model provided by Finance follows (please note that the horizontal axis represents employment and the vertical axis represents income tax revenue):



The coefficient of determination (R^2) indicates the relationship between the employment and tax revenue in the model is 81% (a strong statistical relationship). Additionally, in an email to IA, the Finance Director states:

Forecasting future income tax revenue is challenging. Our methodology is sound. It is based on a single variable linear regression of fiscal year distributions to the 12-month average of the number of county citizens employed during the calendar tax year in which the fiscal year begins. The annual change in employment accounts for 80% of the variation in income tax distributed (R^2). In terms of modeling and forecasting, this is an extremely high number. The remaining 20% of "unexplained" variation is related to a myriad of factors such as characteristics of the income tax laws e.g. capital gains and deductions, taxpayer behavior such as filing dates, and the State distribution process. For fiscal year 2012, the actual revenue exceeded budget by \$7,469,360. This large variance was driven by two factors; most significantly, employment grew at a rate much greater than had been anticipated, with all the employment growth occurring outside the county. The second factor was a change in the State distribution formula caused by the statewide recovery... Underestimating income tax revenue by a large amount in a steady-state economy would be a reason to review the estimating process; however, the economy was in free-fall from 2007 through 2010. Hindsight is 20/20, but when we were estimating employment for CY2011 (the FY12 estimate) there were no clear economic signals pointing towards a rapid recovery in employment. Overestimating County income tax revenue would create the potential for a serious budget crisis, the scope of which would not be known until very late in the fiscal year. This is a scenario that must always be avoided.

IA again offers no conclusion in the matter except to say that we cannot judge future projections with complete certainty until they become historical facts. We reviewed the methodology and input for this analysis and cannot find fault with the calculations.

Respectfully Submitted,

J, Stephen Roser, CPA/CIA